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Guidelines to Reform Business Formalities

Over recent years, governments and international organizations have been doing their best to “simplify” business formalities but with little success. They have often been satisfied with reducing the number of procedures and the most notorious costs involved. However, they should have considered all costs – irrespective of their public notoriety – to ensure the reliability and, in general, the value of the information that public registers provide to their users, both public and private.

This emphasis on value is because the registration of data, documents, contracts and business acts with the various public registers (or, more briefly, business “formalization”, both mercantile and administrative) is an ordinary production process. As such, it not only entails costs but also, and fundamentally, it provides valuable services, both public and private. Amongst the private services, business formalization has to reduce the transaction costs sustained by companies in their future dealings with other enterprises; and, amongst the public services, it has to facilitate future relations between the Administration and business firms.

Although private services have a value, many reforms of business formalities aim only to reduce the best-known costs that companies pay directly. But what often happens is that such reforms only reduce the visible costs by increasing the invisible ones. In such cases, the costs that companies no longer have to pay directly are usually paid for by public agencies that often end up being financed by businesses anyway and, to a lesser extent, out of general tax revenue. Worse still, the reforms forget that policies to minimize the cost of registration services run the risk of reducing their value inefficiently. This is an especially serious flaw because reliable registers are a fundamental catalyst for economic activity, especially in the impersonal transactions that characterize modern market economies.

Regarding public services, Friedrich Hayek considered public business registers to form part of the nuclear activities that are essential in a liberal State^[1]. Some naively liberal approaches today back reforms of formalization processes in which the main consequence would be to dilute any type of control over companies, so that, if applied, the Public Treasury and other public administration bodies would end up being unable to use business registers for tax purposes. They apparently want the Treasury to be unable to collect taxes from businesses, which would not only be difficult to justify but in practice would never happen. As soon as reforms damage the Tax Office's sources of information, it immediately creates new specialized fiscal registers, thus duplicating formalities.

These arguments apply to the reforms undertaken in Spain over recent years, most of which have had poor results. Not only has there been no political will to carry out the important reforms, but those carried out have been based on an erroneous diagnosis so have ended up reforming only secondary matters. Considerable efforts have been made to reduce bureaucracy, but the only real changes have been cosmetic ones in formalities that are seriously holding back economic activity, for example, opening licenses. Incorporation formalities, however, have been reformed several times, even though in Spain they are relatively fast and not very costly and, instead of eliminating or postponing those that are superfluous and not particularly useful in today's economy, a costly process to compress them all has been set up.

In many sectors, the current system of opening licenses only serves spurious interests—it mainly prevents the entry of new firms, protecting existing ones and allowing for corruption of those responsible for processing and granting licenses. The current situation needs to be turned upside down. First, the general rule should be effective freedom for starting up an activity and opening an establishment. When a license is required, there should be a single one, without the need for several bodies to become involved, and it should be granted automatically after a certain period of administrative silence subsequent to submission of the application. Exceptions should apply in a very few cases and should be firmly and definitively defined by a State law. We should, therefore, radically change the system for opening licenses, and adopt an effective, strict system of exceptions in order to put an end to a situation characterized by corruption and abuse of the system for the purpose of preventing competition.

For business formalities, reforms should consider why they exist and what difficulties they entail in order to optimize the added value provided by institutions and not only to reduce the costs that companies pay directly and visibly. Business formalization is necessary and socially useful. In

essence, contractual formalities serve to reduce private transaction costs while administrative formalities (relating to tax and labor matters) mainly serve deal with external effects and public goods. As already stated, reforms that only cover the costs that are most visible for businesses neglect essential elements, especially the social value of services as well as other costs that are eventually covered more or less visibly by businesses and taxpayers. This is the case, for example, when attempts are made to speed up formalities by creating one-stop-shops. These are both costly and unproductive and are funded from taxes instead of fees paid by their users. So, administrative reforms need to focus on being efficient while considering all the costs and benefits involved rather than just reducing the costs that are most visible for users.

The fact that both contractual and administrative formalities are necessary to correct market failures does not mean that they are flawless. This is true of any type of public intervention in economic activity. In the contractual area, for example, in Spain certain pockets of outdated professional activity remain and, in the administrative area, the system of licenses is often manipulated to raise barriers to entry by new firms.

