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Seven theses on Doing Business

For a meeting with the World Bank's Independent Evaluation Group (IEG) and the Doing Business team in Washington, DC, 24-26 September 2008

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Merits of Doing Business:

1. **Doing Business raises awareness of the fact that the cost of red tape and burdensome regulation is a matter which needs attention by policy makers as it negatively affects private sector development.**

The data collected by Doing Business shows that the de jure costs of regulation and the time necessary to deal with it is comparatively higher in many developing countries than in developed countries. Two reasons for this are well known: (i) Many developing countries do not reform and adapt regulations on a regular basis. The consequence is that in many cases regulations in place are outdated, far from efficient and potentially very burdensome for business activities.[2] (ii) Eastern European countries and other developing countries, which followed a socialist-type development paradigm have often created a regulatory business environment that leaves little space and flexibility for the private sector. In such cases where regulation severely limits profits and therefore incentives to invest, reforming the regulatory business environment is certainly very important.

2. **Doing Business provides a benchmarking tool that stimulates public-private dialogue on economic policies and may help to break reform deadlocks.**

It has frequently been reported that Doing Business is a useful trigger for reform as benchmarking discloses bureaucratic burdens and stimulates public-private dialogue about enterprise development and preconditions for economic growth. Specifically if there are powerful opponents of reform, the pressure created by such a benchmarking exercise can help to break a reform deadlock. Moreover, Doing Business helps to identify areas of excessive red tape.

3. **By focusing on domestic small and medium-sized enterprises (SMEs), Doing Business rightly highlights their relevance for creating employment opportunities for the poor. This complements previous investment climate assessments that emphasized e.g. FDI attractiveness.**

SMEs are major contributors to employment and income in developing countries. Moreover, the SME sector is believed to be the greatest seedbed of entrepreneurship (e.g. Berry 2001). While most investment climate assessments take the perspective of the foreign investor looking for big

[1] This paper is based upon our previous works, especially on Altenburg / von Drachenfels (2006, 2008)

[2] Cf. World Bank / IFC (2008: vii): "One finding of Doing Business: dynamic and growing economies continually reform and update their regulations and their way of implementing them, while many poor economies still work with regulatory systems dating to the late 1800s."

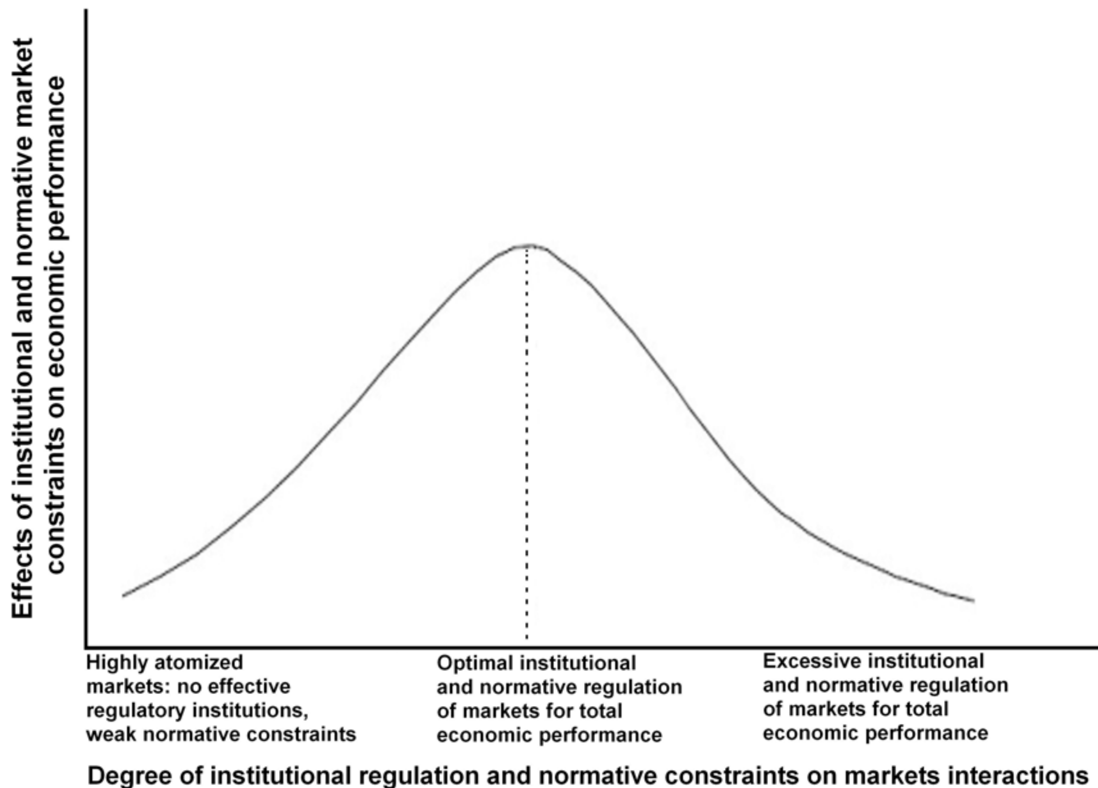
investment projects, Doing Business tries to assess the regulatory environment for domestic SMEs, which often differs markedly from the conditions enjoyed by big (international) corporations.

