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THE RISING COST OF DOING BUSINESS IN EMERGING MARKETS: TARGETING ENTREPRENEURS IN TOUGH ECONOMIC TIMES

SIEMS EMERGING MARKET BRIEF

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I. INTRODUCTION

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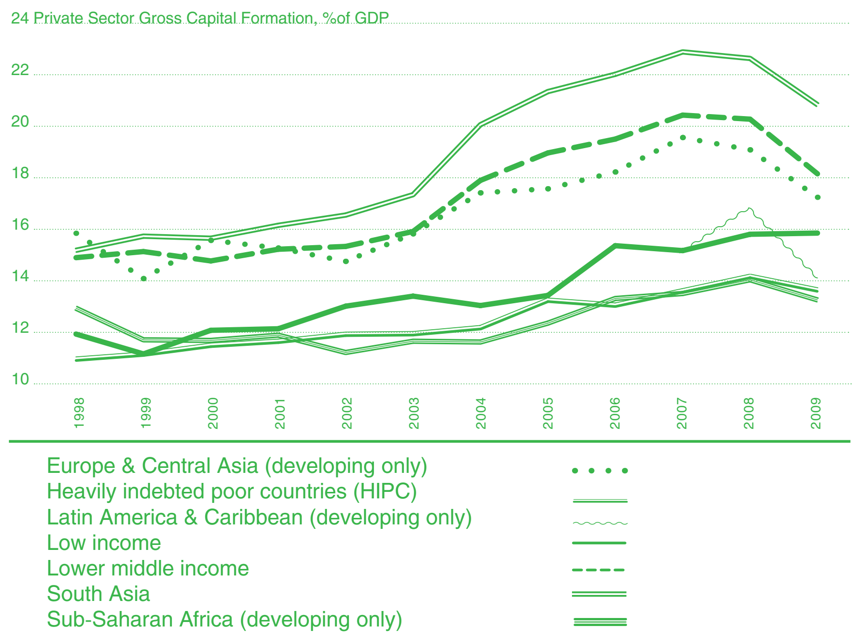
Even in the best of times, it is difficult to be an entrepreneur: raising capital, determining market demands, sourcing property, and making payroll are just some of the arduous tasks that those looking to open a business face. In times of economic distress, the problems appear to compound, as depressed demand can cripple even the most resilient businesses. Indeed, Figure 1 shows just this trend, illustrating the downturn of gross capital formation of the private sector for various areas of the world during the ongoing Global Financial Crisis (GFC).

However, the barrier of government regulations can be one of the most arduous to overcome, in that one can do everything correctly to satisfy the market, but still run afoul of government and regulations. Indeed, government regulations on business can stop entrepreneurs in their tracks and prevent them from even opening a business: for example, it takes 75 days to start a business in Chad, as you must satisfy a myriad of regulations and requirements, including the procurement of a medical certificate and criminal record of company directors![1] Operating a business is also getting more difficult in places like Ukraine, where a new tax code from 2010 contained "the potential to increase administrative pressure on business."[2]

FIGURE 1/ Gross Capital Formation Attributable to the Private Sector, in % of GDP, 1998–2009



Source: World Development Indicators, World Bank.

[1] Not surprisingly, Chad ranked last in the world in starting a business by the World Bank Group's "Doing Business" indicators. Much more on the Doing Business rankings will be seen below.
[2] Edilberto Segura, "Ukraine: Economic Prospects for 2011-12," available on-line at: http://newtbf.sigmableyzer.com/wp-content/uploads/2011/04/Economic-Prospects-for-2011-12.pdf.

As if this were not tough enough, with declining demand, many firms need to shed staff in order to remain in business; this is no easy feat in a place like the countries of South Asia (including India, Pakistan, and Bangladesh) where it can cost a firm up to 18 months' of a worker's salary to dismiss one employee.[3]

Moreover, it can take businesses more time and effort than it is worth to track down all of the regulations they are supposed to legally comply with, even ending up in non-compliance without even knowing that they need to obtain permissions. A recent example comes from the southern states of the United States of America, where the summers can be quite hot and brutal, and the locals find it refreshing to indulge in a glass of lemonade or two. Seeing an opportunity in the market and with hopes of earning enough money to go to a local water park, three young girls in the town of Midway, Georgia opened a lemonade stand on the side of the road. All was going well until they were approached by the local police, who informed them that, in order to be "allowed" to sell their lemonade, they needed to obtain "a business license, peddler's permit, and food permit to set up shop, even on residential property. The permits cost US$50 a day and a total of US$180 per year."[4] Despite a public outcry, the city officials stood firm by their decision, justifying it on grounds of public safety: according to the Chief of Police, "we were not aware of how the lemonade was made, who made the lemonade, of what the lemonade was made with, so we acted accordingly by city ordinance."[5]

