Business environment reforms: Why it is necessary to rethink priorities and strategies

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Abstract:

Reforming the business environment is high on the agenda of the international donor community. The Doing Business reports suggest that excessive regulation is a key obstacle to private sector development. Simplification of the regulatory business environment is thus recommended as the most important private sector reform. Countries achieve the highest score on seven out of ten Doing Business Indicators if they do not regulate at all. Furthermore, it is alleged that reforms can be achieved with the stroke of a minister's pen. This ignores important benefits of regulation and underestimates the difficulties of institutional change. This article argues that the real challenge is to define appropriate levels of regulation, which differ across countries, regions and sectors; and to make governments accountable for services – rather than abolishing them altogether.

Reforming the regulatory business environment is high on the agenda of the international donor community. Mainstream reforms are strongly influenced by the World Bank-IFC's Doing Business Indicators which provide a simple and popular tool to benchmark the performance of countries.

This article sets out to explain why reforming the regulatory business environment has become so popular. It continues by showing that, while there is no doubt about the need to adopt regulatory reforms, some of the key assumptions of reform proponents do not hold. Parts of the reform agenda are misguided and may in fact do more harm than good; and they grossly overstate the relevance of regulatory reforms on private sector development and growth. Furthermore, several reasons are provided why implementation of reforms is a highly complex process of searching for and negotiating appropriate sets of regulation that are country-, region-, and sector-specific.

1 Why reforming the regulatory business environment has become so popular

As Tanburn (2006) shows in a previous issue of this journal the good news in recent years is that the fundamental role of private sector development for sustainable poverty reduction is now almost universally acknowledged by governments and donor agencies. But the debate about what the most binding constraints are, and what the right mix of proactive support, regulation and deregulation should be, remains unsettled. Some private sector development experts and practitioners advocate comprehensive programmes to foster the development of national industries in general, and SMEs in particular, whereas others reject a strong public involvement and instead prioritise deregulation and simplification of procedures that hamper business activity. In general terms, developing countries' private sector polices and donor strategies seem to shift away from sector or cluster-specific support and towards reforms to get the regulatory business environment right.

There are two main reasons for this. First, there is growing consensus that "institutions matter". Research on institutions and institutional change confirms the fundamental role of the "rules of the game" for economic development (North, 1994). An institutional framework that guarantees property rights and enables actors to enforce contracts is thus generally acknowledged as being important for development in general, and for the dynamics of the private sector especially.

Second, targeted interventions for PSD have often had little positive impact on the performance of the target group, e.g. SMEs. Service provision is often not very efficient and only benefits a small fraction of the target group. In some cases it introduced incentives for enterprises to stay small, in other cases public funds benefited those who were not exactly in need (Tanburn, 2006; Committee of Donor Agencies, 2001). Moreover, causal relationships between support programmes and alleged programme achievements can hardly be proven due to the great number of external factors that influence private sector development.

Against this background, the Doing Business series of the World Bank / IFC and related research papers (e.g. Djankov et al., 2006; Klapper et al., 2006) have been very successful in creating a new private sector development paradigm that builds on simple messages: First, that deregulation of the regulatory business environment will immediately stimulate entrepreneurship and unleash economic growth, benefiting especially the informal poor who suffered most from unfair regulation; and second, that reforms to achieve this can easily be implemented and are less costly than traditional targeted support policies.

Regarding the first proposition, the Doing Business series argues that burdensome and unnecessary regulations are causing considerable costs for firms which reduces the scope for productive investments.[1] Furthermore, it is argued that complex regulations are frequently abused by bureaucrats who extract bribes from companies that either cannot afford the time and costs to clarify the legal situation or who are just willing to pay bribes to speed up registration processes. It is also claimed that red tape is the main cause of the widespread informality in developing countries. Informality in turn limits the growth potential of firms. Firms who cannot afford the cost of formalization are excluded from formal business transactions, and their access to public services and to formal sources of finance is restricted. Proponents of Doing Business reforms therefore claim that deregulation would immediately benefit the poor more than proportionally because "heavy regulation and weak property rights exclude the poor from doing business" (World Bank / IFC 2005: 3; Djankov et al. 2002; Klein and Hadjimichael, 2003).