Critique of Doing Business:

4. **Doing Business implicitly advocates for minimum regulation and thereby disregards the important role of regulation as a catalyst of economic activity and an instrument to increase social welfare.**

The concept of the state that Doing Business is recommending is basically neoliberal, where the state should ensure a stable environment and avoid interference in markets. It can be said that, except for the issue of protection of property rights – where Doing Business calls for regulation that enhances the protection of property rights, the reports basically advocate for minimum regulation. This perspective largely neglects the economic and social benefits of regulation. This concern is also shared by IEG (2008: 6): "The ratings do not allow for a minimum desirable level of regulation needed to ensure public benefits. This principle is embedded in 7 of the 10 indicators."

Figure 1: Effects of socially embedded institutional and normative market constraints on economic performance



Source: Wright (2004)

Therefore, whereas Doing Business basically helps to identify minimal levels of regulation, the challenge for societies and policy makers is to find optimal levels of regulation. Figure 1 shows that while excessive regulation is problematic, minimal regulation is not necessarily better. Instead, Wright (2004) argues that there are market imperfections (e.g. highly atomised markets) where regulation improves economic performance, and that only beyond a certain optimum regulation becomes counterproductive. As a result, some countries may be over-regulated while others may be under-regulated.

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An optimal level of regulation will depend on the type of market imperfection, the quality of public goods and services provided, and social preferences – the norms and values of the respective societies. E.g. whether people want their governments to ensure certain standards at the expense of economic freedom varies across societies. Existing regulations are often the outcome of political negotiations and consensus-building involving different groups of society. The fact that countries have different levels of regulatory complexity thus reflects (among other factors) the different preferences of citizens. That is why it seems very problematic to assess business environments across countries by only benchmarking the costs of regulation without taking into account the expected benefits.

For instance, with regard to the **regulation of labour** Doing Business advocates for regulation which makes hiring & firing rather easy for employers. It arguably makes sense to assume that countries with very rigid labour laws are likely to have higher shares of informal employment and higher unemployment rates as employers will be reluctant to hire workers if adjusting labour is not possible in a reasonably flexible manner. Therefore, too rigid labour laws are plausibly limiting the chances of formal employment for many. However, by limiting its assessment to the private costs of labour regulation from the firm's perspective, Doing Business leaves out the further dimensions that determine the optimality of the labour regulation. In fact, the findings of various empirical studies are in line with the arguments presented by Doing Business (e.g. Botero et al. 2004). However, there is an equivalent body of literature highlighting the positive effects on productivity of higher levels of labour regulation. This may be due to higher motivation and commitment of workers as well as greater incentives for employers to train their workforce if substitution of workers is made more difficult (e.g. Storm 2007; Berg and Cazes 2007). Furthermore, there is some empirical evidence that higher levels of labour regulation are associated with a more equal income distribution (Calderón, Chong and Valdés 2004; Freeman 2007).

