Institutional and Evolutionary Failure and Economic Development in the Middle East

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1. Introduction

This Article examines the politics and finance of development among Middle Eastern countries with particular emphasis on the incentives of autocrats to promote pro-growth policies in general and to foster small enterprise in particular. As a point of departure, we start with the observation that there is no fundamental reason why Middle Eastern economies cannot enjoy steady, stable economic growth. At various points in the past, particularly in the late 1970s, various Middle Eastern economies, including Iraq, enjoyed middle-income status. From the 1960s until the end of the 1970s, Middle Eastern countries made massive public investments in economic infrastructure, as well as in health and education, and, less successfully, in state-owned enterprises. Economic growth, at six percent per worker per year, was the highest in the world in the 1960s.[1] Going back still further, during the tenth century the Middle East was extremely advanced as measured by its standard of living, technology, agricultural output, and literacy rates.[2]

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[1] Tarik, M. Yousef, *Development, Growth and Policy Reform in the Middle East and North Africa Since 1950*, 18 J. ECON. PERSP. 91, 96 (2004).

[2] Timur Kuran, *Why the Middle East Is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation*, 18 J. ECON. PERSP. 71, 71 (2004).

This Article begins with a description of the institutional features of an economy that are important to development. There are three critical institutional arrangements that are necessary for economic growth and human flourishing. These are: (1) the ability to create investment vehicles, such as the corporation and the limited partnership, that facilitate risk-taking; (2) the capacity of institutions to adapt to economic and technological advances and changing human preferences and tastes; and (3) the economic and legal certainty and stability necessary to encourage investment in projects with long-term time horizons and to provide the economic and legal infrastructure necessary for trade.

Capacity for risk-bearing is the hallmark of entrepreneurship and the key to economic growth. While economists have placed much emphasis recently on "external finance," **[AU: add citation]** we believe that external finance is a second-order condition thatI is neither a necessary nor a sufficient catalyst for significant economic development. Rather, the critical precondition for economic growth is legal and societal tolerance for failure. Because the probability of failure is high for entrepreneurs starting a new business, the costs associated with such failure must be reduced, as much as possible. One such cost, of course, is personal liability, and the corporate form is highly effective at reducing this direct cost. But an as yet unrecognized additional benefit of limited liability is that it also sends a signal to entrepreneurs that failure is acceptable as a matter of social policy and societal norms. In other words, when society grants to an entrepreneur status as a limited liability entity, it is removing, or, at a minimum, reducing, the social stigma associated with failure.[3]

The benefits of the limited liability form of corporate organization have, in our view, been significantly misstated because they have failed to take into effect the norm-creating implications of such rules. Where the state encourages the formation of business in the corporate form, it is sending a powerful green light to entrepreneurs, telling them that not only is it permissible to start a new firm, but also it is permissible to fail in the creation of a new firm. The failure of a firm organized as a sole proprietorship or a partnership lies with the sole proprietor or with the partners; the failure of a firm organized as a corporation or limited liability partnership, however, lies with the entity. This reduces the social stigma of failure not only on the entrepreneur, but also on his family and on his investors.

The value of the corporate form in enabling private entrepreneurs to escape individual liability for failure has been overstated, particularly for small businesses. Since lenders typically require such entrepreneurs to sign personal guarantees in order to receive credit, the narrow "economic" value of limited liability is not great as entrepreneurs generally must risk their personal assets when they start a new business. Rather, in our view, the value of limited liability lies in its signaling function for entrepreneurs: signaling that failure, while not desirable, should not be viewed as a reflection on the personal character or honesty of the entrepreneur. This signal, in turn, leads to a dramatic increase in the supply of entrepreneurs within an economy.

[3] In the United States, many scholars bemoan the reduction in stigma associated with declaring bankruptcy, cite Elizabeth Warren xxx **[AU: please provide pincite]**, but the level of stigmatization can also be inefficiently high if it chills socially valuable entrepreneurship and risk-taking.

People have to be willing to take risks in order for an economy to grow. Where these risks include the high likelihood of shame, the inability to start another business, stigmatizing effects on oneself and family, possible personal criminal liability for defrauding creditors, as well as personal liability for a firm's debts if the business is unincorporated, the supply of entrepreneurs is likely to be small.

When the state makes access to the limited liability form easy and inexpensive, it signals that it is encouraging risk-taking. The regulation of limited liability may more broadly signal other aspects of a state's regulatory attitude toward business formation. Since entrepreneurs starting new businesses often are asked to sign personal guarantees in order to obtain credit, insulation from personal liability is only modestly important. Instead, it is the de-stigmatizing effects of the state liberalization of the corporate form that matter.

Since it is so easy for the state to enact the legislation necessary to facilitate the formation of limited liability forms of business organization, we consider why certain countries, particularly those in the Middle East, have not done so. Here we turn to the economic theories of politics, particularly public choice and social choice theory,to show that, under certain conditions prevalent in Middle Eastern politics, it would be irrational for the ruling coalitions to encourage small business entrepreneurship. These theories demonstrate that increasing the number of small businesses will lead to a rise in the middle class, which in turn will lead to destabilizing pressures for democratic reforms. In addition, new business will bring increased competition to the existing firms that are, by definition, providing political support to the incumbent ruling class.

Finally, we argue that simplifying the process of forming new businesses will require depoliticization of the process. Depoliticization, in turn, will lead to a diminution in the demand for the services of incumbent government bureaucrats, thereby leading to a reduction in the ability of the incumbent ruling coalition to extract rents from supplicants.

In this Article we also consider, and reject, the rationales for underdevelopment in the Middle East contained in what currently passes for conventional wisdom. It has been asserted that underdevelopment in the Middle East is attributable to the pathological nature of certain Middle Eastern institutions, particularly: (1) the Islamic law of inheritance, which is said to have inhibited capital accumulation; (2) the strict individualism of Islamic law, which is said to have prevented the rise of the corporate form; and (3) the *waqf*, Islam's trust vehicle, which, it has been argued, locked wealth into inefficient institutional arrangements that could not evolve over time.[4] It is wrong, in our view, to blame the lack of development in the Middle East on these institutional characteristics.

Significantly, each of these institutions was, in all likelihood, efficient when it was first introduced. In fact, all of these arrangements could easily be cited as reasons for economic growth and development, rather than as reasons for economic stagnation, had history turned out differently. Thus, they are not the cause of the region's lack of development. Instead, we will argue that the lack of development in the Middle East is attributable to a lack of incentives to implement economic liberalization, not because of religious or cultural impediments to development.

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[4] Timur Kuran, Why the Islamic Middle East Did Not Generate an Indigenous Corporate Law 1 (USC CLEO Research Paper No. CO4-16), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=585687 (Feb. 9, 2005); Kuran, *Why the Middle East Is Economically Underdeveloped*, *supra* note 2.

Path dependence is a problem. Inefficient institutions, once they come into existence, tend to remain *unchanged* even in the face of changing circumstances. The apparent incapacity of Middle Eastern economic and social institutions to evolve in the face of changing circumstances that has led to the lack of economic development has been compounded by the lack of diversity and choice among rival institutional arrangements. The centralization and ossification of historical institutional arrangements create obstacles to economic development in the Middle East. But the real problem is not path dependence; it is the lack of political incentives for reform. We argue that incumbent ruling elites rationally oppose economic development when such development is likely to lead to social changes that threaten their hold on power. It is this rational calculation—not culture, or history, or religion—that sustains obstacles to growth in the Middle East.

These problems appear to exist, improbably, despite the relative clarity and simplicity of Islamic business law. Relative to Christian or Jewish Law, the Qur'an has few economic rules, and there has not been the explosion of rival interpretations to these rules that has occurred elsewhere. The problem has been a lack of dynamism: legal rules and institutions, once in place, tend to remain in place. In a rapidly changing world, this has prevented the emergence of modern, efficient institutional arrangements for financial intermediation and investment. Adding to the problem is a distrust and intense dislike of America which, among other things, is a metaphor for economic freedom and laissez-faire economic policies. This anti-Americanism prevents reform because market liberalization is resisted as western cultural imperialism.

2. Determinants of Growth

The explosion of research in development economics, particularly by economists whose specialty is microeconomics and the theory of the firm rather than macroeconomics and interest-rate policy, has yielded a dizzying farrago of theories about the necessary pre-conditions for economic growth. Among the common characteristics of successful economies are heavy capital investment, extensive schooling, relatively little income inequality, low fertility, temperate climate, good seaports, laissez-faire government, well-developed capital markets, political and economic freedom, strong property rights, ethnic homogeneity, British colonial origins, common-law legal systems, political stability, good governance, foreign direct investment, and suitably conditioned foreign aid.[5]

As interesting as these various theories are, a causation problem arises: it is not clear whether such things as good schools cause economic development, or whether economic development enables and therefore causes certain societies to be able to afford good schools (and other things, such as political stability and low income inequality).

Another vexing problem with most extant theories of growth and development is that under such theories, the most important determinants of growth appear to lie in historical, institutional features that are the result of long-standing, highly path-dependent factors that are not susceptible to change or improvement in those regions that have the misfortune to have inefficient cultural and institutional historical antecedents. In other words, under most theories of growth, weak patterns of development are the economic equivalent of a genetic malformation for which there is no known cure or therapy.[6] But

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[5] Rafael La Porta et al., *The Quality of Government*, 15 J.L. ECON. & ORG. 222 (1999); Romain Wacziarg, *Review of Easterly's* The Elusive Quest for Growth, 40 J. ECON. LIT. 907 (2002).

[6] *See*, *e.g.*, Valerie Bockstette et al., *States and Markets: The Advantage of an Early Start*, 7 J. ECON. GROWTH 347 (2002).

history, as opposed to economic theory, shows that over time, countries do, in fact, experience periods of rapid growth that often are preceded (and/or followed) by periods of economic stagnation.

A third problem with the dominant theories of growth, particularly La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) is that they focus exclusively on public companies, examining whether common law or civil law systems better protect minority shareholders and provide adequate incentives for the accumulation of external capital. This approach pays insufficient attention to the determinants of business formation. By focusing exclusively on external finance, the LLSV approach misses the fact that businesses must already be successful before they are in a position even to need, much less succeed in attracting external finance. Many new companies fail. The critical determinant of growth therefore, in our estimation, is not whether an economic system provides sufficient access to external finance, but whether the system provides sufficient incentives for the formation of new business. If so, then even in the absence of external finance, firms can grow by financing themselves through retained earnings. Thus, countries like France and Italy, civil law countries with weak protections for minority shareholders and inefficient banking systems, have been able to achieve and sustain admirable rates of economic growth because they provide adequate incentives for the formation of small business.[7] Theories of economic growth must consider that the formation of new business may well be even more important to economic growth than the ability of existing, successful business to obtain external finance from banks or capital markets.

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[7] Arnoud Boot & Jonathan Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356 (2004).

