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COSTS AND BENEFITS OF ELIMINATING INSTITUTIONAL CONSTRAINTS ON THE EXPANSION OF NONTRADITIONAL EXPORTS

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A PROTOTYPE METHODOLOGY

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Table of Contents

INTRODUCTION 1
- Statement of the Problem 1
- Methodological Approach 6
- Organization 8

LEGAL, REGULATORY, AND JUDICIAL ENVIRONMENT 9
- General Legal System and its Implementation 9
  - Separation of powers 9
  - Property rights 11
  - Contracts 14
  - Torts 15
- Business Regulation 16
  - Corporate law 16
  - Commercial law 18
  - Finance regulation 20
  - Regulation of competition 22
  - Environmental regulation 23
  - Labor law 24
  - Intellectual property ownership 27
- Foreign Investment 29
- Business Regulation Pertaining to Public/Private Sector Interface 33
  - Taxation 33
  - International trade 34
  - Legal infrastructure underlying business regulation 39
- Private Institutions That Reduce Transaction Costs 40
  - Banks 40
  - Securities markets 42
  - Service companies 42

COSTS ASSOCIATED WITH INSTITUTIONAL CONSTRAINTS 43
- Identification of Potential Export Industries 43
- Verification of the Potential Profitability of Exports 43
  - Domestic resource cost 43
  - Nominal and effective protection 45
  - Effective subsidy coefficient 45
  - Integrated Model for Policy Analysis Computer Template 46
- Identification of Current Export Constraints and Their Effects 46
  - Infrastructure 47
  - Information 47
  - Institutions 48
- Effects of Institutional Constraints on Comparative Costs and Incentives 50
- Estimation of Costs and Incentive Distortions 52
  - Compliance with laws and regulations without avoidance 52
  - Compliance with laws and regulations with avoidance 54
  - Influence over discretionary government decisions 54
  - Evasion of laws and regulations 55
  - Recourse to the informal sector 55
- Prioritization 56

APPLICATION OF METHODOLOGY TO CASE STUDY COUNTRIES 57

INTRODUCTION

Through programs of structural adjustment, many developing countries have removed the major policy distortions hampering economic growth and development. As a result, attention has increasingly been focused on the remaining barriers to growth, such as infrastructural inadequacies, lack of information on markets and technology, and institutional constraints concerning the role of the public sector and how it relates to private economic agents. This paper outlines a methodology to focus on the last of these barriers. The methodology proposed is an extension of the Effective Protection/Domestic Resource Cost methodology, which has been used by Associates for International Resources and Development (AIRD) in a number of African countries to measure policy distortions in relation to comparative advantage.

Statement of the Problem

A number of countries in sub-Saharan Africa have undertaken major policy reforms over the past decade These have often comprised some combination of (1) devaluation, (2) movement towards a more flexible exchange rate, (3) reduction or elimination of export taxes, (4) easing or elimination of import controls, (5) reduction in the magnitude and variability of import tariffs, (6) privatization or reform of government parastatals, (7) elimination of price controls and restrictions on private marketing, and (8) reduction of public sector employment. The reforms have been designed to alter the structure of incentives in the direction of opening the economy to international trade and increasing the relative importance of the private sector. The ultimate goal has been to increase economic growth.

Most of the countries that have undertaken major reforms are moving away from highly distorted incentive structures in which goods and services were allocated by administrative decisions rather than by markets responsive to relative prices. Frequently, these economies were characterized by a dual price structure in which prices on the free market were much higher than official prices prevailing in the public distribution network. This gave rise to extensive rent-seeking activities to the detriment of more directly productive economic activity. Institutional structures and business procedures, in consequence, were seriously distorted.

With the advent of reform, opportunities for rent-seeking have diminished and resources are being reallocated towards more productive activities. In the past, these activities have consisted essentially of two types: import-competing production for the domestic market and traditional, primary product, exports. Opportunities for further growth in these sectors, however, are limited. First, expansion of production for the domestic market is limited in most countries by its small size. Second, although there is some scope for increasing traditional primary product exports, and perhaps recapturing markets lost to competitors elsewhere in the world, this avenue of growth is blocked by both demand and supply. On the demand side, world market prospects for many of Africa's traditional exports -- e.g., coffee, cocoa, groundnuts, cotton, oil palm products, copper, bauxite, uranium -- are poor. On the supply

side, population growth is pressing on the land suitable for livestock and cash crops, and mineral deposits and forest reserves are being exhausted.

In the future, African countries will have to rely increasingly on nontraditional exports as the engine of economic growth. A few countries have already begun to diversify their exports away from traditional commodities. Kenya, for example, has witnessed a major expansion of horticultural exports. Mauritius has moved from heavy reliance on sugar towards export of a range of manufactured goods. Madagascar has experienced growth of a number of nontraditional exports from both primary and secondary sectors, e.g., shrimp, butter beans, medicinal plants, meat, leather, cotton cloth, and garments. Nigeria is exporting increasing volumes of manufactured goods to the West African market. Senegal has succeeded in exporting labor-intensive products such as footwear to the European market.

Whether countries in sub-Saharan Africa can and should further expand these types of nontraditional exports depends on a number of factors. First is the pattern of comparative advantage that each country has in the production and export of these products. Second is the infrastructure that exists in transport, telecommunications, energy supply, and other areas essential to competitive export activity. Third, there is a need to invest in mechanisms for acquiring information on market opportunities, production technologies, and a number of other areas through the creation of professional and trade associations, the rehabilitation of agricultural research organizations, the upgrading of training and educational institutions, etc. Finally, there is a requirement to define more carefully the role of the public sector and the institutions that surround it.

Most African countries could profitably expand the range of exportable products that they produce. The Gambia, Guinea, Kenya, Madagascar, Mali, Senegal, and a number of other countries, for example, have the climate conditions suitable for growing a wide variety of horticultural products. Many countries are profitably engaged in the production of primary products, such as cotton and livestock, which could be used as inputs into processing activities. Other countries have the pool of low-wage, semi-skilled labor that would enable them to follow the example of Mauritius in developing labor-intensive manufactured goods for export.

Even more important for the future, Africa's comparative advantage in labor-intensive activities is increasing vis-à-vis Asia's for several reasons. First, rates of population growth are higher, resulting in a rapidly growing labor force. Second, poor economic performance implies that real per capita incomes and wages have been relatively stagnant or even declining in Africa as compared with Asia, where economic growth has been much more pronounced. Finally, in many areas, Africa's population is beginning to press on an extremely fragile resource base. Unless pressure is taken off of these marginal lands through a diversification of employment opportunities, there will be a continuing downward spiral of poverty and resource degradation.

A number of countries that have undertaken major economic reform lack the basic infrastructure to support export-oriented activity. After years of neglect, countries like Ghana, Guinea, Madagascar, and Zaire need to rebuild, expand, and modernize their roads, ports, airports, telecommunications equipment, and power generating facilities. This is especially important for the export trade because of the need for timeliness and flexibility in responding to overseas demand.

Investment in knowledge and other forms of human capital is also essential. The development of horticulture in Kenya depended on investments in research, training, and extension, yet too many countries have allowed their agricultural research and extension capabilities to deteriorate.[1] Countries, such as Mauritius, that have been successful with nontraditional exports have also had to acquire a knowledge of foreign market opportunities, develop linkages with foreign partners, pay close attention to quality control, and develop a pool of competitively priced semi-skilled labor.[2]

Finally, development of an agricultural and industrial sector capable of competing successfully on world markets requires a careful definition of the role of the public sector and how it interacts with private economic agents. Much of this definition is contained within what has often been referred to as the legal, regulatory, and judicial (LRJ) environment. Although that concept extends far beyond the export sector, it is nonetheless crucial to successful export growth.

The legal, regulatory, and judicial environment, linking the public and private sectors, comprises not only laws and regulations but also machinery for the settlement of disputes, an apparatus for the enforcement of judgements, and a minimum degree of consensus among economic agents as to what constitute rules of the game. Of critical importance is a legal system that is sufficiently insulated from the locus of political authority to permit persons not sharing that authority to have confidence that their rights under the law will be upheld if they follow the rules. This is often not the case in many developing countries, which discourages investment by those who are not closely linked through family and other ties with those sharing political authority.

The legal system suited to a market economy rests on three basic foundations: property rights, contracts, and torts (extra-contract liability). Building these three foundations requires a supporting legal infrastructure consisting of a judiciary, independent from other branches of government, and lawyers trained to implement the system.

On top of these foundations rests the full legal system which governs the interaction of the public and private sector. For the purposes of the methodology, the most important part of the system is the body of business law and regulation that deals with such issues as incorporation, bankruptcy, secured transactions, regulation of competition, labor law and

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[1] Nural Islam highlights the importance for exports of market information, quality control, processing and storage facilities, and agricultural research. He also describes how horticultural exports have served as a natural bridge to exports of nontraditional manufactured goods. See Nural Islam, Horticultural Exports of Developing Countries: Past Performances, Future Prospects, and Policy Issues, International Food Policy Research Institute, Research Report No. 80, April 1990.

[2] Foreign firms may play an important catalytic role, here, by providing access to the world market network, the capacity to package exports, and technical, marketing, and management knowhow. World Bank, Industry and Energy Department, and USAID, Bureau for Africa, Building a Competitive Edge in Sub-Saharan Countries; the Catalytic Role of Foreign and Domestic Enterprise Collaboration in Export Activities, December 10, 1991.

environmental regulation. Regulation of business may extend to such areas as licensing and concessions, financial market regulation, price regulation, and intellectual property. Business regulation pertaining primarily to the functioning of private markets may be distinguished from regulation relevant to public sector concerns, including taxation, national security and monetary control.

Ideally, this body of law and regulation serves to reduce transaction costs through streamlining of procedures and increasing predictability of outcomes. It is also possible, however, especially in the developing world, that regulation poses additional barriers to business and trade, whether by intention--to increase equity or meet other social goals--or unintentionally through poor design. The methodology makes no assumptions about the predisposition of law to enhance or constrain economic efficiency and indeed identifies economic efficiency as only one of several criteria by which to measure the efficacy of law. Velenchik refers to this as a central tenet of the law and economics literature, traceable to the Coase theorem: "If there are positive transaction costs, the efficient outcome may not occur under every legal rule. In these circumstances, the preferred legal rule is the rule that minimizes the effects of transaction costs, These effects include the actual incurring of transaction costs and the inefficient choices induced by a desire to avoid transaction costs."[3]

Just as a legal infrastructure is required to support and enhance the functioning of a system of property rights, contracts, and torts, so is an infrastructure required to operate the system of business regulations, whether pertaining to the private or public sector. Such a system requires for its maintenance a cadre of specialized administrative and agency personnel and trained lawyers in order to ensure the legal functioning of government and the compliance of private parties with existing business regulation.

Finally, quite apart from the realm of private business actors, public agents, and the bodies of law that pertain to their interaction, lies a group of private institutions geared toward reducing further the transaction costs of commerce. This institutional group includes all of those services that exist to expedite the interaction of private commercial actors, and ranges from banks to stock exchanges, from insurance companies to trading houses. A distinct structure of laws, rules, and expectations governs this group of private institutional actors, who necessarily overlap with actors in both the private and public sector.

Even though policy reforms in recent years have diminished the relative importance of ministries and other agencies of government, these institutions nevertheless play a vital role in implementing the laws and regulations which govern the private sector. Major issues relate to the capacity of these institutions for effective implementation and the potential that exists for abusive use of discretionary authority. Though laws and regulations designed to achieve social goals, such as those involving conditions of employment, might be quite laudable, the economic

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[3] Polinsky, A. Mitchell, *An Introduction to law and Economics*, (Boston: Little, Brown, and Company, 1983), cited in Valenchik, Ann D. "Preliminary Review of Literature on the Influence of the Legal, Regulatory, and Judicial Environment in LDC's." Department of Economics, Wellesley College. Photocopy. 1991.

distortions that they introduce may easily make society worse off than if the laws and regulations had never existed.

How these various actors and institutions develop, public and private, is the focus of a growing body of literature clearly relevant to the problems facing many developing countries in sub-Saharan Africa and elsewhere. Douglass North has written extensively on the importance of the development in northern Europe of private sector institutions that were conducive to the process of industrialization and the expansion of market exchange. These institutions reduced transactions costs enormously by (1) increasing the mobility of capital, (2) lowering information costs, and (3) spreading risks. This was done through innovations in financial intermediation, accounting, insurance, management, contract enforcement, mercantile law, and other areas. Equally important, limits were established to arbitrary intervention by government in the market place at the same time that the role of the state in enforcing contracts became increasingly important. Both private and public sector institutions thus permitted the emergence of the complex impersonal forms of exchange that were essential to capture the economic benefits of modern technology, in contrast to the personalistic, discretionary style of resource allocation that has continued to characterize less dynamic economies.[4]

A number of studies have examined problems related to the legal, regulatory, and judicial environment in Africa and elsewhere.[5] Although these studies have quite effectively discussed these problems and how they are likely to inhibit private sector initiative, there has been no effort to quantify the harm done or to estimate the cost that it, or its avoidance, entails. As a result, there is little guidance as to the priorities for reform.

The research project of which this paper is the first step proposes to identify and measure the relative importance of the problems associated with the LRJ environment as these constrain nontraditional export growth. The focus is on this sector for several reasons. First, as argued above, it is key to economic growth in most African countries over at least the next two or three decades. Second, the development of nontraditional exports, frequently in cooperation with foreign partners, requires that close attention be paid to the transactions costs associated with property rights, technology transfer, contracts, financing, investment incentives, trade policy, foreign exchange policy, and a host of other areas that can frequently be ignored if production is destined for the domestic market or for traditional export markets. Thus the nontraditional export sector can be seen as key to opening countries up to flows of capital, technology, and institutional innovation, which have proved elsewhere to be vital for economic development.

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[4] See Douglass C. North, "Institutions," Journal of Economic Perspectives, 5(1), Winter 1991.

[5] Samuel Paul, "Assessment of the Private Sector: a Case Study and its Methodological Implications," World Bank Discussion Paper No. 93, Washington:1990; Louis Aucoin, "Current Status of the Legal System and the Rule of Law in Chad and its Effect on the Private Sector," Country Report No. 10, Center for Institutional Reform and the Informal Sector, October 1992; Clive S. Gray, "Reform of the Legal, Regulatory and Judicial Environment -- What Importance for Development Strategy," CAER Discussion Paper No. 10, Harvard Institute for International Development, August 1991.

Methodological Approach

The methodological approach used here is an extension of that used by AIRD over the past twelve years to estimate comparative cost and incentive indicators for a number of African countries.[6] The methodology emphasizes the calculation of domestic resource cost (DRC) as an indicator of comparative costs and of nominal and effective protection/subsidy coefficients (NPC and EPC/ESC) as measures of incentives. These indicators have served in many countries as an important input into decisions related to programs of structural adjustment and policy reform.

The extension of this methodology involves estimating the costs of various institutional constraints associated with the LRJ environment. These costs are categorized according to whether or not they may be interpreted as an implicit tax or subsidy on tradable or nontradable goods and services, or, alternatively, whether they are part of the real economic cost of doing business. As an example, long delays in clearing imported inputs through customs have a cost that can be measured in terms of interest charges and administrative effort. This acts effectively as a nontariff barrier, which can be converted to its equivalent tariff on tradable inputs. Similarly, firms that are unable to obtain financing through the formal banking system may have to borrow from the informal sector at much higher rates of interest. If the reason why bank credit is unavailable is that the government is crowding out the private sector in its demand for credit, then the higher interest charges may be considered as a tax on nontradable capital due to government policy. On the other hand, if the firm is unable to borrow because it is considered a bad credit risk, given the poorly developed capital market, then this represents a quasi-regulatory institutional factor, and the additional charge should be considered as a real cost of doing business.

The distinction between the costs associated with discretionary policies and those that are related to the level of market development is somewhat arbitrary but nevertheless critical. The former may be seen as influencing private profitability, but not economic costs, whereas the latter are part of the total costs that must be considered in deciding whether exports are potentially profitable.