The barrier of government regulations can be one of the most arduous to overcome, in that one can do everything correctly to satisfy the market, but still run afoul of government and regulations

These are just some of the most blatant examples, but there has been a worrying trend in the world during the still-continuing GFC towards expansion of the regulatory state and a sharp increase in regulations, imperiling the world's nascent recovery from crisis by expanding the reach of the state at the exact moment that the private sector is already reeling from government excess. In the United States alone, the number of pages in the Federal Register, which contains all national-level regulation, has increased from 54,834 pages in 1970 to 134,723 pages in 1998 and a record 163,333 pages in 2009.[6] The situation has also been deteriorating in emerging markets;

[3] Chidanand Rajghatta, "India's Licence Raj is Alive and Well," *Times of India*, February 14, 2007, available on-line at: http://articles.timesofindia.indiatimes.com/2007-02-14/international-business/27870186_1_india-ranks-india-and-pakistan-india-fares.
[4] "Midway Police Shut Down Girls' Lemonade Stand," *Coastal Source*, August 1, 2011, available on-line at: http://www.thecoastalsource.com/news/local/story/Midway-Police-Shut-Down-Girls-Lemonade-Stand-for/zrEiyVv1oUOATfSoZQDX5A.cspx.
[5] *Ibid.*
[6] James Gattuso and Stephen Keen, "Red Tape Rising: Regulation in the Obama Era," *Heritage Foundation Backgrounder No. 2394*, March 31, 2010, available on-line at: http://www.heritage.org/research/reports/2010/03/red-tape-rising-regulation-in-the-obama-era.

countries such as Mexico and Hungary have increased the administrative burdens on starting a business,[7] while countries such as Russia, Uzbekistan, and Madagascar that already had onerous regulatory apparatuses saw them expand even more over the past two years.[8]

The purpose of this brief report is to examine the state of doing business in emerging markets and detail how some governments are crushing the fragile economic recovery under the weight of red tape. Put another way, how much of the downturn in the private sector internationally as shown in Figure 1 is attributable to government policies? Have regulations helped or hindered the private sector in weathering the financial crisis? The state of business regulation will be evaluated using three separate indicators. These are the World Bank's annual "Doing Business" rankings, the OECD's Product Market Regulation (PMR) database and the Fraser Institute's regulatory components in its "Economic Freedom of the World" rankings. In turn, the strengths and weaknesses of each indicator are evaluated.

The situation has also been deteriorating in emerging markets; countries such as Mexico and Hungary have increased the administrative burdens on starting a business

[7] Data obtained from the OECD Product Market Database, sub-domain "Administrative Barriers to Start-up." Database is available on-line at: http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html.
[8] Based on rankings from the World Bank's "Doing Business 2011" Report, available on-line at: http://doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf. The report and the Doing Business approach will be critiqued below.

II. DOING BUSINESS IN EMERGING MARKETS: A BURDEN ON ENTREPRENEURS

The determinants of doing business in a country can be split up into three separate attributes, all of which act as a constraint on opening and operating a business:

- *Supply:* In this context, supply refers to the internal attributes of creating a firm, including the ability and cost to a firm to generate a good or product. The supply of businesses in a country, without any external constraints and with all else being equal, would theoretically be equal to the number of entrepreneurs that want to open a business and can find the financing to do it; thus, the constraint on the supply-side is not only desire, but availability of capital, sufficient benefits that would accrue to the entrepreneur in excess of costs (in opening the business), and availability of suitable labor to operate the business.
- *Demand:* In contrast to the endogenous factors of supply, demand for a particular business is mostly exogenous and depends on the market for the good or service, including the particular demand at that point in time and especially the demand at the price point offered by the business. Demand-side factors constraining a business include other factors such as availability of substitutes, broader macroeconomic conditions (i.e. is the country in a recession?), and perhaps even geographic-specific issues.
- *Regulation:* The final constraint is perhaps the most difficult to deal with, as it has nothing to do with either the intrinsic production function or desire of the firm, nor of the demand of the market, but instead with the demands of government. Regulation acts a constraint on not only what a business can produce or how, but also as a resource constraint in that it takes time, effort, and money away from productive uses and channels them towards paperwork. Moreover, the exogenous nature of regulatory burdens means that their costs are internalized by producers but not by the governmental agency, as the marginal cost of another regulation may be miniscule from the point of view of government; however, the burdens they impose have a large direct cost on businesses and on the formation and operation of firms. This misalignment of incentives makes it much harder for businesses to adapt than in the case of supply- or demand-driven constraints.

