

*Financial and Banking Services Market*

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**INSTITUTIONAL STRUCTURE  
FOR CAPITAL ATTRACTION:  
IMPLICATIONS FOR UKRAINE'S ENTRY  
INTO THE EUROPEAN UNION**

**Abstract**

The author discusses the issues of the most attractive and, as Victor Yushchenko puts it, «peaceful» and quiet climate for attracting foreign capital covered in books by Hernando De Soto and William Easterly who studied the eventual entry of Ukraine into the European Union.

**Key words:**

Legal and financial institutions, foreign capital attraction, property rights, incentives, segments of society, private propertied economy, legal standing.

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*«Money Likes Peace and Quiet»  
Victor Yushchenko<sup>1</sup>*

Ukraine's former Prime Minister, Victor Yushchenko, clearly understood the basic requirement for attracting foreign investment when he said, «Money likes peace and quiet».<sup>2</sup> Increasingly economists are recognizing that the legal and financial institutions of a country are primary determinants of the «peace and quiet» that attracts money and capital. And behind these institutions is good government. As the flier for this conference so rightly indicated, «competent government is not a luxury, but a vital necessity».<sup>3</sup> The Ukrainian government's goal ought to be to provide such «peace and quiet» that it can attract foreign investment. Such investment will do much to improve Ukraine's economic performance. This, in turn, will create the conditions necessary for Ukraine to meet the EU admission requirements. These are known as the Copenhagen Criteria and are the following:

«Membership criteria require that the candidate country must have achieved

- stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership including adherence to the aims of political, economic & monetary union».<sup>4</sup>

This paper reviews the work of two contemporary economists, Hernando De Soto and William Easterly, who have stressed the importance of the legal and institutional framework that is necessary to attract foreign capital investment and to retain it. Their independent publications point to one unifying theme, namely, if a country desires to attract foreign investment and see that it contributes to economic prosperity, the country must first develop a business-friendly environment that actively fosters entrepreneurship, the ultimate foundation for a thriving domestic economy. Towards this goal, they differ only in terms of emphasis; De Soto focuses on enhancing the access of the poor to basic property rights and Easterly stresses incentives.

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<sup>1</sup> Віктор Ющенко. Гроші люблять мир і спокій (Money Loves Peace and Quiet), The Ukrainian, no 1 volume 2000, pp. 74–77.

<sup>2</sup> Ibid.

<sup>3</sup> From the brochure that was sent as an attachment via e-mail in organizing this conference.

<sup>4</sup> <http://europa.eu.int/comm/enlargement/intro/criteria.htm#Accession%20criteria>

## Hernando De Soto: the Peruvian Adam Smith

Development economists are becoming increasingly interested in the work of Hernando De Soto. He has advised many national governments, including Mexico, Egypt, and Russia, to name only a few. His recent book, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2000) has received great attention in the public media both in North America and South America, his home continent.

His message is quite simple: in much of the non-Western world poor people are unable to participate in their own capitalist economies. This is because government bureaucracies have effectively excluded them from enjoying the basic rights of private property ownership that are available to richer segments of their societies. People in the developed West have taken too much for granted in assuming that everyone in poorer capitalist economies have enjoyed the same property right protection as people in the developed West have enjoyed. Instead, the poor in non-West countries have often lacked the simplest prerequisite for participation in a private property economy, that is, the clear title to their private property.

This lack of legal title to land or real estate has created a situation in which poor people tend to work on the margins of their economies – often in the underground economy or black market. This has severely hampered their efforts to accumulate capital and to allow capital to fully serve them as capital has served the richer segments of society. Working in the underground economy or in the black market essentially disqualifies the poor from enjoying the benefits derived from legally enforceable contracts and from using their property as collateral for further business expansion. Contracts are enforced by courts, but if a poor person has no legal title to his property or business, he has no standing in court. If his property has no standing in courts, his business assets or real estate cannot be used as collateral for loans for further business expansion. His business either remains stunted, unable to expand and prosper, or it is severely disadvantaged in competition with legitimate businesses.

De Soto conducted an experiment in his own country, Peru. The experiment illustrated how the legal system in Peru hampers the development of entrepreneurship. In this experiment, De Soto's research team attempted to set up a garment workshop near Lima. The results were revealing:

«Our goal [that is, the research team's goal] was to create a new and perfectly legal business. The team then began filling out forms, standing in the lines, and making the bus trips into central Lima [Peru] to get all the certifications required to operate, according to the letter of the law, a small business in Peru. They spent six hours a day at it and finally registered the business – 289 days later. Although the garment workshop was geared to operating with only one worker, the cost of legal registration was \$1,251 – thirty-one times the monthly minimum wage. To obtain legal authorization to build a house on state-owned

land took six years and eleven months, requiring 207 administrative steps in fifty-two government offices. To obtain a legal title for that piece of land took 728 steps. We also found that a private bus, jitney, or taxi driver who wanted to obtain official recognition of his route faced twenty-six months of red tape». <sup>5</sup>

De Soto's research team conducted similar experiments in other countries, e.g., Egypt, the Phillipines, Haiti, Brazil, Venezuela, and Mexico to name a few, and found similar or even worse results. <sup>6</sup>

By comparison, to start a legitimate business in Hong Kong, it takes only a day. <sup>7</sup> Thus, Hong Kong, even though now part of China, continues to function under the legal system it inherited from the British. In Hong Kong, the newly established business immediately enjoys all the rights of obligations of a legitimate business. Business can count on the legal system to enforce contracts, adjudicate disputes, and to protect private property. The Hong Kong businesses enjoy full legal standing in any court of justice. Essentially all businesses in Hong Kong can then offer their assets as collateral for loans to expand and to prosper.