Based on what Doing Business measures it is therefore not possible to conclude that labour laws are too rigid, nor that there is a need for stricter labour regulation. Doing Business recently reassured critics that it will not advocate to go below ILO core labour standards as these are an agreed upon minimum level of labour regulation. However, this neglects the fact that labour laws in most countries are granting workers significantly higher levels of protection and rights and that the search for an optimal level of labour regulation (regarding e.g. severance payments, number of paid annual vacation days) takes place on a level much above ILO core labour standards. In the Doing Business methodology countries with a legal workweek of less than 50 hours or with more than 21 paid annual vacation days are "punished" by getting assigned less scores in the *employing workers* indicator. No convincing arguments are presented for why these apparently arbitrary threshold values shall be good approximations of unique optimal levels of labour regulation that apply to such diverse countries like e.g. Sweden and Mozambique. Depending, among other things, on the productivity of the workforce of the country in question, the wage levels and the social preferences, optimal levels of regulation are likely to differ substantially between countries.

Regarding the **paying taxes** indicator, Doing Business does not only measure the administrative burden to firms when paying their taxes (which obviously should be as low as possible) but also includes the total tax rate. Here again, the (implicit) judgement is that the lower the tax rate the better. However, this disregards that important public goods and public services (like environmental protection, health, education and, for instance, business registers or courts necessary to enforce commercial law) need to be financed out of taxes. In particular, education and vocational training need to be financed, at least partly, by taxes or levies imposed on employers – which leads to lower

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ranks in the *paying taxes* indicator. However, education and vocational training are essential to overcome the shortage of skilled labour in many developing countries and to boost economic development (see below). Therefore, the level of the tax rate should not be judged without taking into account social and economic benefits achieved due to the delivery of public goods and services.

Moreover, with regard to the **regulation of business entry,** Arruñada (2008) argues that the key challenge for developing countries is to increase the value of formalisation (e.g. providing firms with information that reduces the cost of business transactions), rather than simply lowering the initial costs of formalisation.

Shifting the focus from *minimal* to *optimal* levels of regulation changes the whole policy agenda. Although deregulation may be necessary in many cases, policymakers need to distinguish between necessary and unnecessary regulations, make regulations more efficient, and ensure that governments are held accountable for service delivery. This implies engaging in a public sector reform agenda that addresses e.g. securing the rule of law, ensuring an independent and efficient judiciary, making public service delivery and tax administration more efficient thereby increasing the public benefits of regulation for firms in general and the value of formalisation for informal firms in particular.

5. Doing Business is exaggerating the explanatory power of what it measures for economic development.

In previous editions of the report, Doing Business has claimed that those regulations measured by its indicators are crucially impacting on various dimensions to ultimately foster private sector development and national economic growth.[3] However, there is not much convincing and conclusive evidence from the empirical literature for this claim. While Djankov, McLiesh and Ramalho (2006) present some empirical evidence concerning the influence of the Doing Business indicators on GDP growth, e.g. Commander and Svejnar (2007) do not find much robust evidence that the Doing Business indicators have an influence on firm performance. Moreover, Commander, Svejnar and Tinn (2007) do not find any evidence that the Doing Business indicators are robustly related to GDP growth.[4]

Doing Business concentrates on a specific set of business regulations, leaving out further dimensions of the investment climate that are considered important for achieving private sector development and national economic growth: e.g. management and labour skills, access to finance, infrastructure, access to information, and political stability.[5] The focus of the Doing Business seems too narrow to adequately reflect the various dimensions of the investment climate that affect economic development. E.g Doing Business does not address the importance of the skill level of the labour force as a (if not THE) key factor explaining competitiveness of firms. The Africa Competitiveness Report 2007 of the World Economic Forum (2007) provides us with two interesting findings regarding the importance of labour regulations versus the skill level of a labour

[3] Cf. World Bank / IFC (2008: vii): "These [Doing Business] data also provide a basis for analyzing how different policy approaches - and different policy reforms - contribute to desired outcomes such as competitiveness, growth and greater employment and incomes" and furthermore World Bank / IFC (2008: 7): "(...) reforms are leading to change on the ground. Confirming this are the findings of an increasing number of studies using the Doing Business data to analyze the effect of regulatory burdens on such outcomes as informality, job creation, productivity, economic growth and poverty reduction."
[4] On this matter cf. also the review of literature provided by Altenburg and von Drachenfels (2006).
[5] Cf. e.g. Krause et al. (2008: chapter 4.2) for a review of this body of literature.