While supply- and demand-factors intuitively impact the number and quality of businesses operating in a country, a growing body of economic literature has arisen to examine the relationship between regulations and private sector development. Perhaps the most difficult task in ascertaining this relationship has been the most basic, and that it actually measuring the burden that government regulations add to starting a business. The most widely-known metric of regulations and their impact on business is the World Bank Group's annual "Doing Business (DB)" rankings, which creates a standardized ranking amongst 183 economies from the past nine years based on nine separate indicators on starting and operating a business:

- Starting a Business
- Dealing with Construction Permits
- Registering Property
- Getting Credit
- Protecting Investors
- Paying Taxes
- Trading Across Borders
- Enforcing Contracts
- Closing a Business

Even as the Doing Business methodology is at present the most comprehensive measurement of burdens, there are many shortcomings in the rankings that may paint too rosy a picture of the actual state of regulations in a given country. In the first instance, the methodology itself is constantly evolving, with components being added or subtracted, making it difficult to compare a single country, much less groups of countries, over time. Perhaps more troublingly, however, deals with the intrinsic scoring, in that much of the time and cost attributed to a specific regulation is based on the official sources, i.e. legislation and regulation, which can be widely divergent from the actual cost that a business incurs (either in the form of corruption, bureaucratic inertia, or activities beyond the scope of the law). For example, in some countries in the South Pacific, obtaining a business licence is noted in legislation as only taking seven days, but in reality it can take much longer if the Minister decides not to officially enter an application as "in process" and leaves it on his desk. Thus, for applications that do enter into the formal process, it may only take an average of 7 days to receive a licence, but for some licences that may languish for months or years but never be counted because they didn't actually enter the process. While Doing Business attempts to remedy this issue through broad-based surveys of important private sector figures in the country, the local knowledge that would be needed to go in-depth with each country is expensively prohibitive to obtain, and so a second-best estimate of cost relies on the governments themselves to provide.

Additionally, given the narrow focus of Doing Business, there is always a chance that a country could focus on one or two components of the Doing Business methodology in hopes of "gaming" the system and appearing as a reformer, when in reality the country remains overburdened with regulations and/or corruption.[9] In this scenario, a country could undertake reforms in paying taxes and enforcing contracts that may satisfy the methodology but may have only marginal effects on actual ease of doing business – such as allowing one to pay taxes on-line but keeping tax rates high – which then translates into a "reform" that can move a country up the rankings. In this way, only cosmetic changes are made, the government is rewarded with a higher ranking, and doing business in a country remains just as difficult.

Perhaps most problematic, as the World Bank Group has always emphasized in its technical assistance, the Doing Business ranking does not measure the absence of regulation, it merely measures the transparency and time needed for each of the components. Thus, a country can have a large amount of regulations and requirements, but if their timeframe as stated in legislation is short and/or they are administered efficiently it does not suffer (as shown in the preceding example). Finally, and an issue that the World Bank itself admits, a country may have a large amount of regulations that are not in the nine areas captured in the methodology, and also score well, thus not reflecting the actual ease of doing business within a jurisdiction.

An alternate way to measure the ease of doing business has been created by the OECD in their Product Market Regulation (PMR) database. Using data that is once again provided by national governments, as responses to the OECD's "Regulatory Indicators Questionnaire," the PMR assigns a rank from 0 to 6 (with higher numbers showing more restrictions) on a much broader series of indicators than the Doing Business Index. While similarly structured, in that the PMR covers only the formal regulations of a country, it expands coverage to the broader areas of state control of business enterprises, legal and administrative barriers to entrepreneurship, and barriers to international trade and investment; these areas are then broken down into several sub-domains such as regulatory and administrative opacity or barriers to competition. Indeed, the level of detail in the PMR allows for a broader examination of economy-wide barriers in a country, rather than just the barriers faced by a hypothetical firm in the capital city. Additionally, unlike DB, which ranks countries against each other, in theory the PMR ranks each country as a stand-alone entity against the scaling from 0 to 6; this can allow for better comparisons across time and countries than the DB methodology.