A reform that really meets the public interest cannot disregard these difficulties which are often rooted in private interests and rent-seeking. Otherwise, it will end up devoting public resources to trivial, or even counter-productive reforms. This has happened, for example, with the “*Sociedad Limitada Nueva Empresa*” (SLNE) initiative, which has allocated huge amounts of funding to compress formalities gaining only Pyrrhic results. Just the cost of the computer systems needed to process the first 2,001 SLNEs created between 2003 and 2006 was 5,560 euros per company, almost double their average share capital. And in 2009, six years after the CIRCE computer system started offering computerized formalization of SLNEs, it was still processing just 1.61% of all companies set up in Spain, even though it had begun to formalize limited liability companies in 2007.

Alternatively, it would have been much more effective to eliminate unnecessary formalities. For example, in this same area of reform, that of company incorporation, current circumstances make it advisable to review the obligatory participation by a notary public, making it voluntary for partners and companies, as is the case in other countries with legal and notarial systems similar to those in Spain. For example, in France and Portugal, the law does not require a notary even in the incorporation of a company and certainly not in other formalities of less legal importance. In addition to the benefits of such a system for companies, such freedom would give the notary profession the incentives

it needs to give up providing trivial, artificially expensive and relatively useless services and start innovating and adapting to the current needs of the market.

Along the same lines, the compulsory nature of company legislation should be reduced in order to adapt it to the times, eliminating mechanisms that are supposed to protect investors but in fact generate huge administrative and legal costs. This is the case, especially, with systems for maintaining share capital, defining the company object and publishing announcements in the press (the latter requirement has recently been only partially eliminated). Also, the legal provisions should be more detailed in order to reduce transaction costs for companies, especially their legal costs. One of the main requirements would be for the law or its annexes to define several standard Articles of Association, to be used by company founders rather than having them drafted individually. In short, company law needs to be liberalized and completed, limiting the obligations and extending the provisions.

Complementarily, the mechanisms for people to identify themselves should be reinforced, this being an essential condition for efficient public registers. These mechanisms have deteriorated over recent decades as a result of urbanization and immigration processes. Such changes have made it impossible for notaries to attest the identity of persons and are increasingly making it difficult to identify agents by their identity documents. An appropriate solution would be to allow people to use their advanced electronic signatures as this gives the added advantage of allowing any type of document to be formally signed remotely with full guarantees and formality.

In the field of organization, any reform of bureaucracy must be skeptical about solutions that entail new bureaucracy. Such solutions tend not to solve old problems but rather just multiply and worsen them. Behind a front of modernity, such new bodies just waste resources and end up multiplying the old defects of the Administration. The reform of business formalities has been no exception, as shown by the high cost and almost zero results achieved by initiatives in this field, especially the SLNE, with its PAIT network and its CIRCE computer system. Future reforms should focus on reforming existing procedures and bodies without creating new bodies or taking on new functions, however modern these might seem.

On the other hand, the key to reforming the Administration is to exploit aspects in which it complements private initiative, especially in the development of competitive "one-stop-shops". The modernization of the Spanish Tax agency procedures can serve, if not as a model, at least as an indicator as to the right direction for combining public and private initiatives, to take advantage of their respective comparative

advantages. This way, the Administration only has to draw up standards and rules for communication while private agents, relying on market incentives, develop multiple systems for the relationships between public bodies and end users. Some private agents can eventually end up functioning like “one-stop-shops” but in a regime of competition which will create powerful incentives to organize themselves efficiently and to provide useful services.

In summary, reforms to simplify initial business formalization (especially to incorporate new companies) incur huge costs but maintain unnecessary formalities and, above all, they disregard the need for business registers to provide sound evidence for future judicial and administrative decisions. A more ambitious strategy is needed, one which will aim to improve institutional efficiency, to identify and eliminate obsolete formalities and to ensure register reliability. Such reliability is essential if registers are to efficiently perform their social function, that of reducing total transaction costs for companies. This strategy should be adopted in collaboration with private facilitating services providing entrepreneurs with advice and assistance in formalities. Any services requiring independence on the part of the decision-maker should be kept in the public arena while others can benefit from the comparative advantages of private initiative.

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[1] Friedrich A. von Hayek, *Law, Legislation, and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy* (vol. 3, *The Political Order of a Free People*), Routledge & Kegan Paul, Londres, 1982, p. 44.

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