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force: i) Only slightly more than 10 per cent of firms in low income countries in Sub-Saharan-Africa perceive labour regulations to be a major or very severe growth constraint.[6] ii) Availability of skilled workers has a bigger impact on employment creation than lowering labour regulations (Fig. 9, p.42).

A further limitation of the explanatory power of the Doing Business indicators is rooted in the methodology applied. In general, Doing Business measures the de jure cost of regulation but it cannot inform about the de facto implementation on the ground. The latter potentially is skewing the picture of the regulatory burden. The administrative and regulatory burden imposed on firms is not only a matter of de jure regulations but of de facto effectiveness of the administration. If public officials lack administrative skills or have little incentive to serve customers, business licensing, for example, may be very burdensome even if the number of procedures is low.

It has to be acknowledged that the Doing Business report 2009 (World Bank / IFC 2008) is the first report in the series, which explicitly and prominently addresses the limitations of what it measures with regard to the explanatory power for economic development. While the previous reports contained bold claims regarding causal relationships e.g. between the Doing Business indicators and pro-poor growth and entrepreneurship, this years Doing Business report is more careful regarding these claims.

6. Doing Business has overstated the pro-poor character of business regulation reforms.

In previous editions of the report, Doing Business has followed an explicit pro-poor reasoning which now seems to have been abandoned in the 2009 edition. Following the view of de Soto (1989, 2000) previous Doing Business reports claimed that high costs caused by red tape are falling especially heavy on the poor. Administrative entry barriers are forcing own-account workers or small firms to operate informally (Djankov et al. 2002). Costly registration of property leaves the majority without formal property rights, thus high levels of insecurity and limited chances to obtain formal credit leave the poor in a vicious circle. Consequently, Doing Business has been arguing that lowering the costs caused by regulations will not only boost economic activity but also make it more equitable by enabling the informal firms to formalise and subsequently continue to grow due to the expected benefits of formalisation (e.g. secure property rights, access to credit and formal contract enforcement).

This uni-causal perspective on the informal economy does not take into account other well-known problems linked to informal businesses in developing countries. According to a long-established view, business activities in the informal economy are trapped in a vicious circle in which low skills, low capital formation, low productivity and low returns on investment reinforce one another (Tokman 2007)[7]. Businesses in the informal economy are thus often more driven by necessity than by opportunity (Mead 1994; Altenburg and Eckhardt 2006: 19-22). Lowering the costs of formalisation is therefore far from enough to make these firms prosper and will not automatically enable them to engage into scaling-up strategies such as improving their product quality and reliability in order to serve higher-end markets etc.

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[6] The report, however, shows that this constraint is much more relevant for firms in the three upper-middle income countries Botswana, Mauritius and South Africa (Fig. 2, p.32). This might indicate that the more developed a country, the more relevant becomes the labour regulation issue.

[7] For a distinction of schools of thought see Chen (2004); for a recent attempt to distinguish between 'necessity' and 'opportunity' driven entrepreneurship in the informal economy of Sri Lanka see de Mel et al. (2008).

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So, while it is plausible that some regulations fall especially heavy on the poor, it is also true that the poor typically are especially handicapped with respect to other important factors, like education, health, financial assets, social capital etc. Therefore, the way out of poverty will require complementary policy intervention in different areas. Making business registration easier may still not be sufficient to enable an illiterate person to register his or her business. In traditional societies with residual property rights for the poor (for women[8]) on common land resources, introducing explicit private property rights might even worsen the situation of the unprivileged.