However, what the OECD index makes up for in comprehensive-

[9] For example, there is a widespread perception in Azerbaijan that this is exactly what the Aliyev government did in 2007 to be named "top reformer" by the World Bank. This criticism has also been made in a report commissioned by the Norwegian Ministry for Foreign Affairs by Bjøn Høyland, Kalle Moene, and Fredrik Willumsen, "Be Careful When Doing Business," available on-line at: http://ifiwatchnet.org/sites/ifiwatchnet.org/files/Doing%20Business_ESOPanalysis.pdf.

ness, it lacks in its coverage; it only covers three data points (1998, 2003, and 2008), as well as only covering the OECD countries (although ratings were assigned in 2008 for Brazil, India, China, Russia, and South Africa and a 2010 paper attempted to extend the PMR index to a select group of developing countries).[10] Also, as noted above, the PMR suffers from the same flaws as the Doing Business index, in that it relies on formal barriers and government surveys to derive a score, while neglecting issues such as corruption. Finally, in any data exercise it is important to "consider the source," and in the past the OECD has proven itself to be in favor of more, rather than less regulation (as in its "harmful tax practices" initiatives), and thus may be somewhat biased in its views towards what constitutes "large amounts" of regulation.[11]

While these two ranking systems are flawed in similar ways, a third index attempts to rectify these issues through fusing aspects of these indices while expanding coverage to a much larger set of indicators and countries. This index is the "Economic Freedom of the World (EFW)" rankings from the Fraser Institute in Canada, which covers 123 countries from 1970-2009. The overall index ranks these countries on a scale from 1-10, with 10 being most free and 1 least free, according to five components: size of government, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulation of credit, labor and business. This last component is most important for tracking business regulation, as it is made up of several sub-components, including labor market regulations, bureaucracy costs to starting a business, and bribes (among others). More importantly, the regulation component draws somewhat on the Doing Business methodology (especially in the area of licensing and business start-up), but also fleshes it out further through use of the Global Competitiveness Report from the World Economic Forum and through their own rankings on financial and labor market regulation.

The EFW rankings may be the most comprehensive approach to regulations, but they are of course not without their detractors. Some have argued that the weighting of the various components is arbitrary,[12] a point that may have ramifications for the entire index but is less relevant for our examination here (as we are focusing on change in sub-components, rather than the overall ranking). Echoing the possible bias in the OECD index noted above, other critics have noted that an index of "economic freedom"

[10] See Wøfl, A. et al. (2010), "Product Market Regulation: Extending the Analysis Beyond OECD Countries", OECD *Economics Department Working Papers*, No. 799, available on-line at: http://dx.doi.org/10.1787/5km68g3d1xzn-en. In addition to the BRICS, this paper extended the PMR analysis to include Chile, Estonia, Israel, Russia, Slovenia, Indonesia, Bulgaria, Croatia, Romania and Ukraine.

[11] Indeed, the aforementioned paper by Wøfl *et al.* comes to the conclusion that "some restrictions of foreign trade and investment might be beneficial for growth in early stages of development."

[12] For this argument, see Jac C. Heckelman and Michael D. Stroup (2000), "Which Economic Freedoms Contribute to Growth?" *Kyklos*, Vol. 53 No. 4, pp. 527-44.

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is inherently ideologically biased, created as it is by a free-market organization. However, the index itself (apart from its use in economic research) remains value-neutral, in that it merely ranks along a continuum, with the ranking methods clearly stated and interpreted. And, as some have argued, even if an ideological bias exists, "this bias actually ensures that the index does capture the desired measurements."[13] Thus, the EFW ranking in the area of regulation may be the best subjective indicator that exists currently to measure the state of and trends in business regulation in the world during the current global financial crisis.