Finally, theories like the LLSV theory, which establishes that external finance is more difficult, and protections for minority shareholders weaker in countries with civil law origins, founder when addressing the issues of minimum capital requirements and bureaucratic hurdles to business formation discussed here for two reasons. First, the LLSV theory does not address why the legal rules in the *progeny* of civil law legal systems are stricter than in the France and Germany, the countries from which these rules originated. In other words, why are the minimum capital and bureaucratic hurdles worse in the Islamic Muslim world than in France and Germany? Interest group politics explains this far better than the LLSV path dependence story.

Second, LLSV argue that civil law legal systems provide inadequate protections to minority shareholders. Yet the public interest justification for minimum capital requirements is that they provide protections for creditors. It makes no sense that these rules are stricter in civil law countries: LLSV's theory predicts that the rules in such countries should be more lenient.

In other words, existing theories of growth in finance function too heavily, in our view, on the *supply* side of the growth equation. The key question for these theories is whether crucial inputs for growth are available. Such scholarship examines the connections between the operation of various financial systems and economic growth, concluding that "the preponderance of the evidence suggests that both financial intermediaries and markets matter for growth."[8] As Merton Miller has asserted, "that financial markets contribute to economic growth is a proposition almost too obvious for

[8] Ross Levine, Finance and Growth Theory and Evidence 85 (NBER Working Paper 10766), *at* http://www.nber.org/papers/w10766 (Sept. 2004).

serious discussion."[9] This may be the case, but before financial markets can supply firms with capital, the firms demanding such capital must come into existence in the first place. Along the same lines, it also seems clear that the demand for capital by firms will determine, or, at a minimum, will influence the shape of the financial markets. As Joan Robinson famously articulated the point in 1952, "where enterprise leads finance follows."[10]

The problem with these rival theories about the determinants of economic growth is that they both presuppose the existence of the engines of growth. According to the finance theory, banks, stock markets, and other institutions of financial intermediation provide the funding and technical guidance necessary for economic development to occur. By contrast, the rival theory posits that the financial sector develops in response to demand for financial services from industry. The difference between these theories is the perennial "chicken and egg" problem. It seems clear that both sides are correct: economics with flourishing industrial sectors are likely to have flourishing financial sectors, and vice versa. The enduring problem is to specify a theory of growth that can provide insights of value to those studying economies that have neither well-developed financial sectors nor well-developed industrial sectors.

Similarly, none of the existing theories of growth and development, in or out of finance, provides an account for why we observe such differences in levels of investment in human capital among countries. Likewise, path dependence appears to provide our

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[9] Merton H. Miller, *Financial Markets and Economic Growth*, 11 J. APPLIED CORP. FIN. 8, 25 (1998).

[10] JOAN ROBINSON, *The Generalization of the General Theory*, *in* THE RATE OF INTEREST AND OTHER ESSAYS 67, 86 (1952); *see also* Robert E. Lucas, Jr., *On the Mechanics of Economic Development*, 22 J. MONETARY ECON. 3 (1988).

only account for why some economies enjoy very high levels of trust and socially beneficial norms and institutions, while others appear to be lacking in such norms and in the element of trust that provides the basic fabric for economic development. Here all agree that education and other forms of human capital investment are important determinants of growth, but we need a better understanding of how to "jump start" this process.

In our view, the gaps in the existing theory exist because existing theory fails to provide an account of the critical *preconditions* to economic growth. This Article develops a theory of growth that posits that growth starts with demand by individual entrepreneurs for small business creation. Many of these small businesses inevitably fail. But some succeed, and those that do provide the demand side for finance as well as the basic engines of growth for the rest of the economy. The difference between developing countries and countries with poor records of growth and development lies in differences among these countries with respect to the incentives provided by government and other societal institutions to start new businesses.

Small businesses are the main engine for growth even in countries with more well-developed economies. For example, in the United States, small business creates approximately 75 percent of the net new jobs added to the economy, represents 99 percent of all employers, employs 50 percent of the private work force, accounts for 41 percent of private sales in the country, and accounts for 39.1 percent of jobs in high technology sectors and for over one-half of private sector output. [11]

Small business is likely to play an even more important role in the private sector of less-developed countries in which undeveloped securities markets and weak banking

[11] Small Business Association, *Small Business Statistics*, *at* http://www.sba.gov/aboutsba/sbastats.html.

sectors make it difficult to accumulate the large amounts of capital needed to capitalize big business. Of course, whether the future of an economy depends on large, medium or small size firms, all firms start small, so unless there are sufficient incentives to start a small business, the economy generally will suffer.

Thus, under our theory, simple things, particularly the ease of starting a new business and the ability to operate that business without fear of personal liability or imprisonment, are critical variables in the solution to the growth puzzle. In particular, we believe that the inability of small entrepreneurs to start and maintain small businesses explains the economic pathology in many developing countries, particularly in the Middle East. The core problems are: (1) the lack of easy access to the limited liability organizational form that provides a vehicle for doing business which allows entrepreneurs to proceed without fear of crushing personal liability; and (2) the lack of choice among a variety of such forms. Limited liability forms of business organization also not only facilitate risk-taking, they also stimulate the demand for capital, and thereby promote the development of the financial sector.

Economic growth requires entrepreneurship. Entrepreneurship requires risk-taking. Different legal frameworks provide different incentives for risk-taking. In the U.S., for example, the ease with which firms and individuals can declare bankruptcy, and perhaps more importantly, the lack of social stigma associated with such declarations provide incentives for firms and individuals to take risks. In countries where there is potential criminal liability for debtors, risk-taking incentives are dampened.[12] Clearly the

[12] Luca Enriques & Jonathan Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001).

ability to form limited liability entities such as the corporation, the joint stock company, and the limited partnership are critical to attract risk capital.

In other words, flexibility in the creation of corporate forms and structures is important not only in attracting outside investment capital to business, but also in providing entrepreneurs with sufficient incentives to start new business enterprises. Middle Eastern countries are among the most difficult places in the world in which to start a business. The difficulty is not religious; it is political and bureaucratic. It takes too long to start a business, there are few alternative business forms available, and there are far too many bureaucratic hurdles, particularly in the form of minimum capital requirements for business.

Risk-taking by small business owners, individual investors and high-net-worth individuals are the critical elements that produce high growth rates. In the U.S., the traditional corporate form is being challenged by a new limited liability form of business organization, the limited liability company (LLC). This new organizational structure combines all the tax benefits associated with partnerships (taxation on profit distributions only at the investor level, not at the entity level) with the limited liability protections of the traditional corporate form. This corporate form, now legal in 48 U.S. states, is considerably cheaper, simpler, and easier to maintain than alternative organizational forms, including Subchapter S corporations and limited family partnerships. LLCs can own subsidiary companies and have an unlimited number of investors, and they also have greater flexibility in allocating profits. LLCs are even better than limited partnerships for protecting investors' (and entrepreneurs') personal assets.

Moreover, the ready availability of the traditional corporate form, the LLC form, and the limited partnership form of business organization is an essential prerequisite to the development of a successful venture capital market.[13] In this context, it is important to stress that venture capital investment is, by definition, investment in unlisted, early-stage or start-up companies, with the objective of profiting by either selling the company or taking it public approximately five years out of the initial investment.

Venture capital investment requires an array of organizational forms. Outside investors typically are limited partners, so something like the limited partnership form of business organization is required as a vehicle for such investors. The virtue of this genus of business organization, which has been adopted in all countries with successful venture capital sectors, is that it permits investors to enjoy limited liability while allowing the pass-through of unrealized tax gains and losses from the investments to the investors without tax being paid at the enterprise level. In other words, the limited liability partnership is not a taxable entity, although it is a limited liability entity. Gains and losses pass through the enterprise to investors for tax purposes. Tort and contract liability, however, remain with the enterprise. Firms may not always choose the most efficient, cost-effective organizational form, but they should be given the flexibility to do so.[14]

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[13] Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

[14] Joe Bankman has shown that new firms, even if they have a plethora of choices among organizational forms, do not always choose the most efficient form. Bankman argues that that start-up companies often could have reduced their net tax liability if they had been organized as subsidiary corporations or limited partnerships, rather than as independent corporations. But many start-ups choose to organize as independent corporations thus causing most firms to lose millions in tax savings. This may be true: our point is simply that such optimization is only possible when there is a menu of choices. Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737 (1994).

Governance of the limited partnership is carried out by the general partner of the enterprise. In the venture capital context, as in other contexts, the general partner of the limited partnership generally is organized either as a corporation or as a limited liability company. The firms in which the venture capital fund invests are organized as corporations, the fund typically taking preferred shares in these companies that are convertible into common shares and giving the venture capitalist the right to a controlling (majority) number of seats on the company's board of directors.

In a recent and important article, Timur Kuran has asserted that Islamic law "provides no room for corporations – collective enterprises possessing legal rights distinct from those of the individuals who finance or serve it."[15] The problem with this observation is that there are no specific provisions in Jewish law or in Christian law for such collective enterprises, either. As with other cultures, early Middle Eastern economies had partnerships that permitted collective investment, and were deemed consistent with Islamic Law.[16] The question is why Islamic law did not evolve more quickly to permit the emergence of corporations and other juridical entities that had the legal capacity to assume risk and enter contracts. It was not until 1851 that the first predominantly Muslim-owned joint stock company, the _irket-I Hayriye Marint Transportation Company, was formed.[17] While the corporate form is available, forming a corporation takes longer, is more expensive, and involves substantially more interactions with government bureaucracy than elsewhere in the world. Clearly this long-standing

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[15] Kuran, *Why the Middle East Is Economically Underdeveloped*, *supra* note 2, at 73.
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[16] ABRAHAM L. UDOVITCH, PARTNERSHIP AND PROFIT IN MEDIEVAL ISLAM 249-61 (1970).

[17] Kuran, Why the Islamic Middle East Did Not Generate an Indigenous Corporate Law, *supra* note 4.

lack of an institutional structure such as the corporate form has historically been the significant impediment to capital formation in Middle Eastern countries.

This, then, leads to the question of why the economic institutions in Middle Eastern economies so frequently appear to lack the capacity to evolve over time to adapt to new economic and technological circumstances and to changing human preferences and tastes.

A. The Role of the State

Central planning has never been a success at allocating capital efficiently. The persistent failure of even the best-intentioned government efforts to make effective capital allocation decisions has proven, to the extent such things ever can be proven, that economies in which the private sector dominates capital allocation decisions are likely to outperform those economies in which government takes the leading role in making decisions about how to invest resources. This, however, emphatically does not mean that the government has no role to play in the economy, particularly in reducing transaction costs, providing standard-form off-the-rack rules, and in dealing with distributional unfairness.[18]

So far, this article has stressed the point that government is necessary to provide the legal framework for entrepreneurship. The legal system provides the business forms that are necessary for the creation of the business entities through which investment is made. In particular, the basic corporate entity, conceptualized as a contracting entity separate and distinct from its investors, is necessary not only to attract investors, but also to provide entrepreneurs with the incentives they need to take the risks inherently involved in the start of a new business.