The difference in these two extremes—that is, between the country where entry into business is difficult and expensive and the country where entry into business is relatively easy and inexpensive—is quite obvious. More businesses will be formed in the countries where entry is free or easy, and fewer businesses will be started where entry is costly or difficult.

De Soto estimates – admittedly it is a crude estimate – that, «By our calculations, the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least \$9.3 trillion». <sup>8</sup> Or, «twice as much as the total circulating U.S. money supply». <sup>9</sup>

De Soto calls this unrealized value, «dead capital», <sup>10</sup> that is, capital that cannot be used to finance, as collateral, further business expansion. «The result», De Soto writes, «is that 80 percent of the world is undercapitalized». <sup>11</sup> In short, «what the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, and guarantee greater value in the expanded market. In the West, every asset – every piece of land, every house, every chattel – is formally

<sup>5</sup> Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), pp. 19-20.

<sup>6</sup> *Ibid.*, pp. 20-28.

<sup>7</sup> «I found out that I could [in Hong Kong], without a lawyer, set up a legal business in just one day. All I had to do was wait in line and fill out one form. The next day I had a book in a shopping mall selling ABC Frisbees... By contrast, I dare you to try to start a business in India. We didn't even try to open one when I was in Calcutta, because the paperwork takes years.» From John Stossel, *Give Me A Break* (New York: HarperCollins Publishers, 2004), pp. 234-235.

<sup>8</sup> *Ibid.*, p. 35.

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*, p. 40

<sup>11</sup> *Ibid.*

fixed in updated records governed by rules contained in the property system. Every increment in production, every new building, product, or commercially valuable thing is someone's formal property. Even if assets belong to a corporation, real people still own them indirectly, through the titles certifying that they own the corporation as «shareholders'».<sup>12</sup>

It is clear how De Soto's work relates to the topic of this conference, namely, capital moves to where it is most comfortable and can enjoy the «peace and quite» it likes. In a country where a considerable part of its economic activity is black market or underground, foreign capital is unlikely to find comfort. The easier a government makes it to establish legal standing as a business and to own clear title to real estate, the more likely it is that foreign capital will be attracted to that country.

### **William Easterly: Incentives Matter**

Having earned a Ph. D. in economics from MIT, William Easterly then worked for the World Bank for fifteen years. Then he wrote the book, *The Elusive Quest for Growth: An Economist's Adventures and Misadventures in the Tropics* (MIT Press, 2000). In it, he severely criticized the World Bank for not better achieving its goal of advancing the well-being of developing nations. Soon after the book was published, Easterly was looking for a job in academia. He now teaches at New York University.

Whether it was Easterly's book that caused him to look for another job, only Easterly can say for sure. At the very least, it would be hard for an employee to remain employed at an institution with which he disagreed so much.

What Easterly said about the persistent failure for the World Bank to foster economic development was simple. His book argues that most of the efforts of the World Bank were ineffective because the World Bank overlooked the fact that people respond to incentives.

Like De Soto, Easterly makes a basically microeconomic argument. If policies do not foster entrepreneurship with proper incentives, nations will not prosper. The World Bank failed to see this. As a result, the World Bank lent money to governments that it assumed were providing businesses with the right incentives. Instead, governments in developing economies were often not providing the incentives for entrepreneurs to prosper. Governments in the developing world often set up massive and expensive bureaucracies that frequently hindered business formation instead of promoting it. Licensing and extensive regulations were often the outcome.

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<sup>12</sup> Ibid., p. 48.

The presence of such licensing and regulation gave rise to corruption. Not until recently did the World Bank begin to acknowledge that corruption was a problem. Before it had come to this realization, the World Bank had lent billions of dollars to corrupt governments that stifled growth rather than fostered it. Easterly argues that providing proper incentives matters more than any other one thing that the World Bank is able to do to help economic development. The importance of providing proper incentives was the one thing that the World Bank was unable to see and therefore failed to do.