[13] Quoted in Thomas A. Garrett and Russell M. Rhine, "Economic Freedom and Employment Growth in U.S. States," *Federal Reserve Bank of St. Louis Review*, January/February 2011, Vol. 93 No. 1, pp. 1-18. The authors point out this argument from earlier research from Nathan J. Ashby and Russell S. Sobel, Russell, "Income Inequality and Economic Freedom in the U.S. States," *Public Choice*, March 2008, Vol. 134 No. 3-4, pp. 329-46.

III. DOING BUSINESS: RECENT TRENDS

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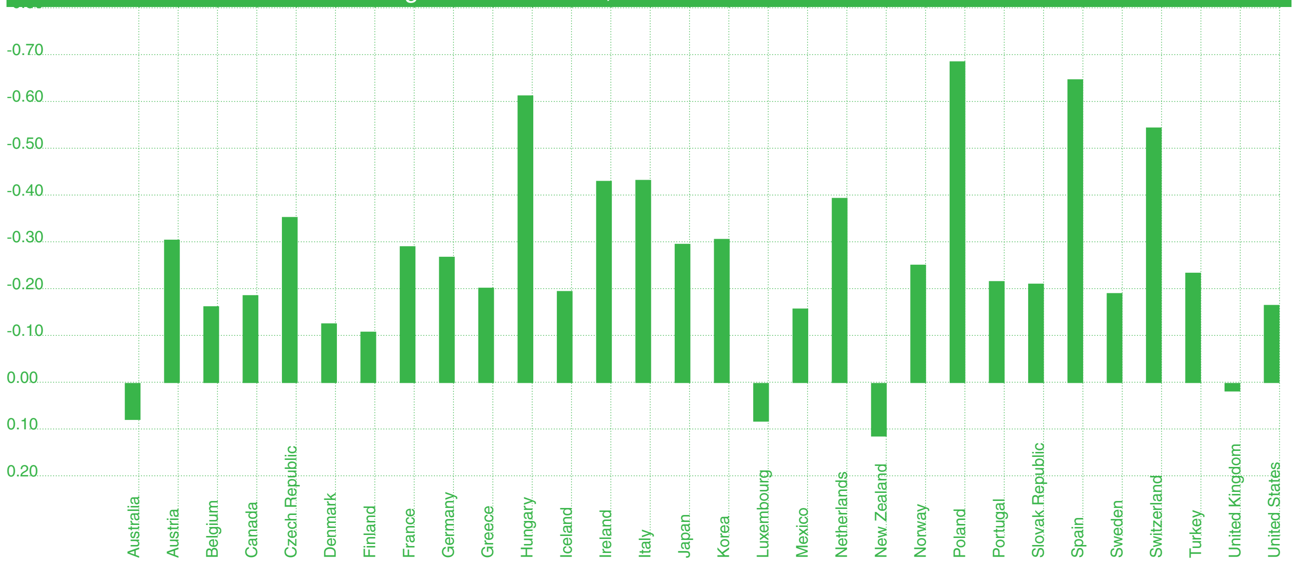
There has been a great deal of discussion, many headlines, and countless pages written in relation to regulation during the Global Financial Crisis, but much of literature and policy work over the past 5 years has been explicitly focused on financial regulation, in response to the perceived weaknesses in the system that led to the crisis. Much less attention has been paid to product market regulation or the regulation of business activity, and it is here that we need to rely on the indicators discussed in the previous section to try and track the current state of regulation.

However, given the caveats in measurement of regulations, it might be expected that there are different tales regarding the current trends in business regulation in the world since the start of the global financial crisis. For example, the latest "Doing Business" report for 2011 claims that the overall trend over the past 5 years has been towards increased ease of doing business, noting that 85% of the countries in the survey made doing business easier while just 15% made it more difficult (based on the level of change in the regulatory environment, as measured by the 9 DB indicators, over 5 years). Even this supposition overstates the trend for regulation, as included in the 15% with a deteriorating business environment were countries such as Finland and Singapore, which the report's authors admitted showed declines only because they have "less room for improvement" (in the 2011 rankings, Singapore retains the top spot while Finland is ranked as number 13 in the world).