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[18] Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts*, 99 YALE L.J. 87 (1989).

This implies that the state is required to do far more than merely create a contracting framework within the context of the classic libertarian's "night watchman state." Nozick, by contrast, articulated the ideal role of the state in the following terms:

> a minimal state, limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on, is justified; that any more extensive state will violate persons' rights not to be forced to do certain things, and is unjustified; and that the minimal state is inspiring as well as right. Two noteworthy implications are that the state may not use its coercive apparatus for the purpose of getting some citizens to aid others, or in order to prohibit activities to people for their *own* good or protection.[19]

Nozick's definition of the role of the state leaves no room for corporations or other limited liability forms of business organizations. In establishing the framework for the corporate form, the state necessarily uses its coercive apparatus for the purpose of getting some citizens to aid others because when the state permits the corporate form, as it ubiquitously does, non-contracting third parties, particularly tort claimants, who deal with the corporation are prohibited by the coercive power of the state from obtaining compensation from the firm's investors, including shareholders and other putative "owners" for damages caused by the firm. These third parties are unwittingly coerced by the state to aid others, namely the corporation's investors, in clear violations of Nozick's strictures.

The corporate form, in other words, involves a disturbing societal decision to permit some to at least potentially be forced to sacrifice their own interests for greater overall

[19] ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA ix (1974). Other prominent proponents of the minimal state include Benjamin Constant, Herbert Spencer, Leonard Read, Ludwig von Mises, Friedrich Hayek, James M. Buchanan, Milton Friedman, Ayn Rand, John Hospers, and Henry David Thoreau.

social good. This clearly breaches Nozick's moral claim that "there is no justified sacrifice of some of us for others."[20]

For development, the state must provide at least three functions: (1) it must create a legal environment in which contracts can be freely made and enforced; (2) it must create and freely permit the use of the various forms of business organization that serve as the vehicles for investing; and (3) it must pass laws that permit these business organizations to have distinct "legal personalities," which, in turn, enables all investors, including residual claimants, to invest without fear of personal liability to non-contracting third parties for the debts and obligations of the business.

Providing the necessary institutional features for growth is not at all technically difficult, particularly since these features can be copied readily from existing common law and civil law economies. The challenge is political, not economic or technical. Permitting corporations and other business organizations to be formed freely necessarily requires the state, and particular bureaucracies within the state, to relinquish some of its powers. Reducing the number of interactions with the state bureaucracy that are required before forming a corporation and reducing or (better still) eliminating the costs of forming a corporation involves something far more difficult: the voluntary sacrifice of power by the state.

Most importantly, a foreseeable consequence of making access to the corporate form cheap and plentiful is the rise of a large cohort of small businesses, and the corresponding

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[20] NOZICK, *supra* note 19, at 33. The corporate form could be made to conflict with Nozick's ideal if limited liability were waived with regard to non-consenting tort creditors. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1881 (1991). This interesting academic proposal has certainly not been the norm. *See*, *e.g.*, Mark Weinstein, *Share Price Changes and the Arrival of Limited Liability in California*, 32 J. LEGAL STUD. 1 (2003).

emergence of a middle class of small business owners and entrepreneurs. Turning specifically to the Middle East, a U.S. state department official made this point in an interview prior to a summit meeting among G-8 foreign and finance ministers and their Arab counterparts at a conference in Rabat, Morocco intended to promote democracy across the Arab world. He observed that technical and financial assistance that facilitates the formation of small business enterprises in the Middle East will contribute to democratic change in that region: "[w]hen you help small entrepreneurs, that creates a middle-class (which is) part of the social underpinning of democracy. . . We (the U.S.) see synergistic links between political and economic initiatives."[21]

From this emergent middle class base will come not only advances in per capita GDP, but also an emergent class of educated citizens interested in all sorts of reforms that inevitably will be viewed as threatening by the incumbent ruling cohort. The emergent middle class base might be threatening both as group and individually. As a group, the middle class may come to wield both economic and political power. And the first generation of middle class entrepreneurs may not be individually threatening. The children of the first generation may turn their minds to bigger things – one of them being politics. What seems to be lost on administration officials is any recognition that the ruling coalitions in these countries may not *welcome* economic initiatives that lead to political initiatives. They will not welcome political initiatives, particularly those aimed at democratization, since such reform necessarily will make threaten their jobs, status, and power.

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[21] Joel Brinkley, *U.S. Slows Bid to Advance Democracy in Arab World*, N.Y. TIMES, Dec. 5, 2004, at A1 (quoting Alan P. Larson, Undersecretary of State for Economic, Business and Agricultural Affairs); *see also* Amir Taheri, *Sowing Seeds of Democracy is Bush's Victory in 'War on Terror,'* GULF NEWS, *at* http://www.benadorassociates.com/pf.php?id=9299 (Nov. 17, 2004).

The threat of an emergent entrepreneurial class to non-democratic institutions is clear. Entrepreneurs will educate their children and this process will, in turn, lead to pressure for social reform. As Ronald Inglehart has observed, two types of social change, rising education levels and rising occupational specialization produce a citizenry that is more articulate, better equipped to organize and communicate, more autonomous, more accustomed to thinking for themselves and more endowed with specialized skills that enhance their bargaining power with the elites.[22]

In other words, it is political (and not economic or technical) factors that conspire to impede the relaxation of the constraints on corporate formation. Economic reform will lead to an emergent middle class of small business owners who will, in turn, provide broad-based and powerful support for democratization. By making it difficult to start small businesses, the ruling coalition can dampen the demand for political reform by stymieing the development of the economic cohort that will be the source of such demand.

Our theory can be viewed as a practical political implication of Robert Putnam's argument about "social capital." Putnam shows that democracy depends on such social capital. Social capital, in turn, is created by the civic and economic institutions that occupy the cultural and political space that lies outside of the family and the state.[23] If this is true, that it stands to reason that rational despots will take steps to retard the development of the civic and economic institutions that create social capital and provide the necessary components for democratic governments. One way to implement this

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[22] RONALD INGLEHART, MODERNIZATION AND POST-MODERNIZATION 163 (1997). [**AE: SOURCE MISSING].**

[23] ROBERT PUTNAM, MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY (1993). **[AU: PINCITE?]**

strategy is to make business formation more difficult. People involved in business further their interests by "networking," which, in turn, creates social capital, which in turn creates pressure for democratization. All of this is quite threatening to despots.

B. The Middle East

Timur Kuran has argued that in light of "the centrality of community building to Islam's mission, the early promoters of Islam would have rejected any concept liable to facilitate factionalism. However receptive to Roman legal concepts, they (the early promoters of Islam) would have spurned the idea of a corporation."[24] **[AU: cannot find this quote at this cite].** This is doubtful. There is much evidence to the contrary, particularly the relatively enlightened position of Islam with respect to trade and commercialism and the absence of anti-market sentiment that characterizes important strands of Christian thought.[25] The Christian notion that it is harder for a rich man to get to heaven than to transverse the eye of a needle is not found in Islam, for example.

Moreover, in the absence of specific provisions to the contrary, it seems unlikely that such a precise prohibition as the one on corporations and other separate juridical entities could have arisen from so broad and universal a concept as the promotion of inclusive communities. As Kuran has observed, "[f]aced with the question of whether it is legitimate to bequeath property to a mosque, which is not a natural person, certain early

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[24] Kuran, *Why the Middle East Is Economically Underdeveloped*, *supra* note 17, at 13.

[25] The first corporation in the world, was likely organized at the Catacombs of Kom el Shoqafafirst, which originally appears to have been developed to serve the funereal needs of a single family, but was expanded in the early second century into a burial site for the masses, administered by a corporation. Members paid dues for the right to have family members buried in one of the many rock-hewn chambers at the site. **[AU: please provide a cite for support]** It is worth noting that, unlike Christianity, Islam has never been hostile to the private sector and to rational, enlightened self-interested behavior among merchants. Indeed the Prophet himself was from a well-to-do family of the Qoreish tribes in Mecca. The chief occupation of his tribe was trade, and he traveled on business with his uncle, at one point meeting the Christian monk Behara during a commercial venture to Syria.

jurists of the had ruled in the affirmative."[26] After all, many who promote inclusive communities find nothing inconsistent with the concept of juridical entities such as the corporation. Moreover, it also is the case that

> From the dawn of Islam, every generation of Muslims faced situations that made it convenient to grant or utilize a group identity less inclusive than that of the community of all Muslims. The exigencies of daily life thus exposed the impracticability of keeping the ever-expanding global Muslim community undivided and undifferentiated.[27]

For example, guilds were organized along monopsonistic trade lines, such that foreign suppliers of goods like flour and butter were given exclusive rights to purchase these particular goods from foreign suppliers.[28] These organizations were treated as juridical entities separate from their constituents. What was lacking in these entities, and other, even more important entities recognized under Islamic law such as the waqf, or Islamic trust, was limited liability, which, in turn, requires an organization structure that gives respect to the "legal personhood" of a firm separate and distinct from its owners that can enter into contract, sue and be sued, and otherwise incur liability separate and distinct from its owners. However, it seems clear that

> [w]ith a modicum of imagination a person steeped in Islamic legal history could have found Islamic precedents showing that the Islamic legal tradition already harbored a concept of personhood. Indeed, numerous historical episodes, some from the revered

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[26] Kuran, *Why the Middle East Is Economically Underdeveloped*, *supra* note 17, at 26.

[27] *Id.* at 22.

[28] *Id*. at 20.

seventh century, could have been used to justify endowing associations with fictitious personhood.[29]

While it is implausible to blame Islam, as Timur Kuran has done, for the failure of Middle Eastern countries to adopt contemporary, flexible forms of business organization, it is even more implausible to blame Islam for the failure of Middle Eastern countries to simplify and reduce the bureaucracy required to do such things as start a business, hire and fire workers, enforce contracts, obtain credit, and close a business and collect debts from creditors. There are no Middle Eastern countries among the top twenty economies in the world as measured by the ease of doing business, despite the presence of developing economies such as Botswana and Thailand on the list. This is a vector along which global economies can and do compete: During 2003-2004, for example, countries in the EU reduced the time required for starting a business by more than 15%, and the cost of starting a new business by almost 10%. Other countries had less than 5% reductions in each of these categories.

A more likely explanation seems to lie in the interests of elites in maintaining their power over capital allocation. The notion of the corporation as separate juridical entity poses a unique political problem for religious elites that provide services which otherwise might be provided by a more efficient government. If the corporation can exist as a separate, for-profit entity, then so too can the state. Private interests matter, and it was never in the private interests of Middle Eastern countries to recognize the creation of separate juridical entities such as corporations or limited liability companies. This, in turn, has retarded economic development.

[29] *Id.* at 17-26 (observing that "the fourth caliph Ali (d. 661) is reputed to have said that the furnishings of the Kaba, Islam's most sacred sanctuary, are owned by the Kaba itself. Such precedents could have served as justification for granting legal recognition to an entity other than a natural person").