In evaluating the cost of each institutional constraint, the existing LRJ situation must be compared with some base situation that represents feasible normalcy. Initially this will be the situation that exists in the U.S., U.K. or France, depending upon whether the country is English

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[6] For an extensive discussion of the EP/DRC methodology as applied to West Africa, see J. Dirck Stryker, B. Lynn Salinger, and Abdoul Barry, "Comparative Costs and Incentives in Agriculture, with Application to Regional Integration in West Africa," AIRD Discussion Paper No. 4, Associates for International Resources and Development, April 1993. The agricultural sector in Madagascar is analyzed using this methodology in J. Dirck Stryker, Jeffrey C. Metzel, and Ashley S. Timmer, *Regional Specialization and Agricultural Growth in Madagascar*, report prepared for the UNDP and the World Bank, Strengthening of Planning Capacity and Economic Management Project, by Associates for International Resources and Development, December 1992.

or French speaking.[7] Where this base case situation appears to be clearly inefficient, however, that which prevails in one of the NICs, such as Hong Kong or Singapore, may be substituted. Clearly, since many of the characteristics of African nations are unique to Africa, neither a former colonial power nor an example from Asia may offer an appropriate baseline, especially in those developing countries where there is a need to place more emphasis on economic efficiency and less emphasis on other issues. In such cases, the costs will be evaluated in terms of a counterfactual situation in which the institutional constraint does not exist.

Costs to be included in the calculations include direct costs (e.g., fees, bribes, labor compensation), imputed costs (e.g., administrative effort to satisfy requirements, cost of holding excess inventories, cost of maintaining excess capacity, opportunity cost of own capital), and the cost of recourse to the informal sector (e.g., cost of capital, limitations on economies of scale, quality of labor). In addition, to the extent feasible, the risk associated with discretionary government intervention, illegal activities, and other sources of uncertainty will also be assessed.

Once these institutional costs are estimated and categorized, a revised set of comparative cost and incentive indicators can be estimated, inclusive of institutional costs and incentives. To distinguish these unadjusted indicators from those that are adjusted, the latter are called the Full DRC (FDRC) and Full EPC/ESC (FEPC/FESC).

In order to estimate the overall magnitude of costs resulting from each institutional constraint evaluated, a calculation must be made of the difference between the level of exports that actually exists and that which could be achieved if each of these constraints were eliminated. Assuming that world demand is not the primary constraint on exports, this implies arriving at some estimate of the supply function for each product. Once the export gap is calculated for each product, the results may be aggregated and the total loss of exports, and even of GDP, may be estimated for each constraint.[8] The constraints may then be ranked according to their contribution to the loss of exports and of GDP. Finally, some attempt will be made to estimate the cost associated with reducing or eliminating the most important institutional constraints, even if this can only be done qualitatively.

To the extent that the costs associated with institutional constraints can be quantified, many of the calculations discussed here will be relatively crude, especially insofar as they relate to the effects of institutional reform on the allocation of resources. This is less true of the FDRC and FEPC/FESC estimates, which indicate the magnitude of distortions that exists per unit of net foreign exchange earned from exports, even if they do not indicate the total loss associated with these distortions. Furthermore, barring major differences in the supply functions

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[7] While there are significant differences in the legal systems of the UK and the US, these differences are not great when it comes to commercial law.

[8] It is important to recognize that once allowance is made for the reallocation of resources resulting from the elimination of one or more institutional constraints, the partial equilibrium model implicitly assumed here becomes less appropriate because of the general equilibrium effects that take place. This is a common problem for any policy analysis, however, and is in no way unique to the estimation of aggregate losses associated with institutional constraints.

for different products, the ranking of aggregate losses should approximate that of unit losses. The most important exceptions would be agricultural products that are produced in particular, but limited, ecological areas, or products for which small market niches are very important. These products are not likely to be very numerous, however. Where they exist, supply and demand constraints are relatively well known.

Organization

The next section discusses in some detail potential problems related to the LRJ environment that constrain nontraditional exports. This section examines first the general legal system, its principles and organization, focusing on those problems pertaining to separation of powers within the structure of government. This discussion moves on to the three foundations of business law and of the general legal system pertaining to trade: property rights, contracts and torts. The section then examines those problems pursuant to particular areas of business law including not only laws and regulations pertaining exclusively to the private sector but also to the interaction of the private and public sectors, such as regulations concerning taxation and trade, as well as the legal infrastructure supporting business law. Finally, the section examines problems pertaining to the group of institutions explicitly designed to reduce transaction costs and enhance the efficiency of the private sector, including banks, stock exchanges, brokerage and insurance. The discussion is based on existing studies, as well as the experience of the research team. This list of problems will be verified, expanded, and explored in more detail in the case study countries. In each instance, comparison is made with the baseline situation, as described above.

Following this discussion, the methodological approach that is to be applied in the case study countries is described in detail. This approach includes

1. Identification of potential export industries.

2. Verification of actual or potential profitability of exports (calculation of DRC).

3. Identification of export constraints and their effects.

4. Estimation of cost/incentives for each public policy-related institutional constraint.

5. Prioritization of constraints.

This section is then followed by a discussion of the application of the prototype methodology to the country case studies. The last section of the paper draws some conclusions regarding the viability of the prototype methodology and the relative importance of different institutional constraints on the growth of nontraditional exports.

LEGAL, REGULATORY, AND JUDICIAL ENVIRONMENT

General Legal System and its Implementation

As countries attempt to liberalize their economies, policymakers stress economic policy and its effects, often bypassing the structure of rules, institutions, and practices that govern business transactions in the private sector. As Gray has pointed out, however, in the wake of economic structural adjustment it is often the legal, regulatory, and judicial environment that harbors the most egregious barriers to efficiency.[9] With the retention of legal systems designed by the former colonial powers to restrict fluctuations in price, supply, and markets, often in wartime, many developing countries are attempting to enter 21st-century markets with 18th-century codes and regulations.

Douglass North describes how in Western Europe the rules and enforcement mechanisms designed to reduce transaction costs and manage a growing volume of trade emerged from the merchants themselves rather than from regulation by governmental authorities.[10] In northern Europe, the emergence of mercantile law transcended state boundaries, literally and figuratively, in response to the need to establish common rules of the game. Carrying mercantile codes of conduct with the tradable cargo, merchants were responsible for the merging of Pisan laws with sea codes of Marseilles and introduced to northern Europe Italian concepts of insurance and bills of exchange.[11] The state became an integral player in the evolution of trade law, primarily as the protector of property rights and enforcer of contracts as the frequency of impersonal exchange increased. The role of the state as regulator of trade and commerce gave way in the 19th century to government being less concerned with market control and limitation than with establishing the security to ensure market efficiency and predictability.

Separation of powers

Closely associated with this trend was the increasingly distinct separation of legislative, executive, and judicial power. An independent judiciary is crucial to the maintenance of a viable system of property rights, contracts, and torts, and is therefore fundamental to an efficient and transparent legal, regulatory, and judicial system.

Problems of arbitrary exercise of executive power. One common source of prejudicial justice is unbridled executive authority. The potential for direct intervention by a country's executive branch in matters that belong in the realm of due legal process can substantially inhibit

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[9] Gray, Clive S. *Reform of the Legal, Regulatory, and Judicial Environment--What Importance for Development Strategy?* CAER Discussion Paper No. 10. HIID, 1991.

[10] See, for example, North, Douglas C. "Institutions." In *Journal of Economic Perspectives*. Vol. 5, No. 1. Photocopy. 1991. PP. 97-112.

[11] Ibid., p. 107.

the efficient functioning of the private sector. While such intervention may be "legal" by virtue of a nation's constitution and tradition, a harmful imbalance of power can take any one of several forms.

Frequently in countries characterized by political instability, the official legal system (i.e. the system of courts and procedures operated by the national government) is superseded for all practical purposes by a parallel legal system, often exercised through the military. In Chad, the constitutional provisions creating the legislature and the Supreme Court, as embodied in the Constitution of 1989, were suspended along with the rest of the Constitution by Idriss Déby soon after he staged a military coup in December of 1990. Déby enjoys broad legislative powers under the National Charter, which is acting as a temporary constitution. While the new Charter does not explicitly render illegal the legislature and the Supreme Court, these institutions remain effectively nonexistent in the aftermath of the coup.[12]

Legal systems characterized by unbridled executive authority need not be parallel and militarily based; they can also exist legitimately as the law of the land. In Ghana, for example, Flight Lieutenant Jerry Rawlings, as head of state, has used the rubric of business legal reform under structural adjustment to reinforce the power of the State and of the executive branch. By awarding broad discretionary power to the Ghana Investment Centre over certification, regulation, and legislation of investment, this public agency has been empowered to supplant the role of statutes and independent courts in the protection of property rights and access to markets for investors.[13] Legal reform has been supplanted by legitimization of the executive's monopoly over economic and political control.

In general, the problems encountered by the private sector in the case of an imbalance of power stem from three main sources: use of *arrêtés* and *décrets* (executive orders/regulations) to override laws and ordinances, direct influence exercised by the executive branch in individual judicial cases, and conflicts of interest, when commercial and political goals intersect. The result of all of these is increased uncertainty and market distortion.

More specifically, executive discretionary power can thwart investment and commerce through actual or threatened misuse of the right of eminent domain and violation of privacy (access by government authorities to private financial records, for example). Widespread abuse has been reported in Chad of the right of eminent domain, in which property is seized without compensation or compliance with other requirements of the law.[14]

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[12] Louis Aucoin, "Current Status of the Legal System and the Rule of Law in Chad and Its Effect on the Private Sector," Center for Institutional Reform and the Informal Sector, University of Maryland at College Park. October 1992.

[13] Julien E. Naginski, "Economic Conditionality and Legal Unconditionality: Structural Adjustment in Ghana (1983-1992)." Unpublished draft, Fletcher School of Law and Diplomacy, Tufts University, Medford, MA. February 1993.

[14] Aucoin, 1992, p. 18.

Mechanisms for restraining executive power. Attempts to counter the potential for excessive executive power have generally taken one of two forms. In many Francophone countries, a system of administrative law exists explicitly to adjudicate disputes in which the "Government," meaning the executive branch and all of the ministries that fall under its jurisdiction, is a party. Thus, the term "administrative law" connotes something very different in France and francophone countries than in common-law countries. Whereas the French legal system in general operates on the principle of a strict and mechanical application of the written law, administrative law is "judge made."[15] Operative legal standards revolve around abuse of discretion, abuse of power, etc. Problems arise under this type of structure in the case of a limited system of appeals, and the susceptibility of judges and lawyers to corruption or interference (in response to either bribes or threats from outside sources, including the executive branch).

In anglophone countries, the Anglo-Saxon system of private challenge through regular courts, as embodied in the U.S. Administrative Procedures Act, for example, guarantees the rights of individuals to seek redress within an independent judiciary from governmental oppression or abuse or the invasion of privacy. Clearly, when the judiciary is less than independent from other branches of government, or when the authority of the judiciary to administer and enforce a judgement over a branch of the government is curtailed, the ability of the system to protect individuals is compromised.

Property rights

The role of government as securer of property rights is one that runs counter to both the body and spirit of existing law in many developing countries. In order to provide such security and assure the efficiency of markets, history has shown that government is best structured in such a way as to create an automatic system of checks and balances in order to limit the abuse of power by any one branch. In industrialized countries, such a system has been guaranteed through the separation of powers of the executive, legislative, and judicial branches of government. In many developing countries (and indeed in the history of many industrialized countries) the executive branch operates with impunity, leading to abuse of power, conflict of interest, and a myriad of more particular problems which thwart the emergence of a robust private sector.

Baseline. The baseline for measuring the adequacy of property rights is established norms and procedures within the international community, especially the former colonial powers. Rights of ownership are clearly established through a standard and uniform procedure of registration or deed. Owners of the property have full rights of alienation, including use as collateral, subject to clear identification of a secured interest in the property by a creditor. In the absence of explicit contractual terms, creditors may seek to exercise rights to that collateral through standard self-help mechanisms that guarantee due process for debtors but also protect

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[15] Aucoin, 1992, p.17.

creditors against premature liquidation of the property or transference by the debtor to a third party.

Many African countries do not require or allow for registration of a substantial amount of property, especially in rural areas. While most of these countries have adopted *de jure* many of the written laws of the former colonial power, *de facto* those laws are inconsistent with customary law and remain largely unknown and unenforced. While it could be argued, especially with respect to property rights, that traditional practice or customary law accomplishes sufficiently the goals of efficient and transparent rights to use and alienation, the fact is that development of international trading networks requires such rights to be transparent not only to local communities but also to potential investors and customers whose interests extend well beyond those communities. Baseline standards, therefore, will be defined here by concepts of property ownership and alienation inherent within English common law and French civil law and applied as international norms.

Limits on ownership and alienation. Rights to ownership of real estate, equipment, and inventories used in the production and processing of exports may be limited according to the type of owner recognized under the law (corporate, partnership, or individual) and the owner's right to use or to transfer the property in various ways. The law may recognize property as formally "owned" by an individual or business only after a registration process has been completed in which the owner and the goods are fully identified.

Limits to ownership are common with respect to real property. A government may recognize as "public" or commonly owned (or government-owned) any real estate that is not explicitly deeded. It then limits the extent to which certain types of real estate can be deeded to private parties, forbidding ownership, for example, of waterways, waterfront, forested land, or other real estate in which the state holds an explicit interest. The state may limit rights of ownership to resources associated with real property, such as energy and mineral deposits, fisheries, and wood. The state may also limit the type of individual or corporate entity that can be legally registered as the owner of real property, limiting foreign ownership or ownership by individuals of a certain ethnic groups, either explicitly or implicitly.

Registration of property may not clarify rights of alienation, which are often less clear than rights of ownership *per se*. The right to transfer full or partial interests in property becomes particularly important for the potential exporter when property is to be used as collateral. In the case of a loan obtained from a customer to finance the production or shipping of inventory, the establishment of a secured interest in property is often key to the completion of a contract. If secured interests are not recognized legally, or if the rights of creditors are not clearly distinguished from the rights of debtors, contracts that do not explicitly detail such rights may not be enforceable under the law, or, if enforceable, may not be enforceable through a timely and transparent judicial procedure. Similar problems can arise in relation to other types of secured interests, such as those pertaining to mortgages.

Cost and difficulty of registering. The registration process, itself, can present an onerous series of steps to be taken with respect to a particular state agency. Proof of purchase,

taxes and fees paid, and deeds of sale or transference may be required to establish clearly that the property has been acquired legally and that all liens against it have been removed. Registration, therefore, may create opportunities for rent-seeking if the government entities in question retain discretionary authority over the setting and collection of fees and the completion of the process. Even in the absence of such discretionary authority, registration fees (levied on an *ad valorem* basis) or stamp duties can pose significant transaction costs to individuals and businesses. Extended delays in recognition of ownership by state agencies can also imply real costs to business.

Other problems may occur with real property. Titling to two individuals, for example, may not explicitly prevent sale or lease by only one of those owners, and the rights of the second are often unclear in relation to the rights of the first. Title to a particular piece of property may not be fully transferred in other ways. For example, when a new owner is registered, records pertaining to former owners may not be updated so that several owners are officially "registered" simultaneously. Additionally, problems concerning clear and adequate measurement of real property are common in the absence of standard, reliable survey practices. Such problems in registration often confound financing, real estate improvement, and investment in protection of land from degradation.

Limitation on use as collateral. With respect to use of real property as collateral for financing, or in the obtaining of a mortgage, laws may ascribe particular rights to creditors but not debtors (or vice versa) which create an uneven playing field and may or may not be subverted through a contract. For example, restricting the right to grant a second mortgage to banks not only interferes with freedom of contracting but also discriminates against other types of creditors and distorts the market for mortgage instruments.

Enforcement of zoning and construction restrictions and standards. A less than even-handed enforcement of rights to develop real property can amount to an investment disincentive. Suppose that a potential exporter observes zoning regulations applicable to a particular tract of land which is suitable for his exporting business. It is an area adjacent to a national border with highway access and could serve as the location for a warehouse. However, zoning regulations prevent commercial development and therefore the exporter chooses to lease a less ideal site, thereby increasing transportation costs. The original tract is then leased and developed by a competitor who has done so based on special (perhaps unofficial) exemption from the zoning regulations. The first firm not only suffers a comparative disadvantage, but operates less efficiently as a result of losing access to a superior site. If regulations concerning zoning and construction are not uniformly applied, therefore, markets for real property fail to fully reflect the value of those restrictions, often regardless of compliance. Opportunities for rent-seeking also arise in the discretionary application of rules which increase costs to investment and ownership.

