Will *Doing Business* Keep Damaging Business?

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Abstract

The success of the *Doing Business* project (for herein, denoted DB) has made administrative simplification policies popular. Unfortunately, by its systematic flaws, DB methodology exerts a perverse influence on the design of such policies. Simeon Djankov's response (2008) to my analysis of DB (Arruñada, 2007) shows again what I criticized DB for: its narrow focus on some costs and rent seeking damages reform efforts. Moreover, the macroeconomic benefits of reducing the cost of initial formalization, which is just a tiny component of total entry costs, should not be exaggerated. Entrepreneurs remain informal mainly because formalizing their businesses increases their tax burden without—in many developing countries—reducing their transaction costs. Empirical tests using DB indexes are of little help in this discussion as they have severe limitations.

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1. The impact of the *Doing Business* project on simplification

My 2007 article criticized DB mainly for promoting flawed policy priorities in the area of business formalization. Both the DB's Starting Business index and DB's recommendations only consider the costs incurred by entrepreneurs for the initial formalization of a company, disregarding all other costs and benefits, especially the value of such formalization services for reducing future transaction costs. Consequently, DB leads reformers to reduce the average time and cost of initial formalization when the priority in many developing countries should be to achieve functional business registers that will be sufficiently reliable for their services to inform judicial decisions and therefore reduce transaction costs for contractual parties.

In addition, my paper pointed out that the DB method impedes considering essential tradeoffs in institutional design, among them those between ex ante and ex post control of business formalization, the costs of mandatory and formally voluntary procedures, and the costs paid by entrepreneurs and by the State. It also prejudices the choice between public and private solutions, favoring public, vertically-integrated one-stop shops. Similarly, it precludes adaptation to local circumstances. For example, its narrow focus on average costs favors capital-intensive solutions even where little demand for formalization implies that economies of scale are unreachable.

Lastly, the way DB has been marketed misguides reform by exaggerating its simplicity and benefits, enshrining a "one size fits all" policy, repeatedly proclaiming as successful reforms that are plain failures, and containing serious measurement errors (e.g., the USA's score in the Starting Business index). This means it ends up promoting new forms of rent-seeking, such as lobbying DB to modify the scores, or introducing "window-dressing" reforms aimed at improving the indicators.

These criticisms explain why DB is damaging simplification policies. Simeon Djankov's response fails to deal with this argument by defending the overall merits of simplification policies, instead of discussing how they are affected by DB. When examining these merits in the rest of this reply, it is therefore important to keep in mind the relevant issue under discussion: the damage that DB is inflicting on these policies, whatever their merits.

2. The rent-seeking trap

Djankov takes opposition to reform by established interest groups as evidence that the reforms are going in the right direction. Definitely, many current procedures—though not all of them, as the DB logic seems to suggest—mainly help private vested interests. However, such emphasis on rent seeking not only distorts reform priorities but also makes it hard to manage the rent-seeking aspect of reform.

On one hand, as made clear in my paper, transactions costs in general, and rent seeking in particular, are just the price we pay for having specialized institutions. 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.

On the other hand, without a proper understanding of the value side of such institutions, reformers are lost when managing the rent-seeking side. First, they are simply not prepared for dealing with professional interests, which enjoy obvious information advantages. Second, public-interested reformers are equally unprepared for managing the rent-seeking practiced by the reform industry itself—that is, the new bureaucrats in charge of the reforms, the consultants selling goods and services, or the politicians seeking rents from international aid agencies. Both factors help to explain why many of these reforms end up in a consensus in which old rent-seekers keep most of their rents as the price for letting reformers (including the new rent-seekers) show off some apparent results, such as speedier procedures, without tackling much more fundamental deficiencies, mainly the unreliability and uselessness of business registers in developing countries.

3. Effect on legal certainty

Focusing reform on minimizing the costs of initial formalization and avoiding rent-seeking is therefore too narrow an approach. The value of formalization services should also be improved, and misguided reforms can damage this goal. DB is also having a negative effect in this dimension, as shown by several of Djankov's comments:

First, business formalization is not an end in itself. It is valuable only if business registers produce reliable information, so that judges rule on litigated cases on the basis of such information and, therefore, private parties can rely on it when writing their contracts. For example, if, because of an unreliable register, register