In other words, the greatest strength of the limited liability form is its ability to accumulate large sums of wealth and, consequently, to accumulate large sums of power. This, in turn, means that the corporate form represents a potential threat to the power of the very authorities that are necessary for its legitimization. The desire to curb institutional competition, in our view, provides the most likely explanation for the long-time failure of Islamic nations to grant legal recognition to non-persons.[30] Even to this day, Islamic countries tend to have restrictions on the formation of limited liability companies, particularly restrictions on foreign investment.[31]

Of course, competition between the private and the public sectors is not in any way unique to the Islamic Muslim world. This phenomenon is ubiquitous throughout the modern world. But the wide divergence in resolutions to this tension raises the question of why the state permitted the formation of limited liability juridical entities in the non-Islamic world. Here the pluralism of the West, particularly the simultaneous existence of rival governments and the competition for authority among religious groups and the state, deprived any particular authority of the ability to benefit itself by limiting access to the corporate form. Market participants who wanted the advantages of the corporate form could engage in "forum shopping," i.e. in the search for a jurisdiction that would permit this organizational form. In other words, jurisdictional competition among competing states and religions, much more prevalent in the West than in the Middle East, explains why the West generated a richer variety of corporate forms than the Middle East. For

[30] It was not until the middle of the 19th century that the first corporate form came to the Middle East, substantially later than it came, for example, to Europe. This company, the _irket-I Hayriye Marint Transportation Company, was formed in Turkey in 1851. **[AU: please provide source].**

[31] *See* http://www.infoprod.co.il/country/index.htm (last visited Mar. 3, 2005) (providing links to Middle Eastern countries that contain descriptions of the business forms and structures in each country).

example, when entrepreneurs discovered that they could incorporate in one U.S. state and do business in another without having to obtain a special legislative charter to do business in the second (host) state, the demand for special legislative corporate charters disappeared and states shifted to the modern practice of granting charters as a matter of right.[32] In the absence of this sort of jurisdictional competitive pressure, it is possible that the U.S., like many Middle Eastern countries, would have developed a much less flexible and dynamic system of business law.

The critical point here is that corporations and other limited liability entities are institutions that have the potential to be both powerfully destabilizing and powerfully democratizing. Corporations are democratizing in two ways. First, on the demand side of the equation, the introduction of corporations and other limited liability entities permit *decentralized* capital formation. Society can pursue modernization and industrialization without the need for decisions regarding capital formation to be centralized in the hands of a few families, or even in the hands of the state. While such decentralization leads to very efficient investment decisions, it also facilitates societal power-sharing in ways that other forms of financial intermediation do not. Perhaps most importantly, when firms can raise the capital they need in the public capital markets, they no longer need to rely on the government or on other sources, such as powerful families, for funding. While this reduces rent-seeking in society significantly, it also reduces the power of government and of the richest individuals and families in society.

On the supply side of the equation, there is a similar dynamic: the corporate form, with its critical features of limited liability and freely transferable shares, allows for the

[32] Henry N. Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985).

creation of a large middle class of investors in an economy that is able to accumulate large sums of capital and to put that capital to productive use. This is what accurately could be called the *democratizing* function of the limited liability form of business organization. In addition to serving the important function of reducing rent-seeking, the corporate form simultaneously permits firms to raise capital from many different sources and permits tremendous heterogeneity among suppliers of capital.

Starting a new business in a Middle Eastern or North African company is unusually difficult. These countries have among the largest capital requirements for startup businesses anywhere in the world, according to a recent report on investment climate reforms. Consistent with our analysis, this report, cosponsored by the World Bank and International Finance Corporation, the private sector lending arm of the World Bank Group, finds that investment climate reforms, "while often simple, can help create job opportunities for women and young people, encourage businesses to move into the formal economy, and promote economic growth."[33] For example, the World Bank

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[33] Press Release, The World Bank Group, Doing Business 2005: Poor Nations Struggle To Reduce Red Tape For Business, Miss Large Growth Opportunities, *at* http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20250634~menuPK:34463~pagePK:64003015~piPK:64003012~theSitePK:4607,00.html (Sept. 8, 2004); *see generally* WORLD BANK, INT'L FIN. CORP., & OXFORD UNIVERSITY PRESS, DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH (2005). The World Bank report measured the number of steps it takes to begin operating a commercial or industrial firm legally. The measurement does not count the days and procedures needed to bring the product to market, but instead counts when the firm may start operations. Typically, procedures included the time required formally to register the company as well as the procedures necessary to comply with regulations concerning: (1) taxation; (2) labor; (3) health & safety; (4) environmental; and (5) substantive "quality" screening (i.e. weeding out "undesirable" entrepreneurs). DOING BUSINESS IN 2005, *supra*; *see also* Simeon Djankov et al., *The Regulation of Entry*, 117 Q. J. ECON. 1, 7 (2002). The dataset measures the number of procedures required to "start an industrial or commercial business." If a country has multiple limited liability forms, the most popular form among small domestic firms was selected. It does not count the days and procedures to bring the product itself to market; instead the precise outcome measured is the moment when "a firm involved in industrial or commercial activity" may "begin operating legally." In counting procedures, only procedures that are required of all businesses are counted, to exclude industry-specific regulations, including industrial and commercial firms. *See* The International Finance Corporation, *Starting a Business*, *at* http://rru.worldbank.org/DoingBusiness/Methodology/StartingBusiness.aspx (last visited Mar. 3, 2005).

observes that between 2003 and 2004, Morocco experienced a jump of twenty-one percent in new business registrations after simplifying its entry procedures. This increase is truly remarkable given the fact that the minimum capital requirement for limited liability companies in Morocco was, until recently, prohibitively priced at $85,000 equivalent (10,000 MDH).[34] However, in light of the fact that the minimum capital requirements for Saudi Arabian companies is SAR 2,000,000 ($533,000) for privately held companies and SAR 10,000,000 ($2,666,000), **[AU: please provide cite; is completed phrase publicly held companies?],** while for Jordanian companies the minimum capital requirement is JD 500,000, or over $700,000, to be "minimally capitalized," this is not completely surprising.[35] In fact, the figure is in line with other Middle Eastern countries such as Oman, which has a minimum capital requirement for its public companies (joint stock companies) of RO 25,000 or $65,000.[36] However, by Western standards, the figure is almost unimaginable, as minimum capital requirement in the United States are zero in most states and close to it in others, and effectively zero in the European Union.[37] It is not random that Arab countries in which Islam is the

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[34] The Ministry of Communication of Morocco, *Corporate Legal System*, *at* http://www.mincom.gov.ma/english/invest/odi/igbook/4/1.html (last visited Mar. 3, 2005); Info-Prod Research (Middle East), *Info-Prod Country Guide: Morocco*, *at* http://www.infoprod.co.il/country/morocc2b.htm (last visited Mar. 3, 2005).

[35] Info-Prod Research (Middle East), *Info-Prod Country Guide: Jordan*, *at* http://www.infoprod.co.il/country/jordan2b.htm (last visited Mar. 3, 2005).

[36] Info-Prod Research (Middle East), *Info-Prod Country Guide: Oman*, *at* http://www.infoprod.co.il/country/oman2b.htm (last visited Mar. 3, 2005).

[37] Some countries in the EU have a (relatively paltry) minimum capital requirement of €25,000. *See* Luca Enriques & Jonathan Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001). However, since under a series of rulings by the European courts it is possible to organize a shell company in an EU member state with little or no minimum capital requirement and then organize a "branch" in a member state with a high minimum capital requirement, these requirements can be avoided easily and cheaply. This is not the case in the Middle East.

dominant religion account for six of the ten countries in the world with the highest minimum capital requirements for starting a business.

Interestingly, the report, which measures the efficiency of regulation in 145 countries, "finds that poor nations, through administrative procedures, still make it two times harder than rich nations for entrepreneurs to start, operate, or close a business, and businesses in poor nations have less than half the property rights protections available to businesses in rich countries."[38] Similarly, the report found that Jordan reduced the time it takes to register a new business by nearly nine weeks and now gives regulators an incentive to maximize the value recovered for creditors when a business must close. The Jordanian government still requires a new business to have minimum capital equivalent to eleven times the nation's average per capita income. In Saudi Arabia and Yemen, the minimum capital requirement is more than fifteen times average income. In Syria, the requirement is a stunning fifty times average income. By comparison, more than fourty nations worldwide, including the United States, have no minimum capital requirement for a startup business.

Despite the fact that Jordan's King Abdullah II claims to be strongly in favor of market-oriented economic liberalization, and is ostensibly pursuing privatization schemes and pro-investment reforms, our critique of inefficient small business regulatory regimes remains.[39] Part of this disjuncture between words and action may be attributable to the

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[38] Press Release, The World Bank Group, Doing Business in 2005: Middle Eastern Nations Struggle to Reduce Red Tape for Business, Miss Large Growth Opportunities, *at* http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20250838~menuPK:34466~pagePK:64003015~piPK:64003012~theSitePK:4607,00.html (Sept. 8, 2004).

[39] Jordan's indicators in the *Doing Business* report are abysmal. It takes entrepreneurs 11 steps and 36 days to launch a business, as compared to an OECD average of 6 steps and 25 days. Furthermore the cost of starting a business is equal to 53% of gross national income (GNI), as compared to the 8% average for OECD nations. The most staggering figure, though, may be the ratio of minimum capitalization requirements to GNI per capita. Jordanian businesses must deposit at least 1147.7% of GNI per capita to

fact that economic liberalization is often focused on external (i.e. foreign) investors and multinational corporations rather than on the small businesses that are likely to be organized by local entrepreneurs. This, in turn, may be due to the fact, for the reasons developed in this article, the incumbent ruler prefers that the economic gains associated with market reforms inure to foreigners, rather than domestic entrepreneurs. Any new entrepreneurial class created by market reforms is likely to push for democratic liberalization and other changes threatening to incumbent rulers.

In October 2002, King Abdullah unveiled a-high profile publicity and public relations campaign called the "Jordan First" program.[40] Structured as a sort of "compact" between the government and its people, the program features government promises to abide by the principles of accountability and transparency, and, in turn, asks Jordanian citizens to place "Jordan's national interest at the forefront of all considerations of civil society."[41]

The Jordan First campaign features a government pledge to enact procedural, legislative, and administrative reforms to "stimulate and encourage private investment in the various economic facilities." In return, it hopes that the private sector will "plac[e] the Homeland's interests among its priorities," including private sector investment in education and job training as well as hiring preferences for Jordanians.[42]

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receive a business registration number, as compared to a mere 44.1% for OECD nations. World Bank & International Finance Corporation, *Snapshot of Business Environment – Jordan*, *at* http://rru.worldbank.org/DoingBusiness/ExploreEconomies/BusinessClimateSnapshot.aspx?economyid=99 (last visited Mar. 6, 2005).