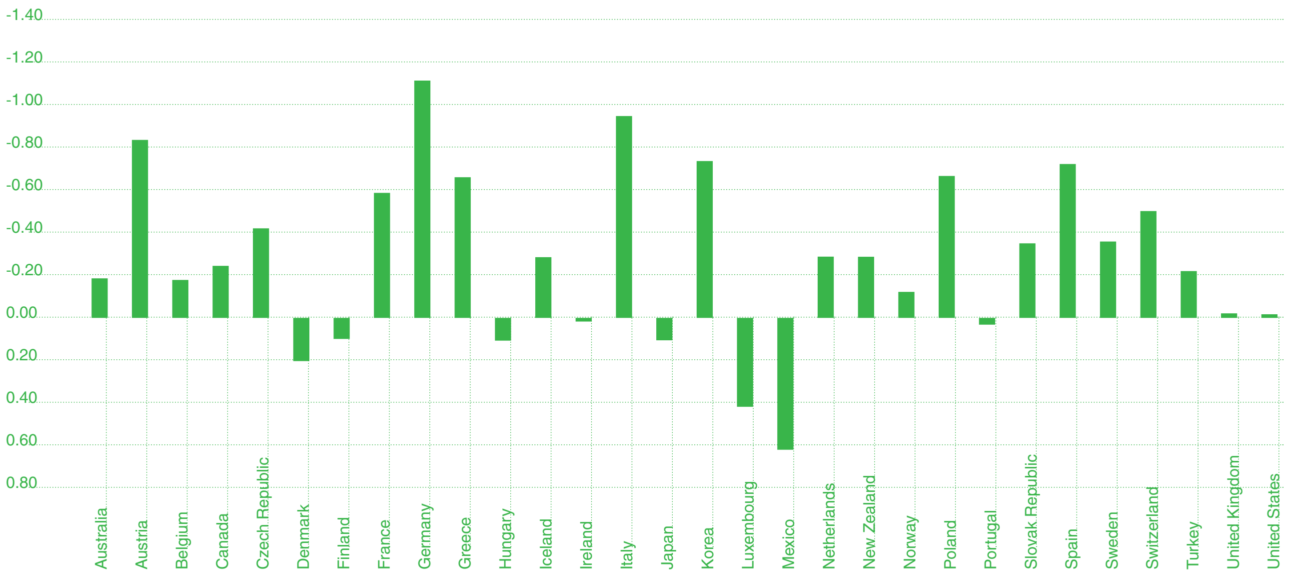
The OECD Product Market Regulation database shows a similar picture at the aggregate level, with the broadest measure of product market

FIGURE 2/ PMR Indicator Changes for the OECD, 2003-08



Source: OECD Product Market Regulation Database, author's calculation. Scale is inverted to show countries with more success in removing regulations versus those that are increasing regulation.

FIGURE 3/ Change in Administrative Burdens to Start-ups, 2003-2008



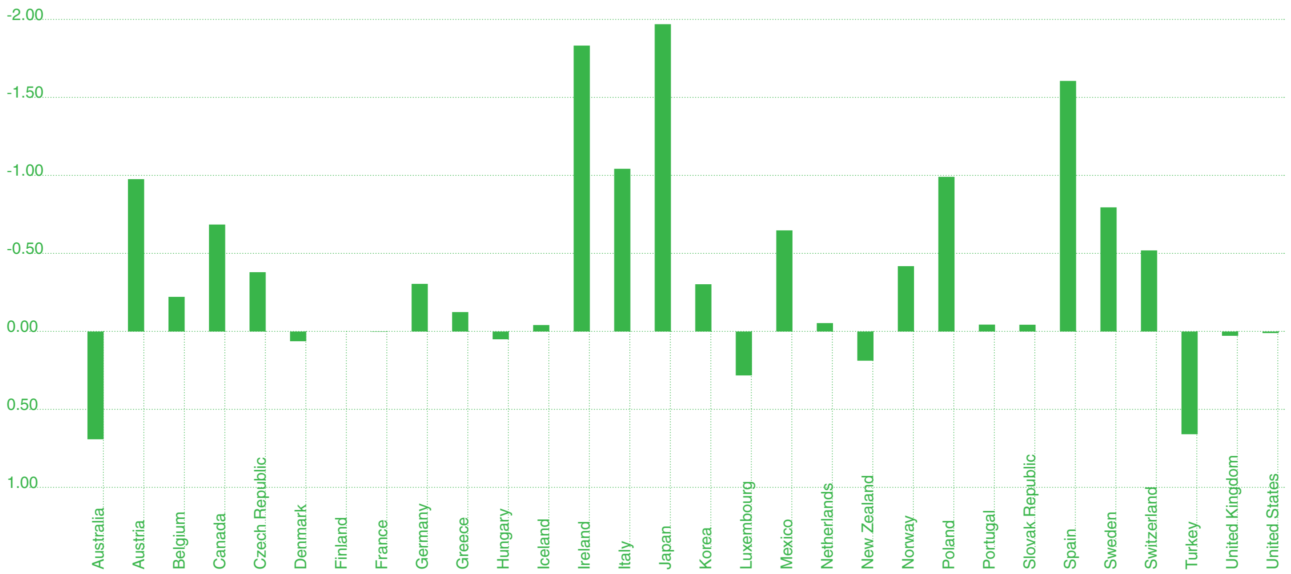
Source: OECD Product Market Regulation Database, author's calculation. Scale is inverted to show countries with more success in removing regulations versus those that are increasing regulation.