Concerning the second proposition, the Doing Business series points out that "the cost of reform to ease business entry is minor. Often it is done by the stroke of a minister's pen." (World Bank / IFC 2006: 9). The reports are also suggesting a number of policy measures

[1] In their latest edition, the Doing Business Indicators are covering the costs caused by regulations for 178 countries with regard to starting a business, employing workers, getting credit, enforcing contracts, closing a business, registering property, dealing with licenses, protecting investors, paying taxes, and trading across borders.

taken by good performing countries that seem to be easy to implement, such as one-stop-shops.

2 Why the reform agenda is partly misguided

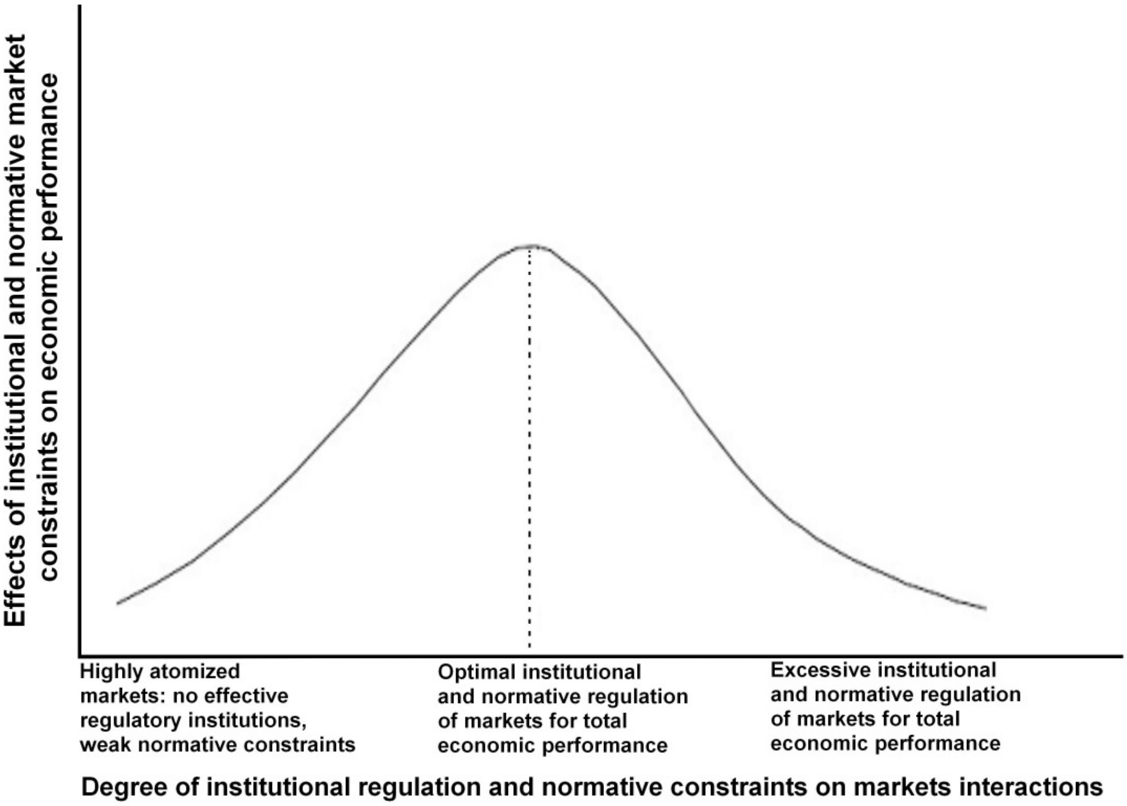
The Doing Business report and other (mainly World Bank) publications rightly stress the need to improve the regulatory business environment in many developing countries. The key message, that investments are held back by unreliable market institutions (such as property rights and contract enforcement mechanisms) and cumbersome regulations, are probably true for most developing countries. Highlighting this message to governments and donors is a great merit of these publications. However, the reform agenda is misguided in five important aspects:

1. The main challenge for societies is to search for an optimal, rather than a minimal, degree of institutional and normative regulation.
2. Burdensome regulations are not among the most binding constraints for private sector development in developing countries - especially not in the informal economy.
3. Empirical evidence does not show a clear link between level of regulation and micro or macro economic performance.
4. Empirical evidence also shows that property titles have no significant positive effect on access to credit.
5. Property titling may have undesired effects, crowding out poor producers and leading to a more unequal distribution of assets.