[40] Embassy of the Hashemite Kingdom of Jordan, *Economic Reforms*, *at* http://www.jordanembassyus.org/new/aboutjordan/er1.shtml

[41] *Id*.

[42] *Id*.

The Jordan First program's objectives are to help build a free, democratic Jordan which is still Hashemite. The campaign involves the articulation of the government's self-imposed obligations to various sectors of society (e.g. private sector, media, education) and the state's suggested reciprocal actions for these sectors. A central goal of the campaign is to engender feelings of nationalism and patriotism in Jordanian citizens. The state, for example pledges to provide citizens with "justice, equality, the Rule of Law, transparency and accountability." In turn the people are "duty-bound to respecting its laws and dignity, safeguarding its constants, protecting its stability and national security, and defending its interests faithfully and with dedication."[43]

The World Bank also reported that, around the world, rich countries undertook three times as many investment climate reforms as poor countries during 2004. None of the top ten reformers of investment climate (Slovakia, Colombia, Belgium, Finland, India, Lithuania, Norway, Poland, Portugal, and Spain) was from the Middle East.

Other findings related to Middle Eastern nations:

- Of the fifty-eight countries that reformed business regulation or strengthened the protection of property rights in the last year, only seven were in the Middle East.
- Only two nations in the region, Tunisia and Israel, ranked in the top quartile of the countries surveyed on the ease of doing business. Both countries improved further last year. Tunisia improved the recovery rate in bankruptcy and increased the coverage of borrowers in its public credit registry. Israel established a new procedure for debt recovery in the courts, which takes less than seven months. Previously, it took a year for creditors to collect overdue debt.
- Among nations enacting reforms, Jordan improved the process for starting a new business the most, by cutting the number of procedures from 14 to 11 and the number of days from 98 to 36.
- Jordan, along with Morocco, Egypt, Saudi Arabia, Yemen, and Syria, still is in the list of the 10 countries in the world with the highest minimum capital requirement for starting a business.

[43] King of the Hashemite Kingdom of Jordan, *Jordan First*, *at* http://www.kingabdullah.jo/main.php?main_page=1&lang_hmka1=1.

- Algeria, Morocco, and Yemen also recently reduced the number of days necessary to start a business. Saudi Arabia reformed its public credit registry, nearly doubling the number of borrowers with information available at the registry.[44]

However, despite these reforms, Michael Klein, World Bank/IFC Vice President for Private Sector Development and IFC Chief Economist, observed that "poor countries that desperately need new enterprises and jobs risk falling even further behind rich ones who are simplifying regulation and making their investment climate more business friendly."[45] The main research findings of *Doing Business in 2005* relevant here are summarized as follows:

- ***Businesses in poor countries face larger regulatory burdens than those in rich countries***. Poor countries impose higher costs on businesses to fire a worker, enforce contracts, or file for registration; they impose more delays in going through insolvency procedures, registering property, and starting a business; and they afford fewer protections in terms of legal rights for borrowers and lenders, contract enforcement, and disclosure requirements. In administrative costs alone, there is a threefold difference between poor and rich nations. The number of administrative procedures and the delays associated with them are twice as high in poor countries.

- ***The payoffs from reform appear to be large***. The report estimates that an improvement from the bottom to the top quartile of countries in the ease of doing business is associated with an additional 2.2 percentage points in annual economic growth.[46] An indication of the payoff comes from Turkey and France, each of which saw new business registration increase by 18 percent after the governments reduced the time and cost of starting a business last year. Slovakia's reform of collateral regulation helped increase the flow of bank loans to the private sector by 10 percent. The payoff comes because businesses waste less time and money

[44] Press Release, Doing Business in 2005: Middle Eastern Nations Struggle to Reduce Red Tape for Business, Miss Large Growth Opportunities, *supra* note 38.
[45] Press Release, The World Bank Group, Doing Business in 2005: Recent EU Entrants Are Top Reformers While Others in the Region Struggle to Reduce Red Tape for Business, Miss large Growth Opportunities, *at* http://www.worldbank.org.yu/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/SERBIAEXTN/0,,contentMDK:20252027~menuPK:300923~pagePK:141137~piPK:141127~theSitePK:300904,00.html (Sept. 8, 2004).
[46] But as mentioned above, it is difficult to determine whether the growth helped spur movement for de-regulation.

on unnecessary regulation and devote more resources to producing and marketing their goods and because governments spend less on ineffective regulation and more on social services.

- ***Heavy regulation and weak property rights exclude the poor - especially women and younger people - from doing business***. The report finds that weak property rights and heavy business regulation conspire to exclude the poor from joining the formal economy. "Heavy regulation not only fails to protect women, young people, and the poor - those it was intended to serve - but often harms them," said Caralee McLiesh, an author of the report. Doing Business shows that countries with simpler regulations can provide better social protections and a better economic climate for businesspeople, investors, and the general public. The Report builds on noted economist Hernando de Soto's work, showing that while it is critical to encourage registration of assets, it is as important - and harder - to stop them from slipping back into the informal sector.

What is striking about the reforms described above for simplifying regulation and facilitating the process of starting small businesses is that they are so amazingly simple. It does not take a sophisticated understanding of economics, finance, or administrative procedure to be able to organize a simple corporate code and to reduce the costs, both direct and bureaucratic, associated with starting a business. Therefore, one must consider the possibility that growth is not encouraged in Middle Eastern countries because the elites in these countries do not want such growth to occur for political reasons. As Enrico Colombatto and one of us (Macey) have pointed out previously:

> Growth alters the balance of power between the rulers and potential rival coalitions and increases the probability of political change.[47] In other words, in these economies growth can bring the political information and transaction costs associated with opposing an existing ruler into reach. When these costs become affordable [internal] interest groups that are powerful enough to fight for [regime change] will form. Hence the frequently observed

[47] *See also* ALEXIS DE TOCQUEVILLE, L'ANCIEN REGIME ET LA REVOUTION GALLIMARD (1985); Mancur Olson, *Rapid Growth as a Destablizing Force*, 23 J. ECON. HIST. 529 (1963).

> efforts by [ruling elites] to stifle growth opportunities are consistent with the rational self-interest of such leaders.[48]

In other words, in certain countries, low growth exists because it is difficult to displace existing rulers, and existing rulers, of course, have an interest in keeping it difficult to displace them. One way that such rulers can make it difficult to be displaced is to prevent potential rivals from amassing enough wealth to pose an effective democratic challenge. By contrast, in developed countries, which tend to be democratic, where growth rates become too low, changes in power are likely. In democracies, low economic and political transaction costs encourage interest groups to come together to demand change. As growth slows, these groups will be increasingly more successful at advocating for reform. But democracy, tolerance for dissent, and a minimum level of wealth and security are prerequisites for groups successfully to demand reform. Often, in developing countries, incumbent rulers have no incentives to press for even the simplest reforms that will lead to improvements in economic performance because these reforms would promote political dissent by providing some of the prerequisites necessary for groups to galvanize into effective political coalitions to demand reform. In other words, high growth is in the interest of the leaders of democracies, but not necessarily in the interests of the leaders of non-democracies, where growth will lead to greater pressure for reform and greater contestability of leadership positions.

Here our argument is consistent with the point made by Noah Feldman that the "optimal strategy" for autocrats in the Muslim world is "to eliminate secular democratic dissent, keeping just enough Islamist opposition alive to make Islamism the only

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[48] Enrico Colombatto & Jonathan Macey, *Information and Transaction Costs as the Determinants of Tolerable Growth Levels*, 155 J. INSTITUTIONAL & THEORETICAL ECON. 617, 622 (1999).

alternative without enabling it to become strong enough to overthrow the government."[49] Autocrats have incentives to keep enough Islamist extremist opposition alive to permit them to make a credible (though false) claim to that Islamism is the only alternative to the *status quo*. It also is important to such autocrats that no group becomes "strong enough to overthrow the government."[50]

Autocrats have the same incentives to stifle the emergence of a middle class of small business entrepreneurs that they have to repress democratic (and non-democratic) Islamic opposition parties: they don't want serious opposition to their power to emerge. This, appears to us to be the best "rational choice" explanation for the regulations that we observe in autocratic Middle Eastern countries that make business formation so difficult.[51]

We are not claiming that the contestability of democracy is somehow a pre-requisite for having responsive rulers who would be willing to shelve anti-growth business law. The pro-growth, pro-limited liability stance of China, Singapore, Taiwan, Suharto's Indonesia, and other non-democratic countries suggests otherwise. Our point is that democratic countries inevitably and ubiquitously feel pressure to grow. It also is the case that non-democratic countries sometimes feel similar pressure.

Our claim, therefore, is that democracy is a sufficient condition for responsive rulers who would tend to avoid anti-growth policies (such as those restricting the creation

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[49] NOAH FELDMAN, AFTER JIHAD: AMERICA AND THE STRUGGLE FOR ISLAMIC DEMOCRACY 23 (2003).

[50] *Id*.

[51] Rational choice theory posits that humans are purposive and goal-oriented. They have sets of hierarchically ordered preferences, or utilities, and tend to make rational calculations about the utility of alternative lines of conduct with reference to the preference hierarchy, particularly with respect to major decisions, such as whether to support policies that would facilitate the creation of small business. The theory also predicts that social phenomena—social structures, collective decisions, and collective behavior—are ultimately the result of rational choices made by utility-maximizing individuals. JONATHAN TURNER, THE STRUCTURE OF SOCIOLOGICAL THEORY 354 (1974).

of limited liability business forms). In non-democracies, the leaders will have to balance the personal benefits of growth against its costs. Leaders that have other threats to their continued power – especially external threats – may still find it worthwhile to encourage the growth of corporate forms of organization and the entrepreneurship that goes along with it.[52]

Promoting entrepreneurship brings to incumbent leaders both risks and rewards. The rewards come in the form of greater wealth, as the proceeds from taxation and other forms of revenue collection increase as national income increases. The risks come from the fact that, as many studies show, when incomes rise, governments tend to become more democratic.[53] Clearly, countries with more economic freedom (lower taxes, less regulation of markets) have greater wealth and higher rates of growth. There is a statistically significant positive relationship between economic freedom and per capita national income.[54] Economic freedom today leads to greater wealth tomorrow. More interestingly, economic freedom may in some way lead to or "cause" political freedom.[55] This political freedom, in turn poses risks to incumbent leaders.[56]

The natural endowments of particular nations also play an important role in the extent to which leaders feel pressure to assume the risks and rewards associated with promoting entrepreneurship. Oddly, states with greater natural resource

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[52] Colombatto & Macey, *supra* note 48~~49~~, at 637.

[53] Peter Kurrild-Klitgaard & Niclas Berggren, *Economic Consequences of Constitutions: A Theory and Survey*, 14 Journal des Economistes et des Etudes Humaines 3 (2004).

[54] *Id.* at 19 (citations omitted).