regulation showing only 4 economies with increasing regulation from 2003 to 2008 (Australia, New Zealand, Luxembourg, and the United Kingdom – see Figure 2). However, while the broad PMR indicator shows improvement, sub-indicators do show that some countries have tightened their business regulations, especially in the area of starting a business (approximately 24% of OECD countries – see Figure 3), while the United States and United Kingdom have remained nearly stagnant. Similar trends are apparent in the extent of state control of business (see Figure 4), which shows a rollback from 2003 to 2008 for some large economies.

As noted above, however, the OECD indicators focus on only middle- and (mostly) high-income countries, leading to only one view of regulatory trends, while the Doing Business index focuses on specific attributes of starting and operating a business. Thus, the final view we will have is of the Fraser Institute's EFW index Component 5 on regulations, which tells a somewhat similar tale to the PMR index and Doing Business over 2003-08; as Figure 5 shows, the majority of countries in the world saw increases in economic freedom pertaining to business regulation during this period, with only a surprising few countries (such as the United States and Hong Kong) increasing business regulation.

However, if we narrow down our timeframe to 2007-08 (that is, during the GFC), we see a much different story (Figure 6). Sixty-five of the countries in the Fraser database, or more than half, have no change or experience a deterioration in their regulatory indicator (with a further 23 countries

FIGURE 4/ Change in State Control, 2003-2008



Source: OECD Product Market Regulation Database, author's calculation. Scale is inverted to show countries with more success in removing regulations versus those that are increasing regulation.

having only marginal improvements of 0.4 or less), showing a trend towards greater business regulation. This trend spans across both emerging markets and developed countries; indeed, the United States shows one of the greatest increases in regulation, second only to Syria (which has seen much more deterioration in its economic freedom as of late).

Using the EFW numbers, we can examine an even more interesting proposition: the correlation between countries with the highest increases in regulation and the greatest losses of capital formation, as shown in Figure 1. While this is a very simple exercise (actually examining the relationship would require advanced regression analysis, in order to ascertain the magnitude of the relationship and eliminate third variables that could be influencing both), the correlation between regulation and capital formation still tells an interesting story. Most importantly, amongst countries that showed a decrease in their capital formation from 2007-08, there was a corresponding increase in business regulation that averaged 0.02 on the EFW scale; if we remove Azerbaijan, a large outlier that is somewhat suspect (see footnote 6), the increase in regulation corresponds to -0.03 on the EFW scale. Amongst those few countries that saw increase capital formation from 2007-08, there is a mirror image, with an average decrease in business regulation reflected as a gain of 0.03 in the EFW Index. Again, while not conclusive, this represents an interesting area for further in-depth research, including using other metrics of private sector development and the impact of regulation on these metrics.