In criticizing the World Bank, Easterly also criticized economic development literature in general. This is because the World Bank believed more in the economic literature than it paid attention to the little fact that the «incentives matter». Below are his major disagreements:

1. Development economists still use the Harrod-Domar growth model to estimate the investment needed for development even though Evsey Domar, one of the originators of the model, later disavowed it.<sup>13</sup>
2. The World Bank and many development economists still believe that investment is the key to growth. Easterly argues, using theory and evidence, that technology is more significant than is investment. Furthermore, evidence shows no relationship between World Bank investment in countries and subsequent economic growth in these same countries.<sup>14</sup>
3. Educational financing by the World Bank has been a failure. Why? Because in countries where the World Bank has funded educational investment, governments have impeded the market to such an extent that the market cannot provide the proper incentives for the creation of jobs needed to hire the newly educated population.<sup>15</sup>
4. Emphasis on population control has been misplaced since there is no evidence that population, by itself, has limited economic growth or that population control has led to economic growth.<sup>16</sup> Evidence does show that economic growth does limit population growth.<sup>17</sup>
5. The World Bank's loan conditionality has been ineffective. For instance, «twelve countries received fifteen or more World Bank and IMF adjustment loans over 1980 to 1994. The median per capita growth rate for these twelve countries over the period was zero».<sup>18</sup>

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<sup>13</sup> William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (MIT Press, 2001), pp. 28-44.

<sup>14</sup> *Ibid.*, pp. 47-49.

<sup>15</sup> *Ibid.*, pp. 71-84.

<sup>16</sup> *Ibid.*, pp. 91.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*, pp. 115.

6. Only recently have development economists and the World Bank recognized corruption as an impediment to economic growth.<sup>19</sup>
7. Debt forgiveness by the World Bank has generally encouraged the forgiven governments to return quickly to indebtedness.<sup>20</sup>

Clearly, Easterly is quite severe in his criticism of the World Bank and economic development literature. The thesis of his book, and what the World Bank has overlooked, is the simple idea that, «economic growth responds to incentives».<sup>21</sup> As simple as this is, governments continue to ignore it.

It's a lesson all governments of the world need to take seriously because people everywhere respond to incentives. When action does not benefit them, people are less likely to undertake that action. If starting a business is extremely expensive and difficult, as De Soto in the last section found it was in many countries, then fewer businesses will be formed. Or, if it is difficult to conduct business, the fewer businesses will be created, and economic prosperity will not occur.

The questions the Ukrainian government needs to consider are some of the following: «Does Ukraine provide the proper incentives necessary for businesses to thrive?» If you were a foreign investor choosing among other countries of the world, does Ukraine provide the «business-friendly» environment that is «quiet and comfortable» for capital? How easy is it for a person to buy land with clear title or to start a business that has legal standing? How does Ukraine's paper work compare to say Hong Kong's where a legal business can be started in one day?

For instance, are all people treated equally before the law? If this is not so, then the incentives that are incidental to property rights will not exist. Why? Because if some people are immune from prosecution when they take or damage another person's property, then there is less incentive for anyone to accumulate or even take care of even private property. Why work if the fruits of your labor can be taken from you or damaged with immunity?

The United States government paints a negative image of Ukraine's lack of a «business-friendly» climate. Below is the U.S. Department of State's description of this climate:

«While economic growth continues, Ukraine's long-term economic prospects depend on acceleration of market reforms. The economy remains burdened by excessive government regulation, corruption, and lack of law enforcement, and while small and medium enterprises have been largely privatized, much remains to be done to restructure and privatize key sectors such as energy and telecommunications».<sup>22</sup>

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<sup>19</sup> Ibid., pp. 243-244.

<sup>20</sup> Ibid., pp. 123-139.

<sup>21</sup> Ibid., p. XII.

<sup>22</sup> U.S. Department of State, «Background Note: Ukraine,» December 2003, p. 5.

«...complex laws and regulations, poor corporate governance, weak enforcement of contract law by courts and corruption stymie large-scale foreign direct investment in Ukraine. While there is a functioning stock market, the lack of protection of shareholder rights severely restricts portfolio investment activities. Total direct investment in Ukraine is approximately \$6.04 billion as of October 2003, which at \$126 per capita, is still one of the lowest figures in the region».<sup>23</sup>

The U.S. Department of State is not alone in this rather harsh assessment. The «2003 Corruption Perceptions Index,» developed by the University of Passau (Germany) for Transparency International, ranks Ukraine at 106 on a scale of 1 to 133, with a score of 1, Finland, being the country perceived as the least corrupt, and with a score of 133, Bangladesh, being the country perceived as the most corrupt. Ukraine tied with Bolivia, Honduras, Macedonia, Serbia, Monte Negro, Sudan, and Zimbabwe.<sup>24</sup>

In summary, De Soto illustrates how important it is to provide the poor access to the benefits of private capital ownership and entitlement, lessening the degree of black market activity and the corruption the underground economic activity leads to. Easterly stresses how important it is that governments provide proper incentives so that entrepreneurship might flourish and nations develop. Ukraine has great potential for economic development in its talented human resources, in its rich abundance of natural resources, and in its favorable geographic location. These, by themselves, are not enough. Ukraine must do more to improve its «business-friendly» reputation in order to attract foreign investment. De Soto and Easterly suggest a partial map to Victor Yushchenko's «peace and quiet» that is conducive to foreign investment. Once foreign investment begins to flow to Ukraine, the European Union will surely want to invite Ukraine to become a member.

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<sup>23</sup> Ibid., p. 6.

<sup>24</sup> Transparency International at [www.transparency.org](http://www.transparency.org) or [www.gwdg.de/~uwww](http://www.gwdg.de/~uwww).