Rent control and other leasing regulation. As is clearly evident in industrialized as well as developing countries, inefficiencies and market distortions arise not only from the lack of regulation, but also from regulation that explicitly seeks to distort markets for purposes of equity. Rent control is one method of capping growth in the costs of living or doing business,

but it can lead to significant inefficiencies in the valuation of real property. Businesses that gain access to rent-controlled property or that cannot lease property at a fair market rate benefit (or suffer) from a distortion in the market that can translate into inefficiencies in the production and marketing of exportables.

Extension to the informal sector. By definition, businesses and individuals operating outside of the formal sector are not protected by the state in terms of their property rights. Property rights pertaining to the informal sector, therefore, most likely do not exist in a legal sense. What is important to investigate is the extent to which written or customary law recognizes squatters' rights, rights of alienation among family members or community members, or other traditional user rights based on common practice or cultural norms. Whether or not to formalize such rights depends on the net potential benefits of doing so. While little literature exists on this subject, David Atwood theorizes that the benefits of introducing an efficient property rights system in an African context include promotion of transfers, access to credit and promotion of investment.[16]

Contracts

In general, the simpler and briefer is the law pertaining to contracts, the more able are potential exporters to operate freely within the market and maximize both productivity and returns to investment. However, certain areas of the law pertaining to contracts and torts, especially within developing countries, are worth considering with a focus on removing constraints to exports.

Baseline. Contract law is important for two major reasons. First, it increases efficiency by setting standards and norms for the writing of contracts, figuratively and literally through the standardization of certain contracts to set out legal terms for standard transactions or agreements. Second, it stipulates the ramifications for breaches of terms, in order to create incentives for signatories to avoid breach of contract. Setting out the terms for awarding of damages both clarifies ramifications of non-compliance (creating the incentive for compliance in most cases), and articulates the process through which damages may be sought. The efficacy of contract law will be determined using these two yardsticks.

As with most other legal areas to be studied, the baseline against which the adequacy of laws is measured lies in international convention, in this case, norms governing the enforceability of contracts and the existence of tort law. In more specific instances pertaining to international commerce, the baseline lies in such international conventions as the U.N. Convention on International Sale of Goods. This convention establishes a uniform law of commercial sales in international transactions and works to minimize uncertainty with respect to extra-contract liability, breach, and other areas of concern for many potential exporters.

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[16] Atwood, David A. "Land Registration in Africa: The Impact on Agricultural Production." *World Development*, Vol. 18, No. 5, 1990. p. 663.

Limitation v. clarification. One frequent attribute of contract law in developing countries is the tendency to use the law to limit the type or nature of contracts which are considered "legal." Terrell and Svejnar describe contract law in Senegal, for example, that prohibits certain types of contracts between employers and employees and prohibits layoffs by employers without government approval, significantly increasing production costs and negatively affecting the ability of firms to alter production in response to market conditions.[17] Barbara Ibrahim has argued that similar legislated limitations on contracts in many developing countries, detailing such issues as maternity leave, limitations on the work week, etc., unfairly discriminate against women, making them more expensive to employers.[18]

Other aspects of contract law can clearly increase efficiency and equity. To continue to use the example of labor contracts, laws requiring withholding of taxes by employers, minimum age requirements, etc., can all fulfill social goals at the same time as they reduce transaction costs across sectors and across the society.

Role of economic efficiency. Where contract law often fails in the developing world is in maximizing economic efficiency. Contracts may enjoin parties to perform certain acts and meet obligations, but when circumstances change (market conditions, prices, transaction costs, or the legal regime), provisions to keep the meeting of contractual obligations subject to economic efficiency can relieve both the signatories and the judicial system of unnecessary waste. In general, potential exporters are particularly subject to fluctuations in market conditions and therefore can benefit most from built-in contractual flexibility.

Torts

Tort law seeks to encourage certain behavior through the threat of liability. Torts, *per se*, do not exist in the French legal tradition, but many of the concepts embodied in the tort law of common law countries exists in France and francophone countries under the rubric of *lois d'obligations* (law of obligations) and *responsabilité* (responsibility). The French legal concept of *responsabilité* assigns liability on the basis of duty dictated by certain circumstances of human interaction, and negligence of that duty by an individual or company. Given the disparate meanings of the concept of tort, here the term "liability law" shall be used to refer to the legal regimes pertaining to torts, responsibility, and liability.

While the scope of liability law in most African contexts is limited to personal injury causes, liability is an essential component of a legal regime to provide proper incentives to firms. Through the imposition of minimum standards of care and accompanying liability for

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[17] Terrell, Katherine, and Jan Svejnar. *The Industrial Labor Market and Economic Performance in Senegal: A Study in Enterprise Ownership, Export Orientation, and Government Regulation.* Boulder: Westview Press, 1989; Velenchik, 1991, op. cit.

[18] Ibrahim, Barbara. "Policies Affecting Women's Employment in the Formal Sector: Strategies for Change." *World Development*, Vol. 17, No. 7, 1989. p. 1102.

breaching those standards, liability law encourages safety in the workplace and a reduction of adverse environmental impact in manufacturing. Most importantly to firms in the exporting sectors, liability encourages the implementation of quality control systems to ensure safety and health standards for goods sold. Therefore, the threat of pecuniary liability can serve to improve the quality of goods for export--something which is often cited as a key factor for increasing the exportability of African manufactured products to more sophisticated consumer markets. In assessing the efficiency of a liability law regime, three areas of analysis are critical:

1. **Transparency and predictability of the law.** The crucial issue is whether potential liability and responsibility is known by the firms, so that they can act proactively through implementation of safe operating procedures and the purchase of liability insurance. Clearly where duties of care and product safety requirements are imposed by statute rather than case law, the legal regime is more predictable. Another important factor for promoting predictability is the transparency and consistency of liability law administration (see contracts above).

2. **Costs of administration.** Central to the cost of administering the liability regime are the levels of damages generally imposed on exporting firms and the availability of liability insurance. In addition to liability, legal fees may add significantly to the cost of administering the tort regime. The right of lawyers to work on a contingency basis--common in the United States but rare and controversial in Europe--substantially raises a society's liability levels, as such payment mechanisms encourage more suits, especially those where plaintiffs are indigent and otherwise would not be able to bring their case to court.

3. **Scope of the liability regime.** In most developing countries, personal injury cases and trespass cases are adjudicated through either the modern court system or through customary law. Of concern for this study is the degree to which the liability law has evolved to allow product liability cases and class action suits, since these legal concepts are not operative in most developing countries.

Baseline. Establishing a baseline for assessing the efficacy of liability law is problematic. Although the United States operates the most extensive tort regime, the costs to private business are legendary. Using liability standards operative in the former colonial power is clearly preferable both for historical, cultural reasons and for reasons of balance between protection of potential claimants and economic efficiency. However, the efficacy of tort law is best determined on an individual country-by-country basis, employing a baseline that seeks to balance the needs for efficient redress by potential plaintiffs and the interests of the private sector in expansion of economic activity. The extent to which one set of interests is met to the detriment of the other should serve as a guide in recommending changes to the law.

Business Regulation

Corporate law

Baseline. Since the laws governing commerce are based in the English common law tradition, British and American concepts of corporate law offer the most suitable baseline for measuring the efficacy of corporate law in the developing countries to be studied. While regulations governing taxation, for example, vary considerably even among industrialized countries, the basic legal rubric which determines incentives to engage in private commercial activity is fairly standard across international boundaries. It provides for certain legal rights, obligations and protection for businesses conducting international trade.

Types of companies. Upon seizing a concept for export development, entrepreneurs are faced with a myriad of decisions. Among the most important is what type of company to create. In order to make that decision, the entrepreneur must determine what kinds of companies are recognized by national law (limited partnerships, associations, corporations etc.) and what different regulations apply to each. Options concerning capital formation, including the issuance of shares, types of shares, rights of shareholders, and differential regulations governing debt v. equity, are all aspects of corporate law that have a bearing on the choice of entrepreneurs to establish export-oriented businesses.

Export business development depends on the transparency of these regulations. The subversion of existing corporate law by special interests amounts to a disincentive for potential entrepreneurs to create businesses. Therefore, whether legal requirements for incorporation of various types of businesses are simply guidelines for future negotiation with public officials or hard and fast standard rules is critical to measuring the costs of these requirements. Likewise, the complexity and variety of regulations governing various forms of private entities are fundamental. The more complex, the higher the costs of market entry for new businesses just to understand the options, and the less likely the development of rigorous competition.

Incentives for/against incorporation and registration. The more costly and complicated the process of incorporation the higher the costs of market entry. The potential pitfalls surrounding registration of businesses are similar to those surrounding registration of private and real property (see above). What are the rules governing incorporation and registration of companies? How transparent, and expensive, and complex is the process? What are the benefits connected with incorporation and registration in terms of security of property or trademark protection or access to government services or legal rights to dispute resolution or access to private and public financing? If corporate registration simply adds the name of a business to the tax rolls, what incentives exist to register? On the flip side of the coin, what penalties threaten to apply to those operating as a private business without having officially incorporated and/or registered?

The benefits of incorporation and of registration in terms of services and reduced costs to businesses must outweigh the costs in terms of time, effort, and tax liability in order for new entrants to incorporate and register. If costs outweigh benefits, entrepreneurs will migrate to

the informal sector, with potential increases in inefficiency, loss of large market shares, and lost revenue to government coffers.

Limitations on alienation. Corporate law frequently restricts the extent to which corporate assets may be transferred to individuals or to other corporate entities. While some amount of restriction is appropriate to avoid the concealment of assets to avoid taxation or liability, the extent to which laws limit the rights of businesses to sell, lease or grant a security interest to creditors in corporate assets could well hamper the ability of potential exporters to conduct business in the international market. Fees, duties, and other taxes on the transfer of corporate assets should be measured against conventional practices among competitors.

Bankruptcy law. The extent to which companies fail in a competitive sense is dependent upon both the independence of the private sector and market competition. Regulations and rights relative to ending the life of a business may prove to be as important as those regarding its beginning, especially to investors and lenders. Corporate law which does not detail the rights and procedural options for business owners, investors, and lenders may dissuade export business development. Restrictions on the exit of failing enterprises were cited as a major problem in the regulatory framework in Madagascar by the World Bank.[19] Ideally, bankruptcy law seeks to balance the interests of the debtor with those of creditors and seeks a predictable, efficient, fair and equitable resolution of disputes over the distribution of assets.

Procedures. In order to maximize efficiency, the efficacy of compromise and the certainty of outcomes, bankruptcy procedures, first and foremost, must be clear, must be standardized for every business, and must seek to minimize costs in terms both of actual fees (legal, filing, etc.) and lost time to creditors (the opportunity cost of outstanding liabilities). To the extent that procedures are not streamlined, the disbursement of assets could engender enough delays and disputes to discourage new entrants.

Securing the rights of creditors. Actual or perceived incidence of unorthodox transfers in the event of bankruptcy can also dissuade investment and lending to businesses. If bankruptcy laws do not nullify certain transfers for a period prior to filing (including both the settlement of debt to avoid preferential treatment of certain creditors and transfers to family members), the incentives for business owners to shelter assets from their creditors could be great enough to distort the loan market. For the same reasons, explicit definition of protection for secured creditors is a fundamental aspect of bankruptcy law.

Commercial law

Some of the aspects of commercial law to be examined in the context of developing countries are covered under the general section on contracts above. As is evident in the history of the development of commercial law in many common-law countries, general legal principles

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[19] World Bank. "Madagascar: Beyond Stabilization to Susutainable Growth." World Bank. Draft Photocopy. March 1991. p. 55.

pertaining to many aspects of society emerged from the development of commercial law. Commercial law, here, is considered that body of business regulation that is written specifically toward the issues facing traders.

Baseline. In specific instances pertaining to international commerce, the baseline lies in such international conventions as the U.N. Convention on International Sale of Goods. This convention establishes a uniform law of commercial sales in international transactions and works to minimize uncertainty with respect to extra-contract liability, breach, and other areas of concern for many potential exporters.

Capital and current transactions. One area of particular concern is the extent to which transactions involving capital and current financial flows are subject to review, tax, or regulation by government authorities. Foreign purchase of assets (including but not limited to real property, as discussed above) is often restricted or forbidden by national laws in developing countries in order to limit the influence of outside parties in domestic affairs. The important role of foreign catalysts in the establishment and growth of export businesses, however, underscores the importance of enabling foreign capital investment, since the adoption of risk by foreign partners greatly increases the chances that nascent export initiatives will succeed.[20] Inversely, restrictions on foreign purchase of assets have the potential to depress significantly private profits and tax flows from emerging export industries.

Extension to the informal sector. The extent to which positive law on contracts and sales applies to operators in the informal sector is a measure of the universality of that law as it is applied across segments of the society. When courts, whether commercial, administrative, or appellate, do not recognize members of the informal sector vis-à-vis contractual obligations, these parties are often forced to establish their own courts in the form of a parallel legal system, a solution that can prove extremely costly.[21]

Enforcement. In most respects, the problems that accrue to the formal and informal sector with respect to law on contracts and sales arise out of problems of enforceability and enforcement. What kinds of recourse exist for plaintiffs in contractual disputes? Is there a body of law that streamlines the litigation process, identifying a particular system of courts (commercial, administrative, or other) in which compensation or damages may be sought? What assumptions exist concerning torts? What jurisdictional provisions does the law contain when the defendant (or plaintiff) in a dispute is a foreign individual or corporation?

The answers to such questions are tantamount to the incentives for potential exporters to assume risk in writing contracts with domestic and foreign parties in the normal conduct of

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[20] See, for example, Rhee, Yung Whee. *Trade Finance in Developing Countries.* World Bank Industry and Energy Department, Policy, Research, and External Affairs, Policy and Research Series No. 5. 1989; and Rhee, Yung Whee, and Therese Belot. *Export Catalysts in Low-Income Countries: A Review of Eleven Success Stories.* World Bank Discussion Paper No. 72. World Bank. 1990.

[21] de Soto, Hernando. The Other Path: *The Invisible Revolution in the Third World.* New York: Harper and Row. 1989. pp. 163-172.

business. If options for recourse are unclear following a contractual dispute, or provisions for enforcement are inadequate (not only legal but also institutional and financial provisions), whatever other incentives exist for entrepreneurs to establish export industries are weakened as a consequence.

Finance regulation

Baseline. Regulation of financial markets in industrial countries conceptually presumes the existence of functioning financial markets, with demand for and supply of financial goods and services. In many developing countries, the financial sector is either just beginning to emerge as the result of privatization and a transition to a market economy, or, has not emerged at all. Therefore, finance regulation for the purposes of the methodology shall be defined in its broadest terms as those rules, implicit or explicit within the monetary policy regime, that govern access to finance of all types. Additionally, while securities regulation falls within this broad definition, the breadth and depth of securities markets in most African countries is so limited that the discussion here focuses on other credit sources. However, securities regulation will constitute a focus of study and analysis to the extent that it exists.

Credit controls. Despite extensive policy reform in many countries, reform of the financial sector has occurred in a piecemeal fashion. The extent to which access of the private sector in Africa to commercial credit is controlled directly or indirectly by government has been a subject of recent study.[22] Credit controls are a direct function of the extent to which the government has permitted credit and interest rates to be governed by competitive markets rather than planners. Of special concern to exporters is the extent to which the government has implemented a system of currency valuation that is consistent with the monetary regime.

Duesenberry and McPherson comment that, despite significant economic reform, financial sector reform and a move to indirect credit controls in the sub-Saharan Africa region are particularly difficult. The reasons include a history of financial intervention by governments that retards reform, lack of confidence in the banking sector (after years of inflation and period devaluations), and the rents that accrue from financial controls, thereby increasing the direct costs of removing distortions.[23] The setting for reform faced by monetary authorities, therefore, "is characterized by deep-seated distrust and progressive institutional deterioration."[24]

For example, while several of the commercial banks in Madagascar have recently privatized, the amount of credit available to Malagasy entrepreneurs remains governed by credit

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[22] Duesenberry, James S., and Malcolm McPherson. *Monetary Management in Sub-Saharan Africa: A Comparative Analysis*. CAER Discussion Paper No. 7. Harvard Institute for International Development. June 1991; and World Bank and USAID, 1991.

[23] Duesenberry and McPherson, 1991, p. 17.

[24] Ibid., p. 18.

ceilings imposed by the Central Bank rather than by competitive interest markets.[25] Although credit to the private sector increased steadily throughout the last half of the 1980s, credit was directed to the industrial sector at a far greater rate than to agriculture and services.[26] Small-scale entrepreneurs found access to commercial financing difficult. At the same time, despite successive devaluations that maintained the value of the Malagasy franc (FMg) at a level more or less equal to market rates, access to foreign exchange for importers was limited in the wake of a run on Central Bank reserves at the end of 1991, following the lifting of import restrictions.