[55] *Id.* at 21; see *also* W. Ken Farr et al., *Economic Freedom, Political Freedom and Economic Well-Being: A Causality Analysis*, 18 Cato J. 247 (1998).

[56] Michael L. Ross, *Does Oil Hinder Democracy?*, 53 World Pol. 325 (2001), *available at* http://www.polisci.ucla.edu/faculty/ross/doesoil.pdf.

wealth—including oil wealth—tend to grow more slowly than their less well-endowed counterparts.[57] Part of the explanation for this lies in the fact that rentier states, which are states that obtain a large proportion of their revenues from external sources (rents), such as from the sale of natural resources like oil,[58] suffer from a democracy deficit, which in turn, stifles demand for economic growth. It is not obvious why being a rentier state undermines democracy: the argument seems to be that when governments can generate significant wealth from natural resources, they can reduce the tax burden on their citizens, who, in turn, demand less from government.[59] Along these lines, states such as Libya and Saudi Arabia, use their oil wealth for social spending programs that have helped reduce internal pressures for social reform and democratization.[60]

As discussed below, our analysis is not inconsistent with the rentier state hypothesis. In fact, the lack of incentives associated with oil wealth can further reduce the incentives of rulers to institute economic reforms beyond what they would otherwise

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57 Jeffrey D. Sachs & Andrew M. Warner, *The Big Push, Natural Resource Booms and Economic Growth*, 59 J. ECON. DEV. 43 (1999); Jeffrey D. Sachs & Andrew M. Warner, Natural Resource Abundance and Economic Growth (1995) (National Bureau of Economic Research Working Paper 5398), *available at* http://papers.nber.org/papers/w5398.v5.pdf.

58 The concept of a rentier state can be traced at least to Lenin, who opined that '[t]he rentier state is a state of parasitic decaying capitalism, and this circumstance cannot fail to influence the socio-political conditions of the countries concerned." Vladimir I. Lenin, *Imperialism the Highest Stage of Capitalism*, *in* THE LENIN ANTHOLOGY (Robert C. Tucker ed., 1975). [AE: Missing Source][**AU: Pincite Needed**] Hazem Beblawi has defined the rentier state as one in which the state derives income directly from foreign sources, rather than from taxes imposed on resident individuals and business firms, and in which "only a few [people] are engaged in the generation of this rent [income], the majority being only involved in the distribution or utilization of it." Hazem Beblawi, *The Rentier State in the Arab World*, *in* THE RENTIER STATE **49, 51** (Hazem Beblawi & Giacomo Luciani eds., 1987).

59 *See* Giacomo Luciani, *Allocation vs. Production States: A Theoretical Framework*, *in* Beblawi & Luciano, *supra* note 58~~59~~, **63**, 73-74

60 DIRK VANDEWALLE, LIBYA SINCE INDEPENDENCE: OIL AND STATE-BUILDING (1998); John Enteelis, *Oil Wealth and the Prospects for Democratization in the Arabian Peninsula: The Case of Saudi Arabia*, *in* ARAB OIL: IMPACT ON THE ARAB COUNTRIES AND GLOBAL IMPLICATIONS **77** (Naiem A. Sherbiny & Mark A. Tesler, eds., 1976).

be. The problem with the rentier state hypothesis as a global explanation for the legal and bureaucratic obstacles to business development that we observe in the Middle East is that this explanation (obviously) only applies to rentier states, i.e. those that derive a major portion of their income from oil and other natural resources. In contrast, the phenomenon that we observe, the imposition of obstacles to economic growth in the form of regulations making business formation more difficult, is ubiquitous in the Middle East. It is not limited to rentier states such as Saudi Arabia, but also applies to relatively oil poor states such as Egypt, Jordan, and Syria.

Oil causes other problems as well that are not accounted for by the rentier state hypothesis. In particular, scholars have observed that states with natural resource wealth such as oil tend to have more civil wars.[61] This phenomenon makes sense from our perspective: natural resources are worth fighting over, and coalitions that control a country will control its natural resources. While incumbent leaders cannot, as a practical matter, rid themselves of natural resources such as oil in order to reduce the chances of civil war, rulers can stifle entrepreneurship, thereby reducing societal wealth and reducing the growth of an educated middle class that might attempt to gain control of government, or at least pressure the incumbent leadership for democratic reforms. And, of course, as the threat of civil war increases, incumbent leaders can justify repressive, anti-democratic measures, as well as the care and feeding of a large police state capable of quashing both violent unrest and democratic initiatives.

[61] Paul Collier & Anke Hoeffler, *On Economic Causes of Civil War*, 50 OXFORD ECON. PAPERS 563 (1998); Indra de Soysa, *The Resource Curse: Are Civil Wars Driven by Rapacity or Paucity?*, *in* GREED AND GRIEVANCE: ECONOMIC AGENDAS IN CIVIL WARS 113 (Mats Berdal & David M. Malone eds., 2000).

The insights in this paper have implications that complement the rentier state hypothesis regarding the issue of whether oil (and other natural resources) hinders democracy.[62] In the framework developed here, every ruling coalition faces a tradeoff between the benefits of economic liberalization—including, most significantly, higher tax revenues—and the costs—including, most significantly, the emergence of a middle class of small business entrepreneurs.

Assuming, as is probably the case, a diminishing marginal utility of wealth for despots, countries with oil see (ceteris paribus) fewer benefits from liberalization (because they have oil wealth), but no fewer costs. Therefore, non-democratic countries with oil wealth will be even less inclined to liberalization than other non-democratic countries. A related argument has been made by Michael Ross, who has hypothesized that, "[w]hen oil revenues provide a government with enough money, the government will use its largesse to prevent the formation of social groups that are independent from the state and hence that may be inclined to demand political rights."[63] Similarly, Kiren Aziz Chaudhry has argued that governments in the Middle East "deliberately destroyed independent civil institutions" and developed programs that were "explicitly designed to depoliticize the population."[64]

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[62] Ross, *supra* note 7.
[63] *Id.* at 334.

[64] Kiren Aziz Chaudhry, *Economic Liberalization and the Lineages of the Rentier State*, 27 COMP. POL. 1 (1994). Country studies on Algeria, Iran, Iraq, and the Arab Gulf states have argued that oil wealth has been an impediment to democracy by retarding the formation of social capital. *See*, *e.g.*, Jill Crystal, *Civil Society in the Arab Gulf States*, *in* 2 CIVIL SOCIETY IN THE MIDDLE EAST 259 (Augustus Richard Norton ed., 1996); John P. Entellis, *Civil Society and the Authoritarian Temptation in Algerian Politics*, *in* 2 CIVIL SOCIETY IN THE MIDDLE EAST **45**; Zuhair Humadi, *Civil Society under the Ba'th in Iraq*, *in* TOWARD CIVIL SOCIETY IN THE MIDDLE EAST 50 (Jillian Schwedler ed., 1995); Farhad Kazemi, *Civil Society and Iranian Politics*, *in* 2 CIVIL SOCIETY IN THE MIDDLE EAST 119.

Small business formation produces problems for government much the same as oil. Both generate revenues and both generate social unrest. Whether Mideast states use their oil revenues deliberately to inhibit dissent may be subject to some disagreement,[65] but the impediments that we observe to small business formation are unambiguously deliberate.

On the basis of the foregoing, we can divide Middle Eastern states into three categories: poorly endowed states with clear external threats, poorly endowed states with no clear external threats, and, finally, oil rich states. Israel and Lebanon are states that suffer both a lack of natural endowment as well as an abundance of clear external threats. Syria and Egypt are powerful states whose ruling coalitions benefit from a lack of external threats but lack much in the way of natural resources such as oil. Kuwait and Saudi Arabia are oil-rich states with significant external threats.[66]

We predict that poorly endowed states with clear external will be constrained to pursue liberal economic policies that encourage growth and development. The leaders of countries such as Israel and Lebanon (and Singapore and Taiwan outside of the Middle East) must, if they are to survive, produce growth in order generate the resources necessary to provide security against external threats, and to quell internal dissatisfaction.[67] In other words, the presence of external threat makes leadership

[65] Ross, *supra* note 57, at 334.

[66] Oil-rich states can afford larger military forces to arm themselves against both external threats and internal pressure. Oil-rich states also are likely to enjoy the protection of the U.S. security umbrella. Clearly this is the case for Kuwait and Saudi Arabia, whose ruling coalitions enjoy the benefits of a significant U.S. military presence, without which they probably would not long survive.

[67] While control of Lebanon's government clearly is not as contestable as it might be, due to the presence of Syrian "peace-keepers" and the installation of a pro-Syrian puppet government, relatively to other Middle Eastern countries, Lebanon has strong democratic traditions and impulses. For example, on February 28, 2005, Lebanese Prime Minister Omar Karami announced the resignation of his pro-Syrian government.

positions in these countries contestable, as in democracies. This contestability, in turn, leads to responsive government. Nowhere is this dynamic more evident than in Israel, which would cease to exist if it could no longer generate the resources necessary to provide for a strong national defense. Moreover, a weaker economy, as measured by lower GDP per capita, would make it more difficult for Israel to attract Jewish immigration and to prevent emigration to richer countries such as Canada, the U.S. and Australia. Thus, despite the hard socialist underpinnings of the Jewish state, successive governments, although nominally left-wing, pursue pro-growth economic policies.

In contrast, the ruling coalitions in Syria and Egypt, with few external threats, have weak incentives to pursue reforms likely to generate growth, and even weaker incentives to tolerate the political dissent and the democratically inclined social class that such growth is likely to generate. Consistent with this our analysis, while it is relatively cheap and simple to start a new business in Lebanon and Israel, it is costly and complex to do so in Egypt and Syria.

Of course, we do not mean to imply that Egypt and Syria are free from pressure for political reform, despite the lack of democratic government. As a result of the recent U.S.-sponsored elections in Iraq, the entire Middle East is "bubbling with expectations for political reform."[68] The pressure comes both from domestic opposition groups as well as from foreign governments. The pressure on Egypt is particularly strong, since the country receives roughly $2 billion in U.S. aid annually, and has been criticized for moving slowly to enact democratic reforms. In particular, during his State of the Union

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The resignation occurred two weeks after the assassination of Karami's predecessor, Rafik Hariri, which triggered protests in the streets and demands that Syria withdraw its troops from the country. *See* Hassan M. Fattah, *Syria Under Pressure: Worse Trouble May Lie Ahead*, N.Y. TIMES, Mar. 3, 2005, at A3.