FIGURE 5/ Change in Business Regulation Indicator (EFW), 2003 v. 2008

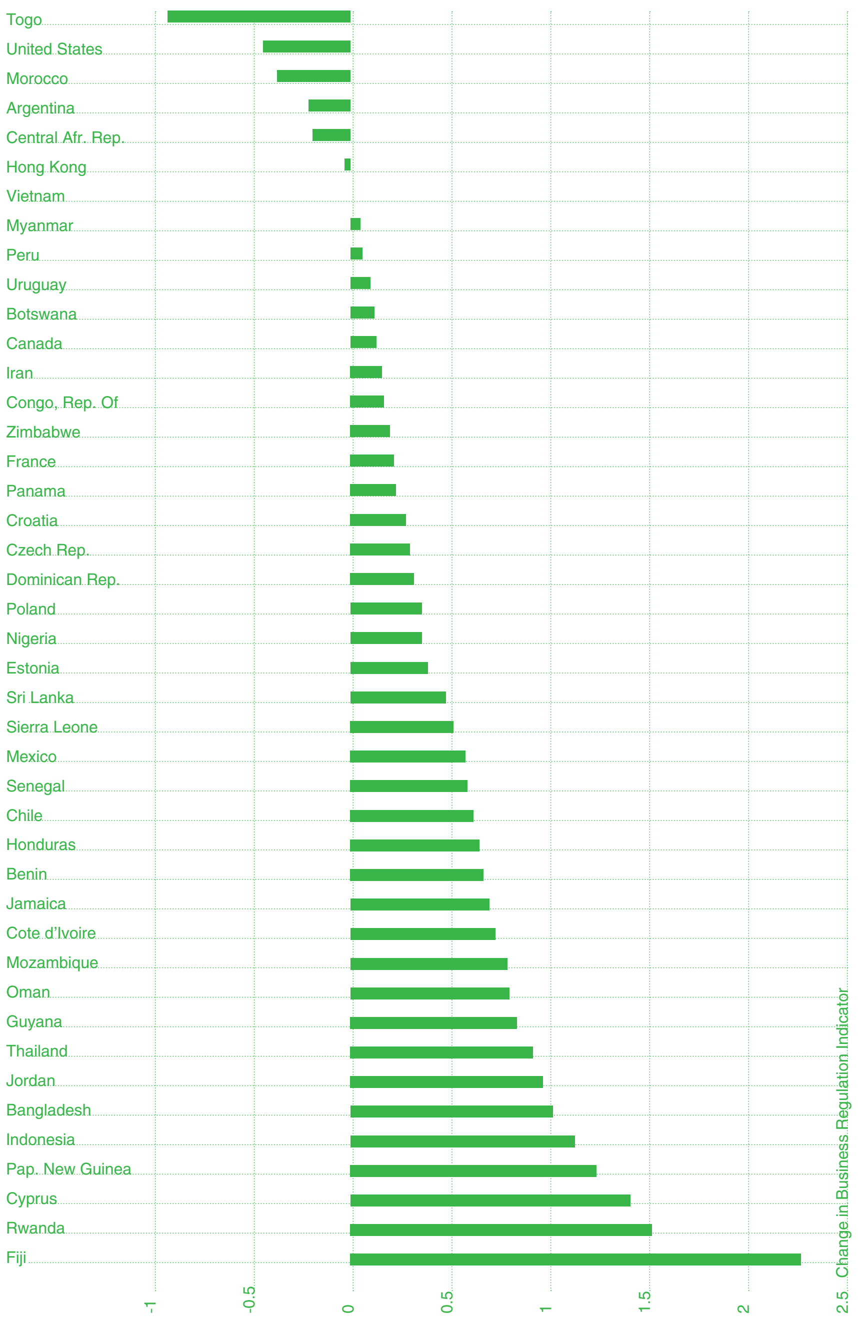


FIGURE 6 / Change in Business Regulation Indicator (EFW), 2007 v. 2008

IV. CONCLUSION

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According to the various indices explored above, business regulations are on the rise, albeit in different forms. The greatest increase in regulations appears to have happened in the developed countries from 2003 to 2008, it also appears to have been on the rise in many developing countries. In particular, the world saw a rapid increase in business regulation from 2007-08 as the GFC took hold. As more data comes on-line from 2009 and 2010, we should also be able to see more of the relationship between regulations and their effect on the private sector during the ongoing Global Financial Crisis. This examination will also be predicated on developing newer and better metrics for quantifying the state of regulation in a particular country, including refining the Doing Business methodology and expanding the reach of the EFW Index. However, anecdotal evidence (especially in OECD countries) appears to suggest that the world could be moving into what OECD Head of Regulatory Reform Scott Jacobs called in 2000 “the golden age of regulation;” that is, that “the state is not withering away in the face of markets,” but rather getting larger and more intrusive.[14] This will have negative implications for private sector development in both developed and emerging markets.

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[14] Scott Jacobs, “The Golden Age of Regulation” (November 2000) *CEPMLP Internet Journal*. The paper can be found at www.dundee.ac.uk/cepmlp/journal/html/article7-13.htm.

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