Let us now discuss each of these points.

Optimal vs. minimal regulation. In the Doing Business rankings, countries achieve the highest score on seven out of ten Doing Business Indicators if they do not regulate at all. This is why in an earlier paper we called the Doing Business reform agenda the "new minimalist approach" to private sector development (Altenburg/ von Drachenfels 2006). Figure 1 shows that while excessive regulation is problematic, less regulation is not necessarily better. Instead, Wright (2004) argues that there are instances of highly atomised markets where regulation improves economic performance, and only beyond a certain optimum regulation becomes counterproductive. As a result some countries may be over-regulated while others may be under-regulated. Te Velde (2006: 1) is therefore correct when he states that the "key dilemma facing business regulation is to ensure an optimal level of regulation, not just a minimum level of regulation". With regard to the informal economy Arruñada argues that simply lowering the initial costs of formalization is a wrong priority as the key challenge for developing countries is to increase the value of formalization. In his words (2008: 2): "Reforms should aim for efficiency, which means that not only the costs but also the value of the services being provided must be considered. And this is especially so for institutions such as business registers, whose services act as catalysts in the economy." He further elaborates that the costs associated with the introduction of new systems and in general with the improvement of the provision of public goods (which will be an essential incentive for firms to formalize) may as well justify a recovering of these costs via higher fees.

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



Source: Wright (2004)

Burdensome regulations as constraints. Proponents of lowering the costs of registration assume a dynamic response by firms, in particular the informal ones that suffer from administrative entry barriers. This is based on two assumptions. First, that a majority of the people in the informal economy are vibrant entrepreneurs who only wait for their chance to expand their businesses significantly once they are formalised; second, that cumbersome registration procedures are the major barrier to growth.

The assumption about the entrepreneurial potential represents a major deviation from the traditional view according to which the majority of own account workers and micro entrepreneurs are "necessity entrepreneurs" who mainly seek to sustain their livelihoods in the absence of better job opportunities. Informal firms according to this traditional view are trapped in a vicious circle in which low skills, low capital formation, low productivity and low returns on investment reinforce each other. A recent attempt to better understand the extent of entrepreneurial potential in the informal economy is undertaken for Sri Lanka by de Mel et al. (2008). They find for their sample that about two-thirds of own account workers can be classified as wage workers rather than entrepreneurs.

There are also doubts about the second part of the assumption. Van Stel et al. (2007) find no evidence that number of procedures, time and cost to start a business have a significant impact on start-up rates and therefore conclude that countries which are heavily regulating entry are not becoming more enterprising and wealthy by lowering these barriers.

These findings suggest that ease of entry does not solve structural problems of the majority of informal firms. "Necessity entrepreneurs" are unlikely to turn into highly dynamic businesses just as a result of lower registration costs. Any approach to tackle informality and increase economic opportunities for the poor in a sustainable way therefore needs to consider additional barriers to growth. Developing informal enterprises requires specific support measures including entrepreneurial capacity building, technical training, financial services, market information, linkage building with formal enterprises. Lowering the costs of registration makes sense as one element of an integrated strategy to develop the informal economy.

Link between regulation and performance. The Doing Business series builds on the assumption that there is a strong causal relation between the level of regulation and micro or macro economic performance. This is not the case. Eifert (2007: 42) analyses four Doing Business Indicators (Starting a business, Closing a business, Employing workers und Enforcing contracts) and concludes that "de jure regulatory reform over the period 2003-06 has not significantly boosted either aggregate investment or employment in the short run. (...) The results contrast with recent research that uses the cross-sectional dimension of the Doing Business data and finds strong cross-country correlations between regulatory burdens and economic outcomes." Likewise, Gørgens et al. draw the following conclusion based on their econometric analysis using the Fraser Institute Economic Freedom Index: "(…) there is no simple, linear relationship between growth, income and regulation. A low level of regulation is optimal for rich countries, and highly regulated middle-income countries can benefit from deregulation. However, regulation does not matter much for poor countries, nor for middle-income countries with low levels of regulation" (2005: 16).