[68] Neil MacFarquhar, *Mubarak Pushes Egypt to Allow Freer Elections*, N.Y. TIMES, Feb. 27, 2005, at A1.

address on February 2, 2005, George W. Bush suggested that "[t]he great and proud nation of Egypt, which showed the way toward peace in the Middle East, can now show the way toward democracy in the Middle East."[69] Shortly thereafter, on February 26, Egyptian President Hosni Mubarak unexpectedly called on that country's Parliament to amend the Constitution to allow for direct, multiparty presidential elections for the first time in the nation's history.[70] President Mubarak predicted that the next president of Egypt "will be elected through direct, secret balloting, opening the opportunity for political parties to run in the presidential elections and providing guarantees that allow more than one candidate for the people to choose from with their own will."[71] The proposal was heralded in the press as responding both to "vocal domestic demands for increased democracy as well as stepped-up pressure from the Bush administration."[72]

On a more modest note, bowing to international pressure, Syria has said that it will remove its troops from Lebanon. And recently, Syria arrested and turned over to Iraqi officials some thirty former leaders of Saddam Hussein's regime who were being sought by coalition forces for aiding the insurgency. Hussein's half-brother, Sabawi Ibrahim al-

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[69] President George W. Bush, State of the Union Address Before a Joint Session of Congress (Feb. 2, 2005), *available at* http://www.whitehouse.gov/news/releases/2005/02/20050202-11.html.

[70] MacFarquhar, *supra* note 69.

[71] *Id*.

[72] *Id*. During his speech, President Mubarak did not discuss amending Article 77 of the Egyptian Constitution, which provides for an unlimited term of office for the Egyptian President. His comments were restricted to amending Article 76 of the Constitution, which deals with how presidents are selected. Not all observers were convinced that the proposed changes are meaningful. *Id*. Columnist and political analyst Ibrahim Eissa observed, "[t]his is a way [for Mubarak] to improve his image with the Americans and to please them with some formal changes . . . [w]hile at the same time he is keeping everything else unchanged, like the emergency laws, imprisoning the opposition, the state controlling the media and political parties existing just on paper. This is deception." *Id*. at A4. Ayman Nour, head of Al Ghad, a newly approved political party, was imprisoned on January 29, 2005, on allegations that he forged signatures to gain government recognition of his political party. Critics of Mubarak such as Hisham Qassim, Vice President of Al Ghad, observe that "the only credible candidate against Mubarak is lying in prison on trumped up charges." *Id*. at A4.

Hassan al-Tikriti, the former chief of Iraq's two most powerful security agencies was among this group.[73]

Our theory is that democratization will bring with it internal pressure for economic reform. We also posit that economic reform will bring increased pressure for democratization in countries such as Egypt and Syria. For this reason, economic reform of the kind we discuss in this Article (simplifying and reducing the costs of business formation) will be a good "leading indicator" of political leaders' real interest in implementing meaningful democratic reforms that go beyond mere public relations gimmicks.

Finally, our third category of countries, Kuwait and Saudi Arabia, have even weaker incentives to pursue high growth economic policies than countries such as Egypt and Syria, since their natural resources provide them with the wealth necessary to pacify local dissent, and to attract the protection of the United States military. In these countries starting a new business is costly and complex. And, as we would expect, the situation is relatively worse in Saudi Arabia than in Kuwait, because Kuwait's position is relatively more vulnerable to external threat.

Another concern for the leaders of non-democracies might concern the management of inequality. While we have stressed the direct threat that an emergent middle-class poses for incumbent rulers, it is also possible that a newly minted discrete entrepreneurial class would provoke lower-class resentment and thus indirectly threaten to destabilize an incumbent regime.[74] Lower-class resentment would reinforce the impulse for incumbents

[73] John F. Burns, *Syria Turns Over a Top Insurgent, Iraqis Say*, N.Y. TIMES, Feb. 28, 2005, at A1.
[74] Amy Chua has shown how in democracies free market forces can provoke lower-class resentment against "market dominant minorities," but an analogous resentment might arise in non-democracies that spur

to oppose growth policies—especially if the masses resent royalty and old wealth less than new wealth.[75]

However, we stress that, in the context in which we are writing, which concerns the optimal strategy of rulers in an autocracy, we need not make the strong claim that the ruling elite we are discussing is in fact rational. We need only to sustain the significantly weaker claim that these rulers *behave as though* they were rational.[76] This claim seems quite easy to make because natural selection among competing rulers will prevent autocrats who act irrationally (i.e. in ways inconsistent with the goal of remaining in power), will be replaced by leaders who, whether or not they are rational, act consistently rationally such that they remain in power. Nevertheless, in light of the very high stakes context we are consider here, which concerns whether national leaders will adopt rational strategies when their very survival is at stake, the assumption that leaders will consider carefully the consequences of their actions and behave consistently with the policy of maximizing the probability that they will remain in power, seems hardly far-fetched or unrealistic.[77]

Our analysis also is consistent with public choice theory, which applies the assumptions of microeconomics to the realm of government behavior and generally finds

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entrepreneurship as well. *See generally* AMY CHUA, WORLD ON FIRE: HOW EXPORTING FREE MARKET DEMOCRACY BREEDS ETHNIC HATRED AND GLOBAL INSTABILITY (2002).

[75] At the conference, xxx **[AU: please complete attribution]** spoke of Nasser's seduction of the masses with regard to policies that seem to sacrifice growth in the name of equality.

[76] *Cf.* MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953) (articulating the rationality assumption in economics in the same manner).

[77] Our public choice approach parallels a claim that Abdulaziz H. Al Fahad made at the conference. He said that U.S. leaders knew what they were doing at every stage of the Iraq invasion. The recent violent chaos and Sunni-Shia divisions were not a failure of a post-war plan, but an intended part of the plan. We are arguing that the anti-growth policies of Middle Eastern countries are not a failure of implementation but an intended part of regime stabilization.

that, although self-interested behavior leads to desirable results in the sphere of private ordering, such behavior also dominates the sphere of public ordering where it produces political decisions designed to benefit the decision-makers, often with negative consequences for those subject to such decisions. Interest groups and ruling coalitions (and voters in democracies) seek special advantage from the state in a process known as rent-seeking.

Public choice theory applies to bureaucrats as well as to the politicians and autocrats they serve. Indeed, for some thinkers, public sector bureaucrats are the critical agents in public choice theory. While such bureaucrats often, and erroneously, are assumed to work in the public interest by effectuating rational, public-spirited government programs efficiently and effectively, public choice theorists see bureaucrats as self-interested utility-maximizers, motivated by such factors as "salary, perquisites of the office, public reputation, power, patronage . . . and ease of managing the bureau."[78]

From a public choice perspective, increasing the number of procedures necessary to start a new business makes perfect sense. For every government permit necessary to start a business, a new bureaucracy can be formed that is staffed with the friends and relatives of the autocrat. Thus, when the World Bank recently surveyed laws, regulations, and government officials from around the world, the largest single problem in starting a new business was "[t]oo many separate procedures and different offices to visit."[79] In particular the World Bank recommends creating single access points for business, making

[78] WILLIAM A. NISKANEN, BUREAUCRACY: SERVANT OR MASTER? (1973). [**AU: Please Provide pincite**].

[79] DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH, *supra* note 31 at 21.
This point originally was made in HERNANDO DE SOTO, THE OTHER PATH (1987), a brilliant study of the obstacles to starting a business in Peru.

electronic registration of new business possible, standardizing paperwork across bureaucracies, and imposing a "silence is consent" rule in business registrations.[80] As sensible as these suggestions are, it is clear why autocratic regimes are often reluctant to implement these sorts of proposals: the costs associated with effectuating these reforms will be borne by politically powerful and well-connected bureaucrats, and their autocratic sponsors, who will suffer a diminution of power (including, potentially, the ability to collect bribes and to employ lower-level bureaucrats). The benefits from such reform, however, would inure only to an amorphous, attenuated, politically powerless group of nascent entrepreneurs who *might* overcome the transaction obstacles to starting a new business if such costs were reduced.

Consistent with our analysis, it is not surprising that the average number of days required to start a business in the Middle East is 43 (not including Israel), as compared with 8 in France, 13 in Italy and 5 in the U.S., and that more (an average of 10.5) procedures are needed to start a business in the average Middle Eastern country (not including Israel) than in the U.S. (5), France (7), Israel (5) or even heavily bureaucratized Italy (9).[81]

The public choice analysis explains why so much bureaucracy is required to start a new business in non-democratic countries in the Muslim world and elsewhere. The rational choice analysis explains both why so much bureaucracy is required and why minimum capital requirements are so high. Both theories focus on the private incentives of a ruling elite, both in self-preservation and in expanding its power base. Next we

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[80] DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH, *supra* note 31 at 21.

[81] *See infra* tbl 2.

consider the extent to which the heavy bureaucracy and high minimum capital requirements we observe particularly in autocratic states in the Middle East can be rationalized as consistent with the public interest. We conclude that they cannot be.

First, with respect to the requirements regarding bureaucracy, and the suggestion that government can assist business by nominating an existing bureaucracy to be the single access point to bring together representatives of various other agencies, we see no other explanation, other than the public choice and rational choice explanations offered here, for why developing countries do not streamline their procedures for starting new businesses in order to reduce the transaction costs associated with starting a new business.[82] Similarly, other well-known reforms, particularly eliminating court involvement in the registration process, permitting companies to utilize a single company identification number, and permitting a general-objects clause in new firms' articles of incorporation, are all simple, straightforward policy initiatives with clear benefits and no discernible costs, other than for bureaucrats.

Somewhat more controversial, though not much, is our argument that the high minimum capital rules of various autocratic Middle Eastern countries can be explained on the grounds that such rules are necessary in order to protect creditors dealing with the new firm from losses incurred in extending credit to marginally capitalized companies. First and foremost, the protections provided by minimum capital requirements are entirely illusory. These rules are purely barriers to entry: they do not require that firms maintain a minimum amount of capital to protect creditors. Thus, a company with $1 million in minimum capital at the start of operations is free, of course, to allocate this

[82] DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH, *supra* note 31 at 21.

capital to operations. By the end of the first year (indeed, by the end of the first day) of operations, the entire value of the original capital contribution might be dissipated.

Second, with respect to contract claimants, the ineluctable reality is that "creditors today do not rely upon statutory protection (such as restrictions on dividend payments and other distributions, as well as minimum capital requirements). Trade creditors rely instead on security interests or careful monitoring of their receivables while commercial lenders require disclosure of financial data, security interests, and contractual limitations on distributions.[83]

These market-based contractual protections have the advantage of being flexible. Such protections also are superior to minimum capital rules because they can be tailored to the needs of particular companies and their creditors. By contrast, minimum capital rules manage to be both over-inclusive and under-inclusive in the creditor protections they provide. Such rules are over-protective because they require firms with few, if any creditors and little risk (and therefore pose no danger to prospective creditors) to incur the economic waste associated with high minimum capital requirements in order to initiate activity. By contrast, contractual protections are, by their very nature, tailored to the particular needs of individual companies. Instead, minimum capital requirements take a one-size-fits-all approach to the issue of minimum capitalization that necessarily distorts capital markets.