In Ghana, where access to credit has been identified as a major constraint to development of the private sector, the squeeze is most apparent in the manufacturing sector.[27] Despite the establishment of a dual auction system for foreign exchange and a more competitive, market-based system for credit allocation, monetary programming remains hampered by problems in the estimation of balance of payments figures and inflation by the central government.[28]

Capitalization and management. Embedded in the regime governing interest rates, of course, are other more general regulatory issues that have a direct impact on the private sector through the interest rate. What kind of standards must banks meet or seek in terms of "CAMEL": capital adequacy, asset quality, strength of management, earnings and liquidity?[29] How are banks supervised by central authorities? Are banks required to carry deposit insurance? What kinds of other financial services are banks permitted to market to the general public? What are the prevailing standards which define credit-worthiness? To what extent are bank records open to government or public scrutiny? In general, these questions all encompass an analysis of the costs faced by loan-granting institutions and the existing incentives to provide financing at a rate which will encourage exporters to borrow.

Interest rates may not be denominated in traditional financial terms. In countries governed by Islamic law, for instance, explicit charging of interest by even commercial financial institutions may be deemed illegal since it violates traditional Sharia law against usury. Interest rates, in this case, may be figured on the basis of a share in any profits which accrue to the borrower or in some other form of "interest" in equity terms. The form that interest rates take, therefore, may be less important than the transparency, competitiveness, and even-handedness with which rates are determined.

Procedures. Even lending systems considered quite developed in terms of the plethora of available instruments and market-driven rates of interest can levy high transactions costs if the procedures required to obtain financing are unduly burdensome. Part of the success of the

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[25] World Bank, 1991, pp. 41, 65.

[26] Ibid.

[27] Duesenberry and McPherson, 1991, pp. 42-43; Paul, 1990, pp. 25-26.

[28] Duesenberry and McPherson, 1991, pp. 42-43.

[29] Duesenberry and McPherson, 1991.

Korean system of letters of credit (L/Cs), for example, lies in the speed and ease with which L/Cs were made available to firms which could furnish the export order. The costs of borrowing, therefore, must be measured not only in financial but economic terms. The recurrent costs of time, personnel and capital required to obtain credit on an ongoing basis may prove too high for firms to borrow and invest in export-oriented enterprise. Minimizing the procedures required for each loan, or streamlining the process to enable eligible enterprises to qualify for recurrent financing only once is clearly in the best interests of private sector efficiency.

Foreclosure. Even where markets determine interest rates and regulations surrounding collateral are clear and equitable, the procedures and costs of the enforcement of contracts, in this case foreclosure, may pose a potential barrier to lenders and creditors alike. The transparency of the system in terms of foreclosure is one aspect of increasing borrower confidence in the financial sector. What rules define adequate notice of imminent foreclosure? What uncollateralized assets might be seized and on what basis will they be valued against the borrower's remaining liability? Setting aside issues surrounding the resolution of disputes (treated elsewhere), what legal standards apply to the process of foreclosure and do they effectively reduce its costs? Who bears those costs? More important at times than the costs of foreclosure are the potential benefits and to whom the proceeds of foreclosure usually accrue. If parties other than the creditor and debtor (and their representatives), such as government agencies or institutions, become involved at the advent of foreclosure, what interests and power do they hold over the process, its initiation and its closure?

Regulation of competition

The tradition of public monopolies in many African countries renders rather moot a full discussion of regulation of competition in the region. In the move toward privatization and dismantling of public marketing boards, there may be an unmet need for the development of laws pertaining to trust, price-fixing, oligopoly, monopoly, and other manifestations of lack of competition within the private sector.

Baseline. Because of the varying degrees of transition across developing countries with respect to privatization and market reform, the clear identification of a standard against which to measure the efficacy of competition law is problematic. Additionally, the traditions of anti-trust legal development among even former colonial powers falls across a broad range of historical experience and many industrial countries continue to question the role of public companies, the appropriateness of deregulation and competition in the provision of certain basic services, and many other fundamental questions.

The efficacy of monopoly conditions in certain industries or sectors is not an issue with which this paper is concerned. It is assumed that nontraditional export industries will operate most efficiently under competitive conditions. The baseline, therefore, should be defined loosely as the ability of new firms specializing in nontraditional exports to enter the market and have the opportunity to compete. What is the legal structure that derives from monopolist or oligopolist traditions and that effectively blocks new entrants to a sector or industry?

Marketing boards. Many developing countries have relied historically on marketing boards and price controls to smooth the variations in the international business cycle for small and medium-sized producers of tradables. The distortions and inequities which result from such control of the market by government agencies are legendary and well documented. The process of structural adjustment seeks to eliminate such distortions and has contributed to the successful dismantling of many of the parastatals and price controls that prevailed throughout the 1950s, 1960s and 1970s.

Remnants of these controls may remain, however. For example, regulatory power over private sector export-oriented industry in Ghana, a country heralded as a model of successful adjustment, resides with the appropriate ministries, the National Revenue Centre and the Bank of Ghana, the Ghana Investments Centre, the Registrar General of Ghana, the Tripartite Committees on Wages and Salaries and the Prices and Incomes Board. While the control that these latter public agencies maintain may be minimal, their potential regulatory impact is not costless and must be measured against the services they provide to the private sector.[30]

Privatization. Included in this category of law are those statutes and regulations governing the sale of state-owned enterprises to the private sector. Since the development of these regulations and statutes often unfolded in response to a particular industry or legal dilemma, the body of law may prove to be rather distorted when applied more generally to the public and private sectors. In particular, potential conflicts of interest may be embodied in privatization laws which do not prevent the simple continuance of a public enterprise, with all of its prior inefficiencies and bureaucracies under new title. Privatization law ought to ensure that not only are the assets of a particular concern transferred to private interests, but also that competitors within the same industry may emerge and have access to contracts, supplies, credit, and other resources along lines similar to the former public monopoly.

Environmental regulation

The advent of environmental regulation is a welcome development in many countries. Whether geared to Western precepts of a polluter-pays principle, or designed to protect the natural resource base through specific restrictions on use in the interests of conservation and preservation, environmental law is often broad and far-reaching by design. It pertains to land use, resource rights, mitigation liability and can often appear quite byzantine in its configuration around specific interests and problems.

Baseline. Given the complexity and broad scope of much environmental regulation, the baseline for the purposes of this methodology shall consist of those international conventions and agreements which specify an international standard on particular environmental issues, whether or not a particular country is a signatory. An incomplete list of such conventions would include the Convention on International Trade of Endangered Species (CITES), the Montreal Protocol on Substances that Deplete the Ozone Layer, the International Tropical Timber Agreement

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[30] Paul, 1990, p. 32.

(ITTA), and the United Nations Conference on Environment and Development (UNCED) accords on forestry and principles of development.

In most country cases, environmental regulation is likely to be minimal and pertinent only to a few key resources or industries. Where national environmental law is not relevant to these international standards, it should be measured by the extent to which it encourages private firms and individuals to internalize the social costs of production.

Access to public resources. A key element in the economic development of all countries and the profitability of the private sector is access by individuals and firms to public resources. Whether as a source of free industrial inputs, or as a sink for waste, the natural resource base in virtually all developing countries suffers a significant free-rider problem stemming primarily from legal status as an open-access resource. Forests, water resources, and wildlife stocks have traditionally been mined beyond their regenerative capacity as populations increase and demand for land and food expands. While not explicitly a form of environmental regulation, the legal traditions and constitutional rights underlying customary resource access should constitute a focus of analysis. Such a focus is especially important given the linkages between access to resources and the short- and long-term cost structures of emerging nontraditional export firms.

Labor law

Most sub-Saharan African countries share one common comparative advantage in international business. The supply of skilled and unskilled labor is high relative to Asia and Latin America. The cost of labor relative to other inputs, therefore, is relatively low. This economic reality poses a dilemma for export business owners and lawmakers alike. Laws and regulations governing labor must seek a balance between, on the one hand, adequate protection for the worker in terms of health, safety and compensation, both for reasons of basic human rights and to preserve access to international markets, and, on the other hand, preservation of comparative advantage represented in low wage rates.

Baseline. The baseline for labor law lies in internationally accepted standards embodied in the conventions signed under the auspices of the International Labour Organization (ILO) and/or the E.C. Generalized System of Preferences (GSP)[31] since these have a direct bearing on the ability of exporters to operate within the international marketplace. For conditions or regulations not clearly covered by the ILO or GSP, the baseline may be identified in standards articulated under the auspices of the Lomé Conventions (Lomé IV was signed in December 1989) and any other international agreements to which an individual country is a signatory. As is the case with many aspects of the Lomé Conventions, certain provisions relative to labor law in the Lomé agreement may supersede obligations under the GSP of a trading partner or some other agreement.

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[31] The EC GSP was chosen as opposed to the US GSP or the GSP of another country because of the much larger portion of existing trade between African countries and the EC in comparison to African trade with other markets. Where appropriate, the relevant GSP should prevail.

The obligations and responsibilities of employers to meet minimum standards are governed not only by agreements signed by governments but by minimum requirements of the governments of those countries representing potential markets. Employers must have ready access to the laws and regulations detailing obligations regarding labor practices under both national and international law. In addition, exporters face conflicts between the national laws of a signatory country and international standards required of that country by virtue of being a signatory to a particular convention. While the short-term financial incentive may be to behave according to the standard most likely to be enforced locally, exporters in such circumstances are ultimately accountable to a higher standard within the international marketplace. The greater the differences between national and international standards, the greater the dilemma.

Workers' rights. In general, international agreements that detail minimum labor law requirements base those requirements on the concept of workers' rights. The ILO, for example, through various conventions, requires that signatory countries establish minimum standards detailing the rights of workers with respect to free association (ILO Convention No. 87), organization and collective bargaining (ILO Convention No. 98), forced labor (ILO Convention Nos. 29 and 105), minimum age of employment (ILO Convention No. 138), occupational safety (ILO Convention Nos. 148 and 155), and exposure to toxicity in the workplace including radiation (ILO Convention No. 115), benzine (ILO Convention No. 136) and cancer-causing agents (ILO Convention No. 139).

Workers' compensation. National laws frequently establish minimum wage rules and other regulations governing compensation for overtime and additional benefits. Benefits regulations may be brief in developing countries, but, more importantly, they may be too vague to establish a clear standard for worker protection. Benefits laws may address health insurance, workers' compensation for time lost due to illness or injury, severance pay and retirement benefits.

The key to analysis of compensation regulations is the extent to which the laws force companies to become uncompetitive relative to their international counterparts. While ILO standards can form the base against which health and safety regulations are measured, as well as standards regarding access to health and retirement benefits, the ILO cannot speak to the extent to which laws governing wages in local currency unfairly penalize exporting businesses in terms of their competitiveness abroad. Ideally, the extent to which changes in real wages parallel changes in productivity would provide the best measure of both wage fairness and competitiveness. However, data regarding productivity trends in developing countries remain largely unavailable, especially in sub-Saharan Africa.

One alternative measure of judging the suitability of wages is by comparing trends of domestic wages measured in local currency, denominated in foreign exchange (to reflect the impact of devaluations on real wages), and deflated by the CPI. For example, Mauritius legislated wage increases between 1980 and 1990 that surpassed both increases in wages denominated in foreign exchange and increases in the CPI (Figure 1). With 100 as the benchmark in 1980, the wage index in local currency had surpassed 300 by 1990, whereas the index of wages in French francs initially rose above local currency wages (since nominal

devaluation vis-à-vis the French franc did not occur until the mid-1980s) but had leveled off by 1990 at approximately 200. The wage index divided by the CPI for each period also rose throughout the decade, but at a much lower rate, settling in 1990 at approximately 130.[32]

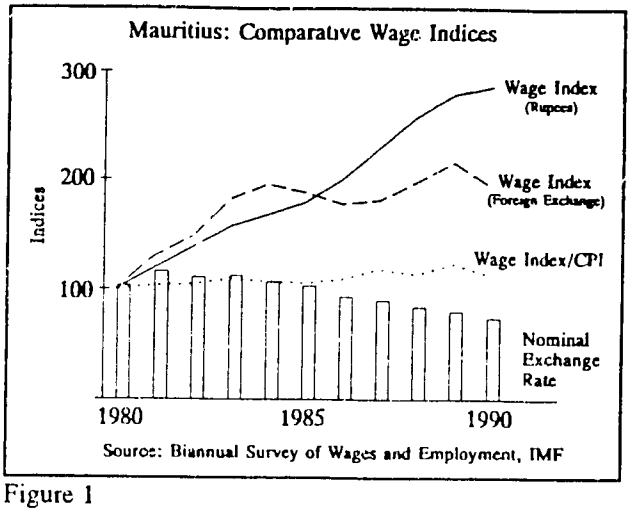

Figure 1

Such a comparison yields very useful information concerning the trends in real labor costs to exporters and the extent to which they can remain competitive despite variable rates of inflation and changes in the value of local currency. The nominal wage rate in the 1980s in Mauritius would seem to have placed exporters at a significant disadvantage in the international marketplace. However, given the economic impact of inflation on wages, real wages increased at a far lower rate. Therefore, the impact of legislated wage increases in Mauritius was far less in terms of international competitiveness than is apparent by looking only at an index of nominal wages in rupees.

Foreign workers and managers. The labor codes governing the eligibility of foreign workers and managers can have an adverse impact on the ability of local firms to compete effectively in the global marketplace. Labor codes of developing countries often restrict the hiring of foreign workers by local firms (and foreign firms for that matter) in an effort to guard against the loss of employment opportunities for nationals. If foreign workers cannot be employed by domestic firms, or if their employment opportunities are limited numerically or in terms of duration through visas and work permits, the ability of local firms to gain from foreign expertise can be severely diminished. If such restrictions exist, their impact on the hiring practices of potential exporters must be measured against what would be the case in an labor market unrestricted as to the nationality of workers and managers.

Foreign partners (or "catalysts") for export development have played a particularly important role in designing and managing production systems and training local workers to operate productively within them.[33] Restrictions on the hiring of foreign workers, therefore, may prove to be particularly counterproductive if they hamper the ability of local firms to train their employees in special skills required for export development, such as assurance of quality standards in manufacturing and transportation.

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[32] The data for this example are taken from World Bank, *Mauritius, Expanding Horizons, A World Bank Country Study*, 1992: 12 *et seq.*.

[33] Rhee and Belot, 1990.

Labor administration and enforcement. Even if exporters were to face labor laws perfectly in tune with international standards, the inability of government agencies to enforce these laws could inhibit export development. Low budgetary resources, unfamiliarity with the demands of regulating a burgeoning private sector and lack of available sanctions in the law could encourage the private sector to ignore their legal obligations regarding labor and could thereby risk international trade retaliation against exporters.

Exporters may also face costs associated with highly efficient labor administration and enforcement if the underlying costs prove unduly burdensome. Since labor costs are often the largest component of total costs, a labor code which specifies minimum wages, benefits, and, especially, job security, may inflate the cost of labor far above the costs faced by international competitors, rendering the business uncompetitive.

The written law may differ substantially from common practice, especially in countries with extensive unemployment or underemployment. Therefore, common labor practices within both the private and public sectors will also be studied.

Intellectual property ownership (patents, trade marks, copyrights, etc.)

Baseline. The baseline with respect to the legal regime governing patents, trade marks, copyrights, and trade secrets lies in internationally accepted practice. These norms are clearly codified in several international conventions. Two key conventions governing patents are the U.S. Model Annex Agreement Concerning the Protection and Enforcement of Intellectual Property Rights (hereafter referred to as the "US IP Agreement") and the draft Agreement on Trade Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods (hereafter, "TRIPS"). Both require compliance with the Paris Convention of 1883. International conventions pertaining to copyright protection include the Universal Copyright Convention and the Berne Convention, as well as the two conventions noted above. Whether a country has acceded to these international conventions should largely dictate the extent to which their internal legal regimes are consistent with international norms.

The goal of protection law in any one country should be to ensure the rights of patent and copyright holders abroad, whose products are imported, as well as inventors of intellectual property at home. Inadequate protection of either sort could dissuade potential exporters from obtaining the industrial processes, software and other intellectual property required to take best advantage of market opportunities.