This applies not only to the macro but also to the micro level. Using data from the Business Environment and Enterprise Performance Survey for 26 transition countries Commander and Svejnar do not find much of a relationship between constraints and performance. Their findings indicate "that country fixed effects, reflecting time-invariant differences in the business environment but also other factors, matter for firm performance, but that differences in the business environment observed within countries across firms do not. Moreover, the limited firm and country-level variations in the business environment over time do not appear to affect performance either. This suggests that the effect of business environment on performance and the analysts' ability to identify this effect are more limited than has been widely assumed to date" (2007: 8).

For many companies it is in fact perfectly rationale to stay informal because the disadvantages of formalisation exceed its advantages. This is because formal companies have to pay more taxes and have higher compliance costs; in addition, they become more visible to authorities which may subject them to more, rather than less, bureaucratic harassment; and they may still have as little access to credit as their informal counterparts (Krause et al. 2008). Kenyon (2007: 9) draws the conclusion that "measures to reduce the costs of entry are unlikely to be sufficient in the absence of positive incentives or carrots. Common sense suggests that linking these changes to access to other resources, such as training, finance and the provision of physical infrastructure may be even more effective."

Property titles and access to credit. The provision of property titles is supposed to enable even the poor to use land as collateral to obtain formal bank credit. As lack of access to credit is usually reported in enterprise surveys of developing countries to be the top constraint for enterprise development, this title-to-credit link is potentially very relevant. Furthermore, security of ownership provided by formal titles is believed to stimulate land markets and increase incentives for long-term investments. Reviews of case studies on Asia and Sub-

Saharan Africa however show that evidence of increased access to credit and higher levels of investment as a consequence of obtaining a property title is patchy (Altenburg and von Drachenfels 2007, 2008). Property titles are usually only one among many preconditions for obtaining bank loans. Even if they hold titles, micro and small enterprises face enormous difficulties when applying for bank loans – mainly because the size of loans is unattractive for larger commercial banks and/or because SMEs lack convincing business plans.

Property titling and asset distribution. According to Doing Business, land titling benefits the poor because it increases the value of their assets. This is partly true, but land titling is a sensitive issue that has often caused conflict and sometimes anti-poor concentration processes. Programmes which promote land titling and formal land markets frequently collide with long established customary land management systems. Customary land management systems often have a security and equity function as they ensure certain access to land even for the very poor, thereby reducing the risk of falling below the subsistence level. Individualisation of these traditional land rights may undermine this function by encouraging exclusionary land usage. It is also reported that women may find themselves in a worse position after land registration if their rights are not set down in newly set up registry (see Hampel-Milagrosa and Frickenstein in this issue). Outcomes of titling programmes may also be anti-poor if increasing land market activity leads to speculation and increasing costs of land and housing. While there are also good reasons for strengthening property rights – both for efficiency and equity reasons – property rights regimes need to be improved in a way that takes existing local customary land rights into account and develops socially acceptable solutions.

3 Why reforms of the regulatory business environment are tricky

As been shown earlier, the Doing Business reports allege that regulatory reforms are not only necessary and highly relevant for growth, but also that they are easy to achieve. Both theoretical considerations and practical experiences, however, show that the difficulties of implementing reforms are underestimated. Quick wins may occur, but they are exceptional. The nature of regulatory reforms is often highly complex, and it is thus not easy to inform the design of reforms on the basis of international benchmarks.

Four aspects need to be highlighted which make reforms of the regulatory business environment rather tricky:

1. **Specificity:** Appropriate regulatory systems need to be country-, region-, and sector-specific.
2. **Overlap with informal institutions:** Formal institutions always co-exist with informal institutions. Especially in developing countries where the outreach of formal institutions is limited, these informal institutions will stay and interfere with reforms of formal institutions.
3. **Implementing capacity:** Simplifying *de jure* regulations is not sufficient. What matters are *de facto* administrative burdens, which depend on the capacities and incentives of the public administration.
4. **Opposition:** Reforms always create losers who are likely to oppose reforms.