An important argument of the Doing Business, however, still is that regulations must establish a level playing field so that the poor can participate in business activities on an equal basis. There is no doubt that levelling the playing field by enforcing and implementing regulations consistently in a lawful manner is important and much better than discriminatory and anti-poor regulation and implementation. However, levelling the playing field in the sense of establishing a uniform tax rate (flat tax) or uniform fees for all kinds of business activities, seems not to be especially pro-poor. Developing countries are characterized by enormous productivity gaps between large, especially foreign, firms and micro and small enterprises. Undifferentiated deregulation may lead to situations where traditional economic activities that sustain the livelihoods of many poor people are rapidly destroyed without providing them alternative employment opportunities. In such situations protective and supporting policies may be required, at least temporarily, to cushion the effects of competition.

7 The Doing Business indicators are not suited for informing governments nor private sector representatives about reform priorities.

As a result of the previous critique, policymakers would be ill-advised if they predominantly used Doing Business indicators to define and priorize their reform agendas.[9] Likewise, private sector representatives cannot gain conclusive insights from Doing Business regarding the most pressing issues to be discussed with governments in order to spur private sector development and overcome growth constraints. The Doing Business philosophy is misleading with regard to

- the optimal degree of regulation;
- priorities for reform, i.e. the Doing Business indicators suggest a standard set of business regulations to be reformed, although for a given country, other factors that affect the cost of doing business may be more relevant.

The challenge for governments is to identify binding constraints to private sector development and economic growth.[10] These constraints differ considerably between countries, economic sectors, firms of different sizes, rural versus urban location, and are in many cases likely to lie outside the narrow focus of Doing Business.[11] Micro and small firms in the informal sector in particular face constraints like low skills and low productivity that seem much more relevant than those captured in the Doing Business indicators. More empirical research is necessary to identify binding growth

[8] On the gender differentiated impact of business environment reforms cf. Hampel-Milagrosa (2008).
[9] Sensibly, Doing Business 2009 (World Bank / IFC 2008) has now started to address this critique, however, there is still too little discussion about the relevance of the regulatory business environment vis-à-vis other aspects of the wider investment climate for private sector development.
[10] On the topic of binding growth constraints cf. Hausmann / Rodrik / Velasco (2005).
[11] On the topic of regional and sector-specific factors of the investment climate cf. e.g. Kaufmann / Krause (2008).

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constraints for specific groups of firms in developing countries. Policymakers may use the Doing Business indicators as proxies but should consult other sources that provide a broader picture (e.g. Investment Climate Surveys, Global Competitiveness Reports, enterprise surveys, specific sub-sector and value chain analyses). Moreover, some of the barriers for private sector development are rooted in the weakness of public service delivery. The answer to this problem is not necessarily deregulation but rather public sector reform in order to improve public service delivery.

Conclusion: Dealing with Doing Business Reports in the future

From the critique put forward above five conclusions can be drawn:

1. Doing Business is apparently responding to the critique put forward and is now more cautious in its wording and suggested causalities between deregulation and growth, and deregulation and pro-poor enterprise development, respectively. Thus, Doing Business 2009 informs the reader in a more balanced manner. It remains to be seen if the communication strategy and as a result the media coverage of Doing Business will reflect this positive development and take note of the limitations of Doing Business. Still unresolved research questions should be addressed more prominently to point to these limitations and to future areas for research.
2. More research, for instance, needs to be conducted to identify the most binding constraints for enterprise development in different firm size classes and economic activities. In particular, correlations (and the direction of causal relationships) between Doing Business indicators and enterprise performance should be tested, controlling for other potentially relevant growth constraints.
3. Reports should clearly state that they only measure the private costs of regulation. Neither the benefits of regulation for enterprises and society at large, nor the administrative capacity of governments (i.e. whether they employ regulations as a means to maximize welfare or to extract rents) get measured. The rankings would probably look quite different if these elements were taken into account. The point that minimal regulations is in most cases not a reasonable policy target, should be pointed out clearly.
4. Doing Business should avoid making strong judgements with regard to policies that reflect social preferences. Consequently, the total tax rate should no longer be used for the *paying taxes* indicator. Likewise, the *employing workers* indicator should be dropped or at least be reformulated in a way that reflects potential benefits of labour market regulation.
5. Given the shortcomings listed in this paper, official development aid should not directly or indirectly be tied to a country's performance in the Doing Business indicators.

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