Definition of protected material and exclusions. Among the first questions to be posed is what exclusions from protection are codified in the relevant laws. National (and international) standards based on ethics and concepts of the common good prevent inventors of certain kinds of goods and processes from profiting from their ideas. Examples include scientific and mathematical theories, medical procedures, and, in some cases, certain types of living organisms. Countries run the risk, however, of stifling invention and entrepreneurship by

identifying a broad range of broadly defined items and concepts which are excluded from patentability or run counter to specific cultural norms.

Terms and procedures of protection. The length and variability of time periods for patent protection specified by existing law is also a potential source of problems for entrepreneurs in intellectual property. If the period of protection is too short, protection can be effectively nullified given the lags inherent in development of foreign markets and sources of supply, especially for entrepreneurs in countries not internationally recognized as technology exporters. To the extent that procedures for obtaining protection differ from international norms, potential creators of intellectual property will have a disincentive to seek protection through patents. Requirements governing the establishment of novelty and utility may well be codified and consistent with international norms, but may not articulate conditions of reciprocity with other countries in terms of effective dates of onset of protection after patent filing or trademark registration.

Right to assign. As with other types of property rights, the transferability of patent rights is as important to clarify as the definition of those rights. Should a foreign collaborator, whether an individual or a corporation, seek to transfer patent ownership, or an interest in that ownership (in the form, for example, of a percentage of royalties and infringement rewards) to an individual or corporation in country, will the receiver qualify for the same protection under local and international law as the assigner? In all likelihood, if the law articulates assignment rights, it probably allows for full assignment of all protection emanating from those rights. The potential costs, therefore, lie in the absence of such a stipulation in the patent law and the uncertainty which arises should protection be challenged after assignment.

Technology transfer. Many of the legal and economic principles governing the desirability of protection of intellectual property pertain to property that is imported as well as to property that originates within national boundaries. Developing countries, especially, are eager to encourage technology transfer. However, in order to assist potential exporters in obtaining appropriate technological inputs as well as to protect them from international retaliation, it is necessary to examine the extent to which rules governing technology transfer adequately protect the technology from duplication once it has entered the country.

At least three potential problem areas deserve mention here. First, encouraging technology transfer requires that licensing restrictions be lifted. Potential users of importable technology need to be able to gain access to user licensing without an unwieldy qualification process. Likewise, ensuring that technology, once transferred, enjoys adequate protection requires that users have access to foreign exchange with which to pay royalties. Therefore, if foreign exchange is not readily accessible due to credit controls by the central bank, potential exporters may receive special dispensation to qualify for access to foreign exchange to enable them to obtain technology according to internationally accepted norms. Finally, states can encourage more technology transfer as well as payment of all royalties to foreign patent or trademark holders through reduction or elimination of tax liability on payments abroad. At a minimum, tax rates on royalty payments should be consistent regardless of whether the holder of the patent is foreign or domestic.

Foreign Investment

As a topic, foreign investment falls into a category of its own for two reasons. First, the issues pertaining to foreign investment are identical to those surrounding domestic investment and therefore the topic does not fall neatly under any one category. All of the issues discussed above apply equally whether the private sector is foreign or domestically based. To the extent that business laws and regulations provide necessary conditions to encourage productive domestic investment, they will encourage foreign investment as well. The distinction drawn is notably a hollow one.

Many developing countries, however, have treated foreign investment as a very separate dynamic in economic development and, in many cases, have created a parallel legal regime pertaining to foreign investment alone, effectively subverting domestic regulation in order to attract or control investment from abroad. The second reason for separate discussion of foreign investment lies, therefore, in the fact that continued institutional barriers often favor either foreign or domestic investment.

The climate for foreign investment is a function of many different factors including patterns of past foreign investment, political and economic conditions and laws and regulations governing investment by entities which are headquartered outside national boundaries or which are wholly or partially owned by non-nationals. Ideally, these factors are mutually reinforcing. However, in developing countries, this is frequently not the case. If economic conditions--in sub-Saharan Africa's case, a comparative advantage in labor-intensive products--prove attractive to foreign investors, political conditions may deter them. Likewise, if a number of special incentives have been created in order to attract investment in a particular sector or zone, but the return on past investment has been poor, then these incentives may not be sufficient to overcome the resulting uncertainty.

This study is concerned especially with the rules that apply to investment by foreign concerns. Clearly, certain restrictions on foreign investment are justifiable for reasons of national security, national sovereignty, and efficiency, including defense, utilities, and transportation infrastructure (e.g. ports). The baseline against which a country's foreign investment regulations is measured is the minimum required for the protection of national security interests.[34] Other restrictions, be they sectoral, quantitative or procedural, may impede the establishment of joint ventures and other types of partnerships that could have a strong beneficial impact on the national economy. Even where a country interested in promoting nontraditional export growth removes legal barriers to certain industries or sectors, the potential for <u>unforeseen</u> export growth in other sectors makes it highly desirable to avoid such barriers wherever possible.

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[34] This kind of baseline necessarily requires a qualitative judgement, but one that is informed by international convention. Utilities, for example, are commonly best managed as public, regulated monopolies (given the alternatives) whereas the history of Central Europe and the nations of the former Soviet Union indicate that industrial manufacturing concerns are more efficient if managed privately.

Restrictions. Restrictions on foreign investment in certain sectors can severely limit the ability of potential exporters to operate in the international market. For example, limitations on the ability of foreign financial institutions to participate fully in the economy could preclude the ability of a firm to obtain insurance or loan guarantees with the full backing of a foreign corporation, unnecessarily limiting export volume. Where non-financial services are reserved for ownership and operation by nationals, this restricts competition and the development of an international standard against which national firms can compete effectively in both the domestic and international markets.

Licensing and/or public agency approvals of certain kinds of equity holdings by foreigners may also impede efficient business practice if the approvals are granted on a discretionary or less than transparent basis. In addition to creating incentives for rent-seeking behavior on the part of public officials, such approval processes run the risk of deterring those investors who fear license or approval revocation. For example, in Chad, the approval processes for qualification for benefits under the Investment Code (for domestic as well as foreign businesses) involve an *agrément* between the state and the firm according to whether the firm falls into one of four categories, and meets various conditions under each one. The standards are judged to be prejudicial and unduly burdensome for small and medium-sized enterprises.[35]

Another common focus of foreign investment law sets minimum limits on the amount of equity that can be held by non-nationals. In general, international standards should apply and should balance security interests with economic interests. In those industries that could clearly benefit from foreign influence and equity capital but that traditionally have been treated as important to the national interest, some restriction on foreign ownership may be appropriate. Broadcasting is a good example. While many countries restrict the extent to which broadcasting companies can be controlled by non-nationals, some foreign investment for the purposes of acquiring technology or expertise may be in the interests of producers and consumers alike.

Incentives. More common than explicit restrictions are targeted incentives created by national laws in order to encourage foreign investment in certain industries or sectors. The potential effect of investment incentives must be measured not only in terms of the benefits accruing to specific those industries being encouraged but also to sectors or industries that may fall outside the purview of the investment incentive package but nevertheless hold strong potential benefits for local entrepreneurs as well as foreign investors. In general, a plethora of investment incentives implies *de facto* that exceptions must be made for a large number of restrictions. Dismantling the restrictions themselves can prove to be far more cost-effective and efficient than creating successive loopholes, since the complete removal of barriers intrinsically streamlines the investment process, reduces transaction costs for investors and opens export opportunities in sectors that might be profitable but were not previously eligible for special exemption.

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[35] Aucoin, 1992, pp. 55-56.

Incentives to foreign investment discussed here are exclusive of those explicitly related to trade through free trade zones, since they are discussed below, although many of the same principles and problems characterize both incentive regimes.

Fiscal incentives. Among the most prevalent type of incentives offered to foreign investors are tax holidays. Countries offer periods of forgiveness of corporate income tax or some other liability for some initial period in order to lure foreign investment, especially by multinational companies. Many of the incentive packages can backfire, however, in that they fail to act as an incentive and merely direct tax revenues into the treasuries of the companies' home governments. This occurs as a result of the concept of "global" income applied in some countries (France is a notable and relevant exception) to firms based within their borders but operating internationally. Such countries tax firms on all income earned everywhere, and taxes paid abroad may often be credited in full or in part against the home tax liability. When developing countries create tax holidays for companies based in such countries, the total tax liability of the corporation does not change, since the home tax liability increases accordingly. Tax holidays can therefore deflect revenue from the host state to foreign treasuries.

An additional potential problem with fiscal incentives to foreign investment is that countries often cannot afford to sustain them. Firms attracted to a given country set up local operations because the net present value of their investment is positive. Reduction of tax liability rarely tips the balance of the profitability equation, and yet the tax revenues from foreign companies, especially large multinationals, can represent a significant share of a government budget. Foregoing that revenue may be impossible in light of the extra government services required to support incoming business.

When is a tax incentive appropriate? Clearly many tax benefits are cost-effective for national governments to offer, but to be cost-effective they must capitalize on a country's comparative advantage within and across sectors and prove to be at least revenue neutral in balancing additional costs with foregone taxes. In general, the less discretionary and the more broadly applicable a fiscal incentive is to potential investors, the more effective it will be in attracting investors seeking to place capital in foreign production and services.

Remittances. A major concern for foreign investors is the extent to which profits may be repatriated. While many countries place restrictions on capital movements, exceptions are often made in the case of corporate profits in order to attract foreign investment. Quite apart from complications involved in trading of foreign exchange, businesses and individuals may be required to pay unusually high withholding taxes on dividends and other profit distributions. To the extent that a country's rules applicable to repatriation of business profits and investment income reduce the comparative advantage of doing business within its borders, potential investors will seek to invest elsewhere.

"One stop shop." Many countries are attempting to overcome the complexities of foreign investment by creating a single window for investment information and approvals from national governments. Designed to reduce transaction costs for investors (both foreign and domestic), the single window concept provides efficient access to the relevant laws and

regulations. Admittedly, the concentration of services, in the worst-case scenario, can threaten to compound the costs and bureaucratic delays associated with investment, especially if one agency is given discretionary power over an investment approval process. However, in most cases, the single windows are limited to providing information and guidance and can serve to expedite foreign direct investment considerably.

Investment treaties. Another potentially useful device is the BIT (bilateral investment treaty). Such treaties most often seek to streamline regulation and tax liability on companies and individuals investing between two countries through negotiation of reciprocal treatment. The advantage of such treaties is that they can be used to formalize a traditional (or growing) trade relationship and strengthen political and economic ties, thereby benefiting both signatories. When BITs are formed in order to exclude third parties, however, or meet politically driven goals, or when they coalesce in conflict with existing multilateral obligations for one or both parties, they can contribute significantly to a climate of uncertainty for emerging export-oriented businesses.

Branches and subsidiaries of foreign companies. Many countries distinguish among domestic companies, branches of foreign companies (wholly owned abroad) and subsidiaries of foreign companies owned in part or totally by nationals. Given the importance of interaction with foreign catalysts of export industries, the extent to which these distinctions affect the costs of doing business can fundamentally alter the chances for successful export development.[36] In general, the less that national laws distinguish between domestic and foreign ownership, and the less that the activities of foreign partners are regulated, the more likely it is that foreign companies will invest in and support the development of nontraditional exports.

The following areas all constitute likely areas for study with respect to the treatment of branches and subsidiaries of foreign companies:

1. minimum requirements for proportion of domestic ownership;

2. approval process for the writing of contracts between foreign and domestic entities;

3. tax treatment;

4. profit repatriation to foreign headquarters;

5. minimum requirements with respect to use of local inputs;

6. minimum (or maximum) requirements with respect to proportion of production exported.

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[36] Rhee *et al.*, 1984; Rhee and Belot, 1990; World Bank and USAID, 1991.

In each of these areas, national laws can inhibit the involvement of foreign companies and generate disincentives for the establishment of foreign/domestic relationships. In some of these areas, the tradition among especially sub-Saharan countries has been to seek legal means to limit foreign involvement in domestic affairs. This has been especially true with respect to foreign ownership of domestic industry and profit repatriation by a subsidiary or branch of a foreign company.

Expropriation. One special issue deserves mention which falls outside the realm of regulation and more in the area of past investment history mentioned above as a factor determining foreign investment. The history of many developing countries both within and outside of Africa has included the successful courting of foreign direct investment only to be followed by a change in ideology or power and the "nationalization" of private property. As a concern of investors, the possibility of expropriation falls outside of the realm of property rights since a single decree or *arrêté* can supersede all existing laws and regulations. While the right of the state to seize property within its borders may be permissible constitutionally (under a proclaimed state of emergency, for example, or for purposes of national security), the fact is that property has been seized in several countries of Africa, Asia and Latin America on the basis of a change in regime and the suspension of the constitution rather than through due process.

Clearly, the possibility of expropriation is a significant deterrent to foreign investment. A history of expropriation or constitutional provisions defining the terms for expropriation should be examined carefully for the possible impact on future investment. Assurances of compensation that is "just" (e.g. market value) or other measures (such as a bilateral investment treaty) to minimize the uncertainty in this regard may be an essential component to a successful investment incentive package.

Business Regulation Pertaining to Public/Private Sector Interface

Taxation[37]

For the purposes of examining institutional constraints to nontraditional export growth, taxation shall be considered in terms both of potential undertaxation and overtaxation, both of which distort the costs of business and engender inefficiency. Therefore, the tax (and subsidy) regime and its effects will be measured by the extent to which it alters the costs of doing business for an exporting firm as compared to the firm's international competition.

Governments seek revenue at any number of points along the chain of export production and processing. Taxes may be levied on inputs, semi-finished and finished products leaving the factory, transportation, shipping inventories, at the border or exclusively on income of shareholders. The combination of potential tax liabilities and their cumulative financial impact constitutes an important part of the total incentive package that exporters face. The choice

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[37] "Taxation" here includes all of the taxes and subsidies which the private sector faces. Import and export tariffs, as a special subset of taxation, are considered separately below under the category of international trade.

among levies by government policymakers can also have a direct impact on the propensity of the private sector to export. Even among those countries that have liberalized their tariff regimes, many have yet to determine the optimal form of taxation in terms either of revenue generation or of export development.

We shall assume that some form of taxation is appropriate to underwrite the provision of fundamental government services to the private sector, including development of transportation infrastructure, provision of utilities, supplying of market information, etc. If that is the case, then the goal of tax policy should be to minimize the marginal cost to the private sector of generating a given amount of revenue for the provision of those services. The general trend is to consider a value-added tax (VAT) the most efficient in these terms. Levied on a standard *ad valorem*, or percentage, basis, the VAT serves as a simple, straightforward method of generating revenue without creating a disincentive to produce or export. Other forms of taxation on corporate income or investment, for example, tend to be less effective. Not only do such taxes generate a small share of additional revenue but they also create incentives to hide financial flows and can tip the scale against an economically optimal mix of factors of production.

Equally important are 1) the collection rate and 2) the extent of tax holidays awarded to certain firms or sectors. If actual collection of corporate taxes occurs at a relatively low rate, it is important to investigate the reasons. Whether the source of a poor collection rate is lack of public resources for tax collection or evasion by liable firms says a great deal about the nature of tax enforcement and the incentives for new business entrants to operate along standard legal terms. Likewise, if competing firms receive some sort of tax holiday on the basis of what they produce or where they produce it or who they are, it is essential for the government to reveal the nature and rationale of these exceptions or risk losing new entrants.

International trade

By definition, the countries considered good candidates for an examination of the institutional constraints to nontraditional export growth have undertaken structural adjustment. Often the economic reform process includes reduction or elimination of explicit trade barriers including tariffs and quantitative restrictions on imports and exports. However, since the focus of this reform is also often on the traditional trading sectors and may be limited initially to certain commodities and industries, barriers linger that impede especially the ability of entrepreneurs to develop new tradeables.

Baseline. The baseline for measuring the impact of the remaining tariff regime is the same international agreements pertaining to trade that determine the international standards in other legal areas, including those falling under the auspices of GATT, the Lomé Conventions, and other regional conventions to which specific countries are signatories.

Tariffs. Despite the fact that many countries have successfully converted quantitative restrictions into tariffs, many trade distortions still remain. The levels of tariffs are key to

determining incentives facing exporters as well as importers. First, tariffs paid on imported inputs raise an exporter's cost relative to the cost of overseas competitors. Second, tariff protection of import-competing industries attracts labor, capital and other resources to those industries, increasing the cost of these resources to the exporter. Finally, import tariffs and quantitative restrictions result in an overvalued exchange rate that penalizes the exporter in relation to the nontradable goods sector. Where export taxes exist, of course, they also act as a disincentive for exports.