Minimum capital requirements are under-protective of creditors' interests for the same reason: by imposing uniform capital requirements, they necessarily do not provide sufficient levels of protection for the creditors of businesses that are hazardous or simply

[83] TED J. FIFLIS, HOMER KRIPKE, & PAUL M. FOSTER, ACCOUNTING FOR THE BUSINESS LAWYER (4th ed. 1991). **[AU: please provide pincite].**

highly risky. Indeed, if minimum capital protections were the only protections available to creditors, then the economy would generate too many risky ventures, and too few safe ventures.

There is a slightly stronger argument in favor of minimum capital requirements as a means for protecting involuntary creditors such as tort claimants, as opposed to contractual claimants who make voluntary investments, and can decline to invest, or who can charge a high rate of interest to compensate for the various sorts of risk inherent in a particular investment.

Even here, though, the public interest argument for imposing minimum capital requirements on all new limited liability companies is very weak. First, the rules do not apply only to non-contractual claimants. The fact that tort claimants and other involuntary creditors do not have a priority over other claimants suggests that the minimum capital rules are not designed for their protection. Moreover, for the reasons mentioned above regarding the illusory nature of minimum capital requirements, requiring insurance would be a far superior strategy for addressing the needs of involuntary insurance than minimum capital requirements, yet, consistent with the public and rational choice theories—and inconsistent with the public interest theory—we do not observe countries imposing the requirement that firms in risky lines of business purchase liability insurance for the benefit of their potential tort victims.

The above point about the efficacy of insurance markets as a substitute for minimum capital requirements is particularly relevant to developing countries, where the argument might be made that weaknesses in the legal system, corruption, poor creditor protection, and other factors make minimum capital requirements the best option in a less-than-perfect world, often riddled with avaricious [**AU: missing word?**] characterized by weak enforcement of contractual terms due to corruption or incompetence in the courts. Presumably such shortcomings will be known to creditors, who can price that risk. Moreover, minimum capital requirements do not help creditors in countries in which weak enforcement is an obstacle.

C. Anti-Americanism as Pretext

The benefits of the limited liability form of business organization are so well known by now that, in addition to explaining the failure of Middle Eastern countries to invent modern forms of business organization through their own internal economic development processes, it also seems necessary to explain why such countries took so long even to mimic the successful forms of business organization in other countries. Middle Eastern countries have been in constant contact with the outside world over the relevant period, which spans the period from the sixteenth century, when joint stock companies were introduced, to the modern corporation, beginning with the Dutch and East India Companies that emerged in the seventeenth century, until about 1850, when the first corporation emerged in the Middle East.

This, of course, raises the question of why Middle Eastern countries did not adopt or borrow some sort of corporate organizational form from Westerners, since it was obvious that this form of business organization is an extremely efficient way to organize an economic system. The above section suggested that ruling elites may have felt threatened by the introduction of the corporate organizational form. In addition, massive anti-American sentiment in the Muslim world may explain the reluctance to adopt a form of doing business so closely aligned with the West in general, and the United States in particular, at least over the past fifty years or so, a period that encompasses the span of time when an intellectual consensus emerged about the economic advantages of private ordering—particularly with respect to capital formation—limited liability for investors, and the contractual theory of the corporation in general.

Survey data show that more than seventy percent of the people in most Middle Eastern countries have an unfavorable view of the United States, and stunningly, only one percent of people surveyed in Jordan and Palestine in 2003 held a favorable opinion of the United States.[84] The same researchers found that in Indonesia, Jordan, Morocco, Pakistan and the Palestine Authority, Osama Bin Laden was among the top three "most trusted" leaders.[85]

While misinformation appears to be rampant in the Middle East (seventy-eight percent of respondents in seven Muslim countries said that they did not believe that the people responsible for the September 11, 2001, terrorist attacks on the World Trade Center and the Pentagon were Arabs), it probably is not much more rampant there than here in the United States (sixty-nine percent of Americans believe that it is likely that Saddam Hussein was personally involved in the attacks).[86] The problem is that the two sorts of misinformation have one thing in common: the misinformation is used in ways that impose costs on countries, and people, in the Middle East itself. The misinformation about Saddam Hussein, of course, was used to justify the U.S.-led coalition's most recent invasion of Iraq, which led to the overthrow of Saddam's regime and the eventual capture of the Iraqi leader.

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[84] THE PEW RESEARCH CENTER FOR THE PEOPLE, VIEWS OF A CHANGING WORLD 19 (2003).

[85] *Id*. at 3.

[86] *Washington Post Poll: Saddam Hussein and the Sept. 11 Attacks*, WASH. POST, *at* http://www.washingtonpost.com/wp-srv/politics/polls/vault/stories/data082303.htm (Sept. 6, 2003).

The unfavorable views of the U.S and the West in general that are held by Middle Easterners inevitably contribute to their systematic reluctance to copy what are, erroneously, viewed as exclusively Western economic philosophies and approaches. Interestingly, the two countries outside the United States that have been the most successful in fostering domestic venture capital practices are Taiwan and Israel. In both countries, active involvement in fostering the venture capital industry occurred only after the private sector had begun, on its own initiative, to follow the U.S. template. Also, and we regard this as highly significant, unlike the United States, both Taiwan and Israel had bank-centered financial systems, rather than stock market–centered financial systems, although "synchronically with the development of the venture capital industry," the financial system transformed itself and the capital markets began to displace the banking system as the focal point for capital allocation decisions in the economy.[87]

The point is not that other countries must align themselves with or even enter the U.S. foreign policy orbit in order to be successful. No such alignment is either a necessary or a sufficient precondition for growth. Rather, to the extent that antipathy toward the United States collapses into an unwillingness to mimic western institutions and organizational forms, that antipathy will lead to a reduction in growth prospects. Successful organizational forms and institutions from the United States and elsewhere should be imported and used as a template by developing countries in the Middle East and elsewhere.

[87] Rafiq Dossani & Martin Kenney, Creating an Environment: Developing Venture Capital in India 14 (June 6, 2002) (Berkeley Roundtable on the International Economy Working Paper 143), *available at* http://iis-db.stanford.edu/pubs/12010/Dossani_Kenney.pdf (last visited Mar. 6, 2005).

Freer access to the modern variants on the basic corporate form can be introduced, as it has been recently in China, Italy, Taiwan, and elsewhere, without the sacrifice of ethnic or cultural individuality. Similarly, the red tape and bureaucracy that impede the utilization of such forms can be reduced or eliminated without the sacrifice of national autonomy. Those who oppose reform in the guise of opposing westernization are pursuing their own selfish political agenda; they are not really working to preserve important historical or cultural or religious institutions, because it is not necessary to sacrifice such institutions in order to achieve growth.

3. Conclusion

Accomplishing the elusive goal of promoting economic growth requires a modest, but resolute, effort by the government. State action is needed to provide the legal institutions that private sector actors require before entrepreneurial activity can begin in earnest. In particular, we argue that government must provide the legal framework for investing in order to give entrepreneurs and capital market participants the incentives necessary to provide not only the money, but also, more importantly, the human capital required to jump-start the economy by starting small businesses.

This task is not difficult. Governments have a number of tested and highly functional templates already in use by other economies around the world from which to choose. The problem faced by policy planners and reformers is not, therefore, a technological or an engineering problem: the designs of successful business organizations are already in place. The challenge, rather, is political. An entirely predictable consequence of establishing the legal framework for a vibrant business sector is the emergence of a politically engaged middle class that might well pose serious challenges for the incumbent governmental elite. A similar problem is that making it easier to form new businesses will dramatically reduce the power of the extant bureaucracies that raise the costs and the time necessary to start new small enterprises in the Middle East.

We recognize, of course, that it is difficult to disentangle the multiplicity of competing explanations for the seemingly perennial problem of underdevelopment in the Middle East. Our theory adds to the existing literature on law, finance, and development, particularly that of LLSV, by relaxing the implausible assumption that incumbent leaders of under-performing economies are doing everything they can to promote growth. We point to a simple fix—making incorporation easier—that is not even being tried. Arguments that lack of reform in this area can be explained by history, religion, culture, or other "path–dependent" rationales are highly implausible in light of the fact that institutional reform in this area would be not only straightforward and simple from a technological perspective: it also would be non-controversial and unchallenging from a religious and cultural perspective. The ultimate challenge for government is not in providing the legal architecture necessary for economic growth. Technically speaking, the task of providing the relevant legal infrastructure for the corporate form and allowing free and rapid access to this form is quite simple. The challenge, rather, is for government to impose upon itself the self-restraint necessary to limit its own power over business. It is to this task that international institutions such as the World Bank, the International Monetary Fund, and the European Bank for Reconstruction and Development should devote their development efforts.

Table 1.		
Country Name	*Population*	*GDP/Capita (US$)*
Algeria	32,129,324	$1,890
Bahrain	1,000,000	$17,100
Egypt	66,000,000	$1,390
Iran	66,000,000	$2,000
Israel	6,199,008	$16,020
Jordan	5,000,000	$1,850
Kuwait	2,000,000	$16,340
Lebanon	4,000,000	$4,040
Libya	5,000,000	$6,400
Morocco	30,000,000	$1,320
Oman	3,000,000	$7,830
Qatar	1,000,000	$21,500
Saudi Arabia	22,000,000	$8,530
Syria	17,000,000	$1,160
Tunisia	10,000,000	$2,240
United Arab Emirates	4,000,000	$20,217
Gaza	1,300,000	$600
West Bank	2,300,000	$800
Yemen	19, ,000,000	$600
Middle East and North Africa (excluding Israel)	313,000,000	$2,532
United States	288,000,000	$37,610

Table 2.					
Country Name	*No. days to Start a Business*	*# or Procedures to Start a Business*	*Cost of Starting a Business (% of income per capita)*	*Minimum capital Requirements (% of income per capita)*	*Minimum capital Requirements in USD*
Algeria	26	14	27.3	65.5	$1,237.95
Egypt	43	13	63	815.6	$11,336.84
France	8	7	1.1	0	$0
Germany	45	9	5.9	48.8	$12,322.00
Iran	48	9	7.3	2.1	$42.00
Israel	34	5	5.5	0	$0
Italy	13	9	16.2	11.2	$2,414.72
Jordan	36	11	49.8	1147.7	$21,219.5
Kuwait	35	13	2.4	148.5	$24,264.90
Lebanon	46	6	131.5	82.3	$3,324.00
Morocco	11	5	12.3	718.6	$9,485.52
Nigeria	44	10	95.2	59.4	$190.08
Oman	34	9	4.9	100.1	$7908.3
Saudi Arabia	64	12	69.7	1549.5	$132,172.35
South Africa	38	9	9.1	0	$0
Syria	47	12	34.2	5053.9	$58,625.24
Tunisia	14	9	11	327.3	$7331.52
United Arab Emirates	54	12	26.5	416.9	$84,284.67
Yemen	63	12	269.3	1716.9	$8,117.72
Middle East and North Africa (excl. Israel)	43	10.5	58.10	870.27	$26,395.76
United States	5	5	.6	0	$0
Source: World Bank, "Doing Business in 2005: Removing Obstacles to Growth"					