Specificity. The previous chapter has shown that the challenge is to establish appropriate regulation rather than just to abolish any kind of regulation. What is "appropriate" is highly context-specific and depends on the preferences of societies. First, regulatory requirements vary across countries, regions, and sectors. In the food industry, phytosanitary standards are a major issue, whereas abuse of labour standards may call for stricter regulation in the garment industry, and anti-trust regulation is key in the telecom industry. Second, socio-cultural values matter. Some societies attach a high value to the economic freedom of individuals whereas others have a preference for egalitarian development and confine economic freedom where it may jeopardise the livelihood of some of its members. Careful context- and country-specific analysis is therefore needed to identify reform needs. What is more, stakeholder dialogue is needed not only to identify constraints but also to negotiate solutions in the light of tradeoffs and to build consensus on the reform agenda. Consequently reforms are – and need to be – contested, incremental and time consuming social search processes.

In this incremental search process transferring 'one size fits all' regulations as they are at least implicitly suggested by Doing Business is in most cases ineffective. Already North (1994: 366), who is so frequently cited in recent documents focussing on reforming the regulatory business environment, argued: "(…) economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western market economies to third-world and Eastern European economies is not a sufficient condition for good economic performance."

Overlap with informal institutions. Societies always have formal as well as informal rules. In developing countries, decisions tend to be less based on formal rules than they are in most industrial countries. Informal land markets or informal substitutes for formal contracts for example are widespread phenomena. Formal rules are usually more effective for modern business transactions, and they may be less exclusive than informal rules, as the latter are often only made for insiders from a certain group of society. However, even in the process of institutional modernisation informal rules will usually not fully disappear. Hence there will be overlaps of formal and informal institutions. Informal institutions can either complement formal ones, or they can compete with them, especially if the latter are not effectively enforced (Helmke and Levitsky 2004). Policy-makers need to take this into consideration. Formal rules need to create value for the public, build on consensus, and be enforceable. Otherwise substitutive informal rules will come up which may render the formal institutions ineffective.

Implementing capacity. Administrative costs depend not only on the number of procedures but also on the 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. Reformers should therefore look beyond "cutting red tape" and address a broader public sector reform agenda rather. Public sector reform and the fight against corruption is also about changing mindsets and setting better incentives. Public officials may need to be trained and given incentives to act in a business-like and customer-oriented manner, while the private sector may need better information about public services.

Opposition. Proponents of administrative deregulation stress the fact that a considerable part of existing unnecessary regulation was created to serve vested interests – either those of incumbents who want to create entry barriers for potential competitors, or by bureaucrats who want to increase their influence (and possibly even extract bribes). If this is correct, then a simplification of the regulatory business environment takes away rents from privileged and politically well-connected groups. It is quite unrealistic to expect that these groups would not oppose reform – which makes reforms 'by the stroke of a minister's pen' quite unrealistic.

4 Conclusions: How targets and strategies need to be adapted

It is absolutely reasonable to assume that unnecessary regulations and insecure property rights are harmful for economic development. It is therefore important to adopt reforms that cut red tape and improve the basic institutions that make market economies work.

The Doing Business Indicators have triggered a public debate about bureaucratic over-regulation that was long overdue. Some of its implicit policy messages, however, are misleading. They reflect a truncated understanding of determinants of competitiveness and the role of public services in supporting the private sector and broad-based economic development. Policy-makers should therefore not overestimate the explanatory power of the Doing Business Indicators, and donors should definitely not use them for imposing conditions on debtors, as it has happened in some cases (Arruñada 2007: 731).

The private sector in developing countries is constrained by manifold factors that are not part of the regulatory business environment – lack of entrepreneurial, managerial and technical skills, deficient infrastructure, weak financial systems, low levels of innovation and specialisation, and lack of international exposure, among others (Altenburg / von Drachenfels (2007, 2008). Country and sector specific strategies are therefore needed that focus not only on deregulation, but also on better services to enhance information, technological learning, linkage building and other measures that enhance competitiveness and make economic development socially inclusive.

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