In order to promote exports or production of certain products, many governments have instituted drawback or exemption schemes. Typically, these allow producers meeting certain criteria to apply for reimbursement of tariffs paid on exports or imported inputs (drawback), or permit the producer to be exempted from certain tariff liabilities altogether. The potential problem with drawbacks and exemptions lies both in the criteria required to qualify for special treatment and in the fair and even application of those criteria to all qualifying firms. If the criteria are too narrow, too industry-specific or exclude certain sectors or commodities from taking advantage of the incentives, potential exporters could be hurt. Likewise, if the criteria are broad but unevenly applied, awarded discretionarily to certain producers and not others without clear differences, or require lengthy and complicated bureaucratic procedures, they prevent the incentives from accomplishing their intended goal.

Another problem arises when imported inputs are not used directly by the exporting firm but in the production of an intermediate good that is supplied to that firm. Ideally, duty drawback and exemption schemes should apply to imported inputs that are used either directly or indirectly in the production of goods to be exported, In fact, the record-keeping and efficient administration required for these incentives to apply to indirect imported inputs are usually too great to allow them to be offered in most African countries.

The administration of tariff regimes may also constitute a net incentive or disincentive to do business for potential exporters. When the method of classification of products subject to tariffs, in itself, is not in accord with international convention, transaction costs increase for potential exporters who must then reconcile and decipher conflicts of interpretation.

Another common administrative pitfall occurs in valuation of products. One valuation issue lies in whether a tariff is calculated on an absolute or *ad valorem* basis. The latter is clearly the standard in international transactions since it does not distort incentives among producers of competitive products. Additionally, there are frequently disparities even within countries with respect to the determination of the base value of a product for tariff purposes. Many trading countries ascribe to the Brussels Definition of Value, which seeks to value products at the price they would command under perfectly competitive market conditions. Since objective market information is far from perfect for officials and producers alike in developing regions, adopting this standard can prove to be burdensome. National and regional trading associations can play an important role in creating and maintaining data banks for this purpose.

While reference has been made to the importance of maximizing the efficiency of whatever customs procedures are in place, a significant lack of administrative resources often

prevents customs officials from performing their appointed tasks. Adequate inspection and duty collection is essential in order to avoid incentives for rent-seeking both by officials and individuals in the private sector. Standard lengthy delays, unclear regulations, untrained personnel, lack of communications equipment and general inefficiency can negate the potential benefits of the most open customs regime, compounding the constraints to export growth.

Quantitative and qualitative restrictions. Both quantitative and qualitative restrictions can potentially affect the profitability and incentive structure of export producers. While many countries have dissembled quantitative restrictions on trade, including licensing procedures, prohibitions and quotas because of the market distortions which result, qualitative restrictions are often sought out as a method of ensuring marketability and building a national reputation.

The persistence of quotas on imports and exports results in the same type of inefficiencies and distortions as tariffs. Quotas generate an additional disincentive for potential exporters in that licenses to import or export are distributed, often free of charge, to a limited number of businesses. The result is that rents are direct, in the form of additional profits to those who obtain necessary licensing for key inputs, or access to export shares. The extent to which lingering quantitative restrictions on both imports and exports create an unfair playing field must be measured in terms of their cost to new market entrants.

Product standards are one form of qualitative restriction that prove to be more controversial. The desirability of such restrictions depends in large part on their purpose. For example, prohibitions on the export of certain unprocessed foods for reasons of meeting minimum international standards of health and sanitation are clearly desirable for reasons of marketability. A national legal authority may justifiably impose restrictions in order to build and protect the reputation of an exporting country in the marketplace, especially of that country is not known as an exporter of a given product. Fruit exporters in Chile felt the impact for years of a fatal prank in the mid-1980s which tainted a few Chilean grapes consumed abroad. Not only was the market for grapes affected, but all Chilean fruit became suspect for some consumers fearful that quality standards in Chile were routinely unenforced. A good argument can be made not only for qualitative restrictions in terms of health and sanitation but also in terms of maximizing value added for any export. One potentially useful role for national governments is in not only ensuring that health and safety standards are met but also in distributing market information on quality standards in target market regions of the world and the effect of those standards on the price those products command. Standards may, on the other hand, be unnecessarily restrictive and fail to allow for substantial quality variation among overseas markets.

Product standards that are not market-driven can also prove to be detrimental. Countries sometimes impose restraints on certain types of exports to retain a given share for domestic consumption, or to assist in the propping up of a national cartel or trading association. In general, such laws unnecessarily distort the market and discourage export growth. To differentiate between potentially positive and negative qualitative restrictions, it is necessary to examine the requirements and benefits of membership in trading associations and whether their formal ties to government afford them any unfair advantage. It is ironic that public marketing

boards and parastatals are often considered to be inefficient while trading associations, which have the potential to prolong many of the same inefficiencies, are being heralded as critical to effective marketing abroad. Questions should be posed concerning the openness of membership, the access to concessionary financing or foreign exchange afforded to members, the types of overhead costs reduced through the association and the freedom of information provided.

Finally, many of the same constraints arising from tariff administration can arise from administration of quantitative and qualitative restrictions on trade. Problems pursuant to methods of product classification, to procedural inefficiency, discretionary authority and potential rent-seeking all pertain to trade regimes reliant on quotas, prohibitions and licensing.

Free trade zones. In order to promote exports, many countries have instituted free trade zones (FTZs). Incentives for export production within a FTZ can include avoidance of import and export duties, access to licensing and concessional financing, access to global market information and contact with foreign partners, all of which have proven to be key factors in successful export promotion schemes in the past.[38]

Given that in a perfectly free market, an entire country (indeed the whole world) would constitute an FTZ, it is important to note that the relative success of an FTZ in changing trade patterns and increasing profits is, first and foremost, a measure of the prevailing distortion in the larger economy. Nevertheless, many of the incentives created under the rubric of the FTZ represent strong and positive steps toward real economic growth.

The administration of FTZs can be fraught with the same dangers as administration of a customs regime. Preferential treatment for approvals, lack of training of the managers of the Zone and incentives for rent-seeking all may result. However, many of the administrative problems can be avoided if the criteria for operating within an FTZ are clear and fair.

Bonding is an administrative device common to export promotion in general and FTZs in particular. Bonding refers to the guaranteeing that a certain stock of goods is destined for export or as an input into the production of exports, and therefore qualifies for reduced taxation or total exemption from import or export duties. Legislation defining bonding procedures can stipulate that individual factories, warehouses, or other industrial sites are bonded, meaning that a bank and/or some other guarantor is prepared to provide proof that inventories of inputs or finished goods do meet the required specifications for duty exemption and, further, that back-up information concerning volume and value of inventories may be furnished to customs inspectors. The ultimate goal of bonding is the reduction of transaction costs through the streamlining of procedures concerning the flow of certain types of goods. Bonding systems that work well frequently require minimal paperwork and expedite the shipment of all relevant goods and information. Problems can arise even in the most successful of bonding systems, however. In Mauritius, for example, bonded factories and warehouses are classified as such explicitly to support export promotion and they work well. However, since the export processing zone that defines the terms of bonding is not geographically based, bonded factories are located throughout

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[38] Rhee *et al.*, 1984; Rhee and Belot, 1990; World Bank and USAID, 1991.

the country. They have had a difficult time taking advantage of adjacent domestic supply sources since the law does not provide for tax-free treatment of indirect inputs into the production of exports.[39]

Another potential problem relative to FTZs is the extent to which they actually differentiate between companies that meet certain criteria and those that do not. For example, the *arrêté* that created the free industrial zone in Madagascar (arrêté no. 2161/90) does not indicate whether investments pursuant to restructuring of a public enterprise qualify under the investment code for preferential treatment.[40]

Exchange controls. The process of structural adjustment often includes the devaluation of the local currency to more accurately approximate its actual market value. The extent of exchange controls depends on the nature of the currency valuation regime, i.e. whether exchange rates are fixed or floating and whether they are pegged to a single currency, to a basket of currencies or to another numeraire such as ECUs (European currency units) or SDRs (Special Drawing Rights of the IMF).

Most countries have monetary control over the creation and valuation of a national currency that is unique.[41] Bearing in mind that the entire national economy is potentially affected by an alteration in the exchange regime, a study of the constraints to nontraditional exports would be remiss if it did not include evaluation of the costs associated with continued exchange controls.

Retention. In order to control the value of a currency, central banks frequently retain all foreign exchange and issue lines of credit to individual firms. Payments due in foreign exchange are made directly from the central bank, which can then control not only official reserves but also all (or most) of the convertible currencies within national borders. If the central bank maintains a realistic (i.e. market-equivalent) value of the local currency through some other mechanism, such as a limited auction, then additional retention of foreign exchange is unnecessary and, in fact, distorting to the functioning of the currency market. The qualifications necessary to gain access to foreign exchange auctions, or any other allocation mechanism, may unreasonably discriminate against firms of a certain size or complexity, rendering them bankrupt when it comes to dealing with customers and suppliers in the international marketplace.

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[39] World Bank. *Mauritius: Expanding Horizons*. A World Bank Country Study. Washington D.C., 1992. p. 37.

[40] Brief 8/90, p. 8.

[41] CFA countries constitute a special, but very important, example of the potential constraints on a nation's ability to change exchange controls. Since several African nations participate in the CFA zone, and since the CFA is pegged to the French franc, no one country has the power to alter the exchange controls without permission of the other members.

Most developing countries do not have freely convertible currencies, preferring to exercise their rights to maintain Article XIV status under the Articles of Agreement of the International Monetary Fund, which permits member countries to maintain exchange restrictions during "transitional" periods of economic difficulty.[42] Since foreign exchange controls are often linked to general monetary control within the economy, in an effort to control credit and inflation, the allocation of foreign exchange often becomes a direct function of general monetary policy. The advent of more indirect controls over the money supply can distance the interdependence of money creation and foreign exchange allocation, through such mechanisms as sterilization--using open market operations to offset changes in the money supply resulting from foreign exchange transactions.

As with other areas of the legal regime facing exporters, the unbiased and transparent administration of foreign exchange laws is critical to efficiency and growth. Any unequal treatment increases uncertainty and the implicit transaction costs for businesses.

Legal infrastructure underlying business regulation

Just as an independent judiciary is required to support the existence of a legal system based on property rights, contracts, and torts, so is a human and systemic legal infrastructure required to maintain a viable system of business regulation. Often, however, the legal infrastructure suffers from problems inherent in the profession in developing countries as well as confusion concerning the efficacy of the written law itself.

Problems in the legal profession. Many developing countries suffer from three basic problems in the legal profession: a dearth of lawyers to represent the private sector, an underpaid bank of judges, and a broad fear of repression by government authorities within the profession. These three problems, whether they exist simultaneously or in isolation, contribute to the inability of the legal system to operate fully, fairly, and transparently. Too few lawyers means that those who do practice can charge exorbitant rates for their services and service only those clients who can afford them. Underpaid judges lead to great incentives for corruption. Fear of repression leads to breakdown of the very rule of law. All of these problems are exacerbated by a lack of training and professionalism within parts of the legal profession.

Conflict between written law and customary law. While such conflict is certainly not limited to developing countries, the disparities between written and customary law in Africa and other developing regions are often extreme. Boundaries imposed by former colonial powers without regard to existing patterns of culture and ethnicity mean that many nation states today are characterized by more than one dominant language and cultural tradition, many of which are not written. The result is that what written law exists often codifies rules, customs, and behavioral patterns far more suited to European than local tradition. Indeed, due to poor transportation and communication infrastructure, large proportions of the population of a given country may be living under the jurisdiction of a body of written law of which they are totally

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[42] IMF Articles of Agreement, XIV (2).

ignorant. In such cases, customary law necessarily supersedes the written law, insofar as the written law is rendered functionally irrelevant.

Because of the colonial histories of most countries in sub-Saharan Africa, the concept in Western societies of law evolving naturally in response to the need to organize human interaction simply does not apply. The disparities between customary law and national and international written law are crucial to understanding the barriers to nontraditional export growth when the rules of the game governing domestic production and commerce differ markedly from international norms.

French commercial tribunal. The commercial tribunal is a uniquely French vehicle which exists in many francophone countries and has no Anglo-Saxon equivalent. The tribunal is a form of court, officially operative as an institution of the judiciary, but composed of a combination of jurists and lay people with experience in commerce and industry. The tribunal adjudicates only disputes that pertain to commerce and industry and that arise between private parties. The tribunal relies heavily on arbitration and mediation in handing down its decisions.

Predictability and transparency. Whatever laws and regulations exist must be published and accessible. Too often, businesses and individuals are held accountable by enforcement agents for laws and regulations of which there is no public knowledge or, worse, that do not exist. Inversely, certain individuals or companies may be granted special favors by public authorities in the form of exclusion from a law or regulation, permitting them to conduct business at a relative advantage compared to their competition. Either phenomenon represents a barrier to predictability and transparency of the business regulation regime, and ultimately increases uncertainty and stifles growth throughout the private sector.

Private Institutions That Reduce Transaction Costs

Banks

Baseline. Since exporters need to be able to operate on a level playing field with international competitors, the baseline for bank lending will be defined by internationally accepted practice with respect to 1) range of credit instruments, 2) credit controls, 3) interest rates, 4) procedures of obtaining credit, 5) collateral and 6) procedures pursuant to foreclosure, bankruptcy or credit contract enforcement.

Credit instruments. The range of credit instruments available to exporters is not only an indication of reform within the financial sector and transition to a market economy. The range of credit options also serves as a measure of how well positioned potential exporters will be to compete in the international market, where it is assumed that credit constraints are driven by economics rather than politics or underdevelopment of the financial sector. In sub-Saharan African countries, especially, where credit markets remain largely undeveloped, constraints to nontraditional exports frequently lie in bank lending practices.

Rhee has identified the domestic letter of credit (L/C) as crucial to Korea's export growth.[43] Guaranteed lines of credit, issued by a domestic bank and backed by a customer order, guarantee equal access to credit for all exporting firms and producers of potential exports. Rhee credits this credit innovation, developed in Korea, as a crucial source of incentives for small producers to tailor their manufacturing processes for export and invest in order to meet an international quality standard.[44] A survey of African firms specializing in manufacturing for export noted that access to adequate financing is a major concern in many countries (although not as important as lack of capacity to export, government failure to implement export policy effectively and poor infrastructure).[45]

The availability of L/Cs (or L/C equivalents), the extent of a discount market, and the procedures required in order to qualify for automatic credit options will be a focus of study. While most countries in sub-Saharan Africa rely on overdraft facilities or self-financing for export credit purposes, examples of more "modern" instruments do exist. Pre-shipment export finance guarantees (PEFGs) and export credit insurance/guarantees (ECI/Gs) are in use in Nigeria and Uganda, as are rediscount facilities for pre-shipment and (short-term) post-shipment credit for nontraditional exporters.[46] Since reform and privatization of the financial sector often has been a part of more general policy reform in many countries undergoing structural adjustment, such instruments are being introduced, albeit slowly, as part of the credit package available to private exporters in Africa.

Interest rates. The choice of entrepreneurs to invest depends in large part on the prevailing interest rate. Disincentives to invest arise when information concerning interest rates is not immediately available, when banks are perceived as large profit-takers (often possible through the maintenance of a wide margin), or when nominal interest rates are determined differentially across sectors or without regard to inflation. Many firms may be forced to seek credit in the informal sector at much higher nominal rates. How interest rates are set by commercial banks often is a function of the nature of monetary control. In general, the more competitive the financial sector is with respect to the business of lending, the more transparent will be the market, the lower will be margins, and the more market-driven will be interest rates. How the interest rate regime distinguishes between short- and long-term lending also deserves research, since distortions can arise if the differential rates are not market-driven.

Collateral. Requirements governing the use of collateral can also prove to be problematic if the procedure of transferring a secured interest in inventories or capital equipment is not clear legally. Disincentives to borrow may also exist if the rights of creditors and debtors over collateralized property are not clearly delineated in legal, contractual terms or if creditors

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[43] Rhee, 1984.

[44] Ibid., p. 13.

[45] World Bank and USAID, 1991, pp. 51-54.

[46] Rhee, 1991, p. 94.

are viewed as having an inherent advantage in legal terms (see discussion of property rights above).

Banks and other commercial lenders may likewise have a disincentive to lend if the requirements regarding collateral are too loose. Especially in countries where competition exists for the provision of financial services, the security of collateral must replace other means of ensuring returns on loans when lending margins are slim.

Securities markets

Another method for potential exporters to generate working capital is through securities markets. While there are no developed markets for stocks (and bonds) in many sub-Saharan African countries, they do exist in some (Côte d'Ivoire, for example, opened a stock exchange in Abidjan in 1990-91, the first exchange in sub-Saharan Africa outside of South Africa). The extent to which smaller companies, especially, can gain access to this type of financing can determine the success of export ventures.

As a rule, countries in which the banking sector is not market driven will tend to lack secondary and even primary securities markets. Markets are just beginning to emerge even for government securities.[47] Moreover, a large public sector borrowing requirement (PSBR) in many countries tends to crowd out other types of financing including securities financing within the private sector. Consequently, markets for private securities are embryonic at best and may occur only in the informal sector in the guise of (legally) unsecured interests in future profits of particular firms. Before markets for securities can emerge in many countries, the legal regime governing the establishment of private business--the right to incorporate, to issue shares, to make and retain profits, to gain access to foreign markets in the first place--must be clarified.

Service companies

Finally, in many countries, special regulations apply to specific industries that service the private sector. In most industrial countries, for example, a particular body of regulation is geared toward the financial sector and all of the trading companies and brokerage houses that operate within it. In the U.S., The Securities and Exchange Commission (SEC) is charged with administering this body of law. Likewise, the insurance industry in many countries is regulated in terms of allowable margins, rate increases, and other issues with a broad social dimension.

While such companies and industries may be developed only in a limited fashion in the developing countries of sub-Saharan Africa, the regulation or lack thereof pertaining to such issues as insider trading or insurance rate gouging can have a profound effect on the efficiency of the private sector. The government has a role to play in regulating the business practices of

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[47] Duesenberry and McPherson, 1991.

such service companies and the extent to which the State overplays or underplays this role falls within the purview of this methodology as well.

COSTS ASSOCIATED WITH INSTITUTIONAL CONSTRAINTS

In this section the methodology for measuring costs associated with institutional constraints is described in detail, using specific examples of problems outlined in the previous section. Although the procedural approach to cost estimation is general in scope, the specific measurement techniques employed differ by constraint, depending on the type of costs incurred.

Identification of Potential Export Industries

The first step involves the identification of potential export industries in agriculture and manufacturing on the basis of one or more of the following criteria:

1. current level of exports;
2. historical level of exports;
3. intensive use made of locally produced raw materials;
4. intensive use made of unskilled labor;
5. agricultural crop produced in an ecological area that is particularly favorable.

The list should be based on experience in other countries as well as in the country being studied.

Verification of the Potential Profitability of Exports

In order to verify the potential profitability of exports, comparative cost and incentive indicators are calculated assuming that the product is exported. The comparative cost indicator is the domestic resource cost (DRC); the comparative incentive indicators are the effective protection coefficient (EPC) and the effective subsidy coefficient (ESC).

Domestic resource cost

The domestic resource cost (DRC) is an indicator of the efficiency with which a country's factors of production are converted into a product. More precisely, the DRC for a given economic activity is the ratio of the social opportunity cost of the domestic nontradable resources used in the production of tradable output j to the value added that is created by this activity,

where that value added is measured in world market prices, assumed to equal the shadow prices or social opportunity costs of tradable goods. An economic activity is defined in terms of a given product, technique and location of initial production, technique and location of subsequent processing, marketing channel, and location of final sale at the wholesale level.

$$DRC_j = \sum \frac{f_{sj}P_s^*}{P_j^* - \sum a_{ij}P_i^*} \tag{1}$$

where f_{sj} is a technical coefficient relating nontradable primary factor s (land, labor, capital) to output j,

a_{ij} is a technical coefficient relating tradable intermediate input i to tradable output j,

P_s^* is the social opportunity cost of factor s,

P_j^* is the world market price of output j,

P_i^* is the world market price of input i.

If there are intermediate inputs that are nontradable, these are broken down into their tradable intermediate input and nontradable primary factor components. The numerator of the DRC given in equation (1) thus represents the opportunity cost of all nontradable primary factors employed both directly in the production of output j and indirectly in the production of inputs used in the production of j. Similarly, the denominator equals the value of output less the value of direct and indirect tradable inputs, each measured at their opportunity cost in terms of world market prices.

The distinction between tradables and nontradables is critical to the analysis insofar as the exchange rate is concerned. Both numerator and denominator of the DRC are given in the same currency by multiplying the latter by the social opportunity cost of foreign exchange, or the shadow exchange rate, which expresses the marginally efficient rate at which nontradable primary factors of production may be transformed into tradable value added. Once this is done, the numerator and denominator of the DRC may be compared to see whether activity j is more or less efficient than the activity that, at the margin, is just efficient. If the DRC is less than one, the domestic resource cost per unit of value added is less for activity j than for the marginally efficient activity, so the country has a comparative advantage in activity j. If the DRC is greater than one, the opposite is true and the country does not have a comparative advantage.

An alternative to the DRC measure is net social profitability (NSP), obtained by subtracting the numerator from the denominator of equation (1).

$$NSP_j = P_j^* - \sum a_{ij}P_i^* - \sum f_{sj}P_s^* \tag{2}$$

If NSP>0 (DRC<1), then the country realizes a net gain from this activity; if NSP<0 (DRC>1), the country realizes a loss. The NSP indicator is expressed in units of output, which prevents comparisons being made of the relative profitability of activities involving different products. The DRC is a ratio, on the other hand, which expresses the amount of gain that can be achieved per unit of scarce domestic resources. With the DRC, therefore, different activities can be compared. The lower the DRC, the more efficient is the activity that it measures.

Nominal and effective protection

While the DRC indicator is related to the theory of comparative advantage, nominal and effective protection refer to the structure of incentives involving international trade (import duties, export taxes, quantitative restrictions on imports, etc.). Nominal protection may be measured either as the nominal protection coefficient (NPC = P_j/P_j^*) or as the nominal rate of protection (NRP = NPC - 1), where P_j is the domestic price of output j. These indicators measure the degree to which consumers are either taxed or subsidized by trade policy. If the NPC is greater than one (NRP>0), they are being taxed because they are paying prices that are higher than those paid on the world market; if the NPC is less than one (NRP<0), they are being subsidized vis-à-vis the world market.

Effective protection measures incentives that affect the prices of both outputs and tradable inputs; it is therefore a better indicator of protection offered to producers. The effective protection coefficient (EPC), which measures value added in domestic prices relative to value added in world prices, is given by equation (3). The effective rate of protection is obtained from this by subtracting one (ERP = EPC - 1). If the EPC is greater than one (ERP>0), producers

$$EPC_j = \frac{P_j - \sum a_{ij}P_i}{P_j^* - \sum a_{ij}P_i^*} \tag{3}$$

receive positive incentives vis-à-vis the world market; if EPC<1 (ERP<0), producers receive negative protection, i.e., the structure of tariffs and other trade distortions places producers at a comparative disadvantage in world markets. The denominator of the EPC is the same as that of the DRC if each is measured at the shadow rate of exchange. This is the measure of equation (3) that is assumed here.

Effective subsidy coefficient

The numerator of the EPC shows the scope allowed by world prices and trade distortions for some combination of domestic resource costs, monopoly profits, externalities, economic rents on fixed factors of production, and distortions in the prices of nontradable factors of production resulting from taxes and subsidies on these factors. The numerator of the DRC, on the other hand, consists only of domestic resource costs. The EPC thus indicates the potential for incurring domestic resource costs, whereas the DRC measures the degree to which these costs are actually incurred. The numerator of the EPC can be adjusted for taxes and subsidies on

nontradable factors of production. The resulting indicator, known as the effective subsidy coefficient (ESC), is shown in equation (4).

$$ESC_j = \frac{P_j - \sum t_{sj} f_{sj} - \sum a_{ij} P_i}{P_j^* - \sum a_{ij} P_i^*} \tag{4}$$

where t_{sj} is the net tax (negative if a net subsidy) imposed on each domestic factor used in producing output j. In the absence of monopoly profits, externalities, and economic rents, the ESC will equal the DRC.

Integrated Model for Policy Analysis Computer Template

The Integrated Model for Policy Analysis Computer Template (IMPACT), which has been developed by AIRD as a standard tool for conducting DRC/NPC/EPC/ESC analysis, is used to calculate these indicators for the different products selected as having an export potential. This template greatly facilitates sensitivity analysis on different parameters such as the shadow exchange rate, world market prices, and transportation costs. It also substantially lessens the time and effort required to set up the original models.

Identification of Current Export Constraints and Their Effects

Despite instances in which many African countries had a comparative advantage in exporting certain products, these exports were severely constrained for many years by a distorted policy environment. These policy distortions included overvalued exchange rates, import taxes and quotas, and taxes and marketing board profits assessed on exports. The effect of these distortions in biasing the allocation of resources away from exports was twofold. First, the overvalued exchange rate penalized production of exports vis-à-vis nontradables. Second, the effect of trade taxes and quotas and of marketing board profits was to favor the import-competing sector relative to the export sector.

Most of these biases have disappeared or at least been decreased, in the process of structural adjustment, through devaluation and the elimination or reduction of import tariffs and quotas, export taxes, and marketing board profits. Thus domestic prices in most countries today reflect relatively well the structure of world prices. Yet growth of exports is still limited by a number of other constraints. Among these are inadequate infrastructure, lack of information, and weak institutions linking the public and private sectors. Although this paper is concerned principally with the last of these constraints, a short discussion of the others helps to place the institutional side in perspective.

Infrastructure

Among the first constraints to appear after major price distortions have been corrected are those involving infrastructure. Frequently, the road network is inadequate and in very bad condition. Port and airport facilities are too limited to handle substantial volumes of external trade. Telecommunications, which are essential to link suppliers with overseas markets and to assure timely delivery, are very weak and unreliable. The same may be said of essential utilities, such as delivery of power and water.

The effect of these constraints is to add substantially to export costs, to increase the uncertainty of timely delivery, and to limit the ability of local producers and traders to establish and maintain linkages with overseas markets. This has an effect similar to that of trade taxes or an overvalued exchange rate in that it protects production for the local market and reduces the profitability of exports. Yet the DRC analysis treats these as costs rather than as protective policies that influence incentives.[48]

The reasons for this are clear. Poor transportation infrastructure adds substantially to the cost of delivering products from the farm or plant to the buyer. Investment in infrastructure leads to a reduction in these costs, which is treated as a benefit in conventional cost-benefit analysis used to determine whether this investment should be made. Since this investment is costly, however, the higher transportation rates that are charged in its absence should be treated as a real economic cost in the DRC analysis. Once the investment is made, these costs are reduced, but the resources used for this investment are in themselves a real cost. To the extent that the investment is profitable, however, there may be some scope for testing the sensitivity of the DRC results to a change in transportation costs, though allowance should be made for the investment as well as recurrent costs.

Information

Information may also be acquired by investing in research, extension, market networks, and other ways. This type of investment is critically important to the expansion of nontraditional exports because it helps to define the products to be exported, the production and processing techniques to be employed, and the market channels to be followed. Yet the costs of this type of investment are difficult to incorporate into any particular EP/DRC model because the investment is used to define the activities that are analyzed rather than to reduce the costs associated with existing activities. Once an activity has been defined with respect to product, technique, and location of production, processing, and marketing, EP/DRC analysis may be

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[48] In its analysis of regional specialization and agricultural growth in Madagascar, AIRD looks at transportation infrastructure in two ways in its EP/DRC analysis. First, it performs sensitivity analyses in which the cost of transport varies as a result of improvements in roads and port facilities. Second, it projects the volume of domestic and external trade, assuming rational exploitation of the pattern of comparative advantage, in relation to the capacity of roads and ports, in order to identify future bottlenecks. Stryker, Metzel, and Timmer, *Regional Specialization and Agricultural Growth in Madagascar.*

employed to see whether the activity is profitable. If it is not, the search for new activities must continue until profitable activities have been found.

The benefits from this type of investment result from the gains associated with reallocating resources away from unprofitable activities towards those that are more profitable. These gains may be estimated by aggregating the net social profitability of each activity multiplied by the level of that activity both before and after the investment in information has been made. This requires not only the results of the DRC analysis but also estimates of demand and supply functions for each product.[49]

Institutions

The focus of this study is on the legal, regulatory, and judicial institutions linking the public and private sectors, and on the ways in which these institutions act as a constraint on the growth of nontraditional exports. Of particular importance are ways in which this institutional environment provides for (1) provision of public goods, including attempts to attain objectives other than economic efficiency, (2) payment for these goods through taxation and other mechanisms, and (3) compliance with the rules required for providing and paying for public goods. Closely related to these goals is the concept of rent-seeking behavior undertaken by the private sector in response to action engendered by the government.

Provision of public goods. The principal, and most legitimate, role of government, according to most economists, is to provide public goods. These goods are defined as being (1) collectively consumed (i.e., marginal cost of an additional user equals zero) and (2) non-exclusive, i.e., excluding anyone from their consumption is impossible. The classic example is national defense, since collective consumption by some does not subtract from consumption by others, and there is no way to exclude some people if the rest of the population is already being protected.

Much of the legal, regulatory, and judicial environment involves the provision of public goods. The creation of a sound and secure business environment through a well-defined system of property rights, contract law, corporate law, and other elements, for example, benefits the entire population by creating conditions that are necessary for sustained economic growth. Other laws and regulations are designed to promote objectives other than economic efficiency, such as safety, equity, and national independence. Many of these laws and regulations are aimed at protecting particular segments of the population, such as labor. Nevertheless, these laws and regulations reflect the views of society as to what is just and proper, in addition to what is economically efficient, and they can thus be considered in a very broad way as producing public goods even if the entire population does not benefit.

Payment for public goods. The collective nature of public goods implies that decisions regarding payment for these goods cannot be left up to individual firms and households, which

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[49] In addition, the general equilibrium problems noted earlier would also apply.

have an incentive to become "free riders," benefiting from the goods along with everyone else regardless of whether or not they choose to pay for them. As a result, decisions regarding the provision of public goods, along with the obligation to pay for them, have to be made collectively. This normally involves involuntary taxation or some other mechanism for required payment.

Compliance. Closely related to the provision of and payment for public goods is the need for compliance. Laws and regulations regarding business, for example, need to be complied with if they are going to be effective. Assuring compliance requires legal, regulatory, and judicial mechanisms for dealing with those who fail to comply. In many cases in developing countries, these mechanisms are inadequate or too expensive, so that actual practice may differ substantially from what is on the books.

Rent-seeking behavior. Rent-seeking behavior occurs when the private sector responds to incentives offered by the public sector in ways that waste scarce resources, not by allocating them in ways that are inefficient, but by using them for "nonproductive" purposes. An example results from the establishment of an import quota, which pushes up the price of importable goods on the domestic market while importers continue to have access to imports at the world market price. As the quota premium, or "rent", earned on each imported good rises, importers are induced to compete with one another to obtain scarce import licenses. This competition can take the form of long hours spent waiting outside a government official's office, filling out mountains of paperwork, or other nonproductive activities. Most economists, however, do not extend the concept of rent-seeking behavior to include action, such as lobbying, that induces the government to restrict imports so that the importer might be able to benefit by obtaining a license. This action is instead thought to be a "productive" transaction cost associated with the making of public decisions. The distinction between nonproductive rent-seeking behavior and productive transactions costs, however, is not always clear.[50]

Traditionally, in economics, rent has been defined as the return to a given resource used in a particular activity which is in excess of the return that would be necessary in order to induce the use of the resource in that activity. Rent is often associated with land that has no opportunity cost in alternative uses. In fact, most resources earning rents do have some opportunity cost, but it is less than the return they earn in the rent-producing activity.

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[50] Gallagher defines rent-seeking as "the direct use or waste of economic resources for non-economic gains" (Mark Gallagher, *Rent-Seeking and Economic Growth in Africa*, Boulder: Westview, 1991, p.31). Clearly this can be a very broad definition, which depends critically on what is meant by "non-economic gains". The author goes on to infer that rent-seeking activity is directed towards capturing the scarcity premia that result from government regulation, taxation, and other activities, but he also suggests that it includes the lobbying that goes into influencing these activities, as well as non-governmental activities such as efforts by labor unions to transfer income from management and consumers. The problem with this definition is that it can be construed to include any human endeavor that uses scarce resources but does not involve the buying and selling of these resources in the market. Possible examples include political campaigning, waging war, and spending time on leisure activities. The definition offered here is much narrower.

The existence of rent leads to wasteful competition to capture it unless there are rules regarding access. One of the most important of these is that of private property, which allows the owner to appropriate the entire rent by excluding others from using the resource unless they pay the value of the rent to the owner. Where property is held in common and there are no rules governing access, competition leads to squandering of the rent. This problem is well recognized in the literature on natural resource management.

To the extent that the government creates public goods and the means to pay for them, it also creates rent-seeking opportunities, i.e., opportunities for the private sector to gain the rents that the government is trying to appropriate for the public. What matters is not that rent-seeking opportunities are created -- this is inevitable as long as public goods are being produced and paid for -- but that these rents be transferred to the public in as equitable and efficient manner as possible. As an example, it is generally believed that an import tariff is preferable to an import quota when the government deems it desirable to create a public good by protecting domestic industry against imports, because the tariff not only protects industry but also transfers resources from consumers to the government, rather than to importers who waste these resources as they compete to obtain them through rent-seeking behavior.

Effects of Institutional Constraints on Comparative Costs and Incentives

Earlier it was argued that infrastructural constraints generally operate to raise costs rather than to alter incentives. Investment in roads, ports, telecommunications, and other improvements can reduce these costs, if the investment is profitable, but the resources used for the investment will themselves be costly. Investment in information may also reduce costs, but it is probably better in the DRC/EP models to consider this investment as defining new activities.

Institutional constraints may be considered either as costs or incentives (or, more properly, disincentives), depending upon the feasibility of their being alleviated through policy reform. If the easing of an institutional constraint appears feasible, that constraint should be treated as an export disincentive; if it does not seem feasible, the constraint should be considered as a real cost. Long delays experienced in clearing imported inputs through customs, for example, are a disincentive to the production of exports rather than a real cost because the delays could be shortened relatively easily. As with other nontariff barriers, these delays are likely to result in rent-seeking behavior to take advantage of the profit that can be gained by clearing customs quickly. The delays also encourage substitution of locally produced inputs for imported ones.

Restrictions on bank credit that result in firms having to pay higher costs for their capital in the informal sector would appear, in the first instance, to act as a disincentive to capital investment. However, this disincentive may not be so easy to correct. A recent study suggests that most African countries lack the instruments of monetary policy that would be necessary in order to move away from direct credit restrictions to more indirect means of limiting the supply

of money and credit.[51] This suggests that fragmentation of the capital market in Africa, which results in substantially higher costs of capital for firms that are not well established in the formal sector, is not very amenable to policy reform. As a result, the higher costs associated with recourse by these firms to the informal sector are real and not simply distortions introduced by public policy.

The distinction between the effects of institutional constraints on incentives and on real costs must be carefully evaluated, therefore, in terms of the durability of these constraints and of the costs of lessening or removing them. Most analyses assume that economic policies distort incentives and that these distortions should therefore be treated as financial rather than economic costs. This ignores, however, the real costs that may be associated with the elimination of these policies. Many of the costs of policy reform may be transitional, but they are costs nevertheless. For example, removal of an tax on imports may cause import-competing firms to go out of business, with the possibility of substantial losses being incurred over and above those associated with windfall losses on fixed capital. In a similar way, institutional factors must be evaluated to determine whether they are constraints that should be removed, real costs that must be incurred, or something in between.

By this interpretation, economic and other types of policies comprise a subset of a broader range of institutional constraints -- a subset that is believed to be susceptible to manipulation by policy makers without incurring prohibitively high costs. At one end of the spectrum are institutional constraints that can be removed without incurring any cost; at the other end are immutable constraints for which the costs of removal are prohibitively high. In between, of course, is a range of mutable institutional constraints that may be removed or otherwise manipulated at a cost that is less than prohibitive.

There is, of course, a need to distinguish between the real economic costs that are incurred through the manipulation of institutional constraints and the costs as perceived by policy makers. The latter are likely to be influenced by pressures from those who experience a change their welfare, some of which they may derive from their access to rents created by the constraints. Although part of these rents is likely to be wasted through rent-seeking behavior, part is also normally passed on to those who are especially skilled in acquiring the rents or who derive monopoly advantage in some other way.

An example may be drawn from the area of trade policy. Most economists would agree that taxes and subsidies on trade should be considered as mutable economic policies. They would probably go on to argue that the same should be said for trade restrictions such as import quotas. But they might hesitate when it comes to other nontariff barriers such as the time it takes to clear customs, when in fact this might be much more important than the actual tariff paid. By the standards of the Newly Industrializing Countries (NICs), this time might considered as totally unreasonable, but by African standards it might be the norm. On the other hand, delays in clearing customs give rise to rents, some of which are likely to be transferred to customs officials as bribes or in other ways. These officials are likely to argue that the delays

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[51] Duesenberry and McPherson, 1991.

are necessary in order to assure that otherwise desirable regulations, such as restrictions on the importation of unsafe materials, are complied with. Should these delays be considered as a form of economic policy affecting the structure of incentives? Or should they be thought of as a real cost of doing business in Africa? Or perhaps they should fall somewhere in between. These questions are often very difficult to answer, yet the way in which they are answered very much influences the analysis.

Estimation of Costs and Incentive Distortions

Institutional constraints increase costs or distort incentives, depending on whether the constraints are amenable to manipulation, in a number of different ways. These depend on the nature of the constraint and on how the individual economic actor responds to it. This response, in turn, depends on the original cost of the constraint and the extent to which lower cost alternative courses of action are available. Among the options available are (1) compliance with laws and regulations without avoidance, (2) compliance with laws and regulations with avoidance, (3) influencing discretionary government decisions, and (4) evasion of laws and regulations. Costs may be direct, out-of-pocket expenses or they may be imputed costs that result from the tying up of resources that otherwise might be put to more productive use. There are also implicit costs associated with risk and uncertainty. Each of these costs (distortions) is described here along with ways in which it can be measured. A few illustrative applications are made to particular types of constraints.

Compliance with laws and regulations without avoidance

Firms may comply with laws and regulations without taking any action to avoid their adverse effects or to benefit from those that could affect them favorably. This type of compliance could be very costly. The direct cost associated with compliance might include:

1. fees required for the registration of personal, real, and intellectual property and for the conduct of business;

2. customs duties and other taxes, adjusted for advantages obtained as part of investment incentive schemes, free-trade zones, etc.;

3. legal and accounting fees required to understand and comply with laws and regulations;

4. direct costs associated with foreclosure;

5. direct costs associated with gaining access to foreign exchange;

6. labor compensation that must be paid as a result of laws protecting workers in the formal sector.

Estimation of these costs is generally straightforward once the nature of the costs is understood and it is clear to what extent the firm is obliged or chooses to pay these costs.

Firms may also incur substantial imputed costs in their attempts to comply with laws and regulations. Probably the most important of these are the value of managerial time and the cost of capital tied up awaiting government action. The cost of capital can include inventories and other forms of working capital, fixed plant and equipment, real estate, and various forms of human capital, including training, education, intellectual property, etc. Among the more important actions that give rise to these imputed costs are:

1. registering and using as collateral personal, real, or intellectual property;
2. foreclosure on property used as collateral;
3. execution of sales and other contracts;
4. obtaining bank loans;
5. obtaining approval for investment by foreign companies;
6. bargaining and otherwise dealing with labor unions;
7. obtaining approval for access to investment incentive schemes and free trade zones, and the implementation of those schemes once access has been obtained, including tax holidays, duty drawbacks and exemptions, etc.;
8. obtaining trade licenses, passing product standards, clearing customs;
9. dealing with regulations regarding foreign exchange;
10. dealing with regulations regarding competition law.

Measurement of these implicit costs requires (1) ascertaining the nature of the costs, (2) estimating the quantity of resources (e.g., management time, capital) that are tied up and for how long, and (3) multiplying the quantity-time by the cost of these resources (e.g., management salaries, interest rate).

Many institutional constraints related to the legal, regulatory, and judicial environment result in increased risk and uncertainty. One of the most important of these constraints involves the arbitrary exercise of executive power. If carried out at sufficiently high a level, this can affect any aspect of business activity and is often very difficult to predict. At lower levels, risks are perhaps better understood and more manageable. They generally involve the use of discretionary authority by public officials, which may be predictable with some degree of accuracy and, as seen below, is often amenable to some form of influence. Measuring the cost

associated with this risk involves (1) determining the source of risk, (2) estimating the magnitude of the risk, and (3) assessing the degree of risk aversion on the part of exporting firms.

Compliance with laws and regulations with avoidance

The adverse consequences of most laws and regulations can be partially avoided through legal means even as the laws and regulations are being complied with. Firms may also act in ways that cause them to receive favorable treatment in the implementation of the laws and regulations under established policies and procedures. The result is usually costly in terms of wasted resources.

The most obvious example of avoidance is efforts by firms to exploit loopholes in order to diminish their tax burden. This differs from tax evasion, which is illegal. The decision of whether or not to incorporate, for example, may be determined by the tax obligations involved. Certainly the choice of whether to locate in the formal or the informal sector is strongly influenced by the desire of firms to avoid the taxes that are assessed in the formal sector. In each instance, additional economic costs are incurred in order to reduce the firm's financial tax burden.

Action may also be taken to influence government decisions regarding how firms are to be treated. This requires that the rules for such treatment be known to the firms. One important example is the granting of import licenses and other advantages based on the size of the firm as measured by number of employees, installed capacity, level of production, or other indicators. This acts as a strong incentive to engage in economically inefficient behavior so as to receive the benefits involved. As another example, prior to the abolition of import licensing in Nigeria in 1986, preferential treatment was given in the granting of licenses to agricultural enterprises. This resulted in the establishment of numerous unprofitable farms for the sole purpose of acquiring these licenses.

Measurement of the costs of avoidance and other such actions is similar to measuring the cost of full compliance in that it can involve direct, imputed, and risk-related costs. These costs should be calculated relative to a situation in which the laws and regulations did not exist. As an example, taxes on imported inputs may be avoided by purchasing these inputs, to the extent that they are available, on the local market. This will usually be more costly than importing them exempt from import duties. It may also involve some loss of quality, though the cost of this will be more difficult to measure. Although duty drawback and exemption schemes may make this type of tax avoidance unnecessary for exporting firms, it is likely to remain a problem for their suppliers.

Influence over discretionary government decisions

Frequently, firms will attempt to avoid compliance with laws and regulations or to assure favorable treatment by exerting influence over discretionary government decisions (i.e., decisions

not based on established policies and procedures, as discussed above). This can be done in a number of ways, which may be either legal or illegal. The most obvious way is through outright bribery. Alternatives to bribery include granting of favors legally, exerting outside pressure, and sheer persistence. All of this is likely to involve direct or imputed costs in the form of cash, management time, and tied up capital. There are also likely to be risks since, despite the cost incurred to influence government decisions, the outcome is not always certain. Methods of estimating these costs are similar to those associated with legal compliance, though obtaining the necessary information may be more difficult.

Evasion of laws and regulations

Illegal evasion of laws and regulations may take any number of forms. One of the most obvious is smuggling, which often is costly because transportation via a smuggling route is likely to be more expensive than if goods are traded legally. Over or under-invoicing and other methods of falsifying documents are other common ways of avoiding trade and other taxes. The possibility of evading laws and regulations implies that the government must expend resources to reduce or eliminate this illegal behavior. Although not a financial cost to the firm, these resources represent an economic cost to society that may influence the real costs of exporting -- in assuring, for instance, that product quality standards are adhered to. Again, direct, imputed, and risk-related costs may be involved.

In measuring the cost of evasion or of preventing evasion, it is important to bear in mind the baseline standard so as to assure that costs are measured in the right direction. Certain types of illegal behavior may be desirable if laws and regulations are very restrictive and depart substantially from international standards. On the other hand, widespread evasion of a nation's laws and regulations is, over the longer term, likely to be highly detrimental to the establishment of a stable environment in which nontraditional exports can flourish. If the legal, regulatory, and judicial environment is so distorted that such evasion appears socially desirable, then the first priority is to reduce or eliminate these distortions. This has, in fact, been the goal of most structural adjustment programs. Once this is done, attention can be shifted to measuring the cost of preventing evasion when this cost is likely to influence nontraditional exports. Only in exceptional cases, under these conditions, should the cost of evasion be considered as a real cost of exporting.

Recourse to the informal sector

There is one major exception to the rule that the cost of evasion of laws and regulations not be considered as a real cost of exporting. This relates to the informal sector. Most African countries are characterized by a dual structure regarding the legal, regulatory, and judicial environment. Within the formal sector, records are maintained, taxes are paid, and laws and regulations are generally complied with, albeit with substantial legal or illegal influence over discretionary government decisions.

There is also, in every country, a large and growing informal sector, where records are limited, few taxes are paid, and many laws and regulations are ignored. Firms often have the option of operating within the formal or informal sectors. This may be critically important, in fact, for new firms interested in nontraditional exports. Although there are some advantages associated with being in the informal sector, there are also some important disadvantages.[52]

One of these disadvantages is the generally higher cost of capital. Lack of collateral and the limited resources of borrowers result in high risks to lenders. In addition, costs of administering a large number of small loans are also high. The result is high rates of interest to the borrower. One way of measuring the cost of controls on bank credit in the formal sector, in fact, is to calculate the increase in cost to the borrower who must have recourse to the informal sector.

Another disadvantage of the informal sector is limitations on size. Firms within the informal sector are, almost by definition, small. This is partly because the risks associated with being in that status tend to discourage fixed capital investment. Consequently, there are severe constraints on the ability of successful firms to grow unless they are willing to make the transition to formal sector status. This reduces gains from competition and limits the exploitation of economies of scale. These costs are difficult to measure, but some idea of their order of magnitude is important.

The quality of labor within the informal sector may also be relatively low, especially where skill and management ability are important. Given the scarcity of these factors in Africa, most skilled workers and managers quickly move into the formal sector, where their remuneration is likely to be much higher.

Finally, there is the problem within the informal sector of access to legal property rights, contracts, and other benefits of the legal, regulatory, and judicial environment. Although it has been shown that these legal instruments often exist in rudimentary form within the informal sector, they are generally not well established and are at a significant disadvantage vis-à-vis the legal structures of the formal sector.[53] The result is high risks associated with informal sector activity.

Prioritization

Because of the plethora of potential institutional constraints on the expansion of nontraditional exports, it is important that these be prioritized in order to focus attention on those constraints that are the most costly and the most amenable to reform. The following procedure will be used for this prioritization.

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[52] de Soto, 1989.

[53] de Soto, 1989.

1. Full effective protection/subsidy coefficients (FEPC/FESC) and full domestic resource cost (FDRC), inclusive of institutional costs, will be calculated for each of the potential export industries identified in the agricultural and manufacturing sectors. These indicators will be compared with the EPC/ESC and DRC indicators exclusive of institutional costs.

2. Using available information on domestic demand and supply elasticities, as well as world market conditions, the export gap resulting from the incentive distortions generated by each major institutional constraint will be estimated, for each activity, in terms of value added measured in world prices (i.e.. value of exports minus value of tradable intermediate inputs used in the production of these exports).

3. The total value of domestic resources (GDP) lost for a given activity because of a given institutional constraint will be estimated by multiplying the export gap resulting from that constraint by the loss of domestic resources per unit of value added measured in world prices (1-FDRC for that activity).

4. The total value of domestic resources (GDP) lost because a given institutional constraint will be aggregated across the activities for which that constraint applies.

5. Institutional constraints will be ranked according to their contribution to loss of GDP.

6. The cost associated with reducing or eliminating the most important institutional constraints will be assessed at least qualitatively, if not quantitatively.

APPLICATION OF PROTOTYPE METHODOLOGY TO CASE STUDY COUNTRIES

The prototype methodology will be applied to two case study countries (Ghana and Madagascar) to determine its feasibility and usefulness in identifying priorities for institutional reform. The case studies will include a review of laws, decrees, feasibility studies, and other documentation, as well as informal interviews with lawyers, accountants, business men and women, and others with a knowledge of local business conditions, in order to identify what appear to be the most important institutional constraints on the growth of nontraditional exports. A sample of firms in both agriculture and industry will then be interviewed in order to gather data that will be used to calculate the costs and distortions resulting from these constraints, the export gap that these distortions induce, and the loss of GDP that is incurred because of each of the major institutional constraints.

It is recognized that many of these calculations will be fairly approximate. The cost of some of the most important constraints, such as those involving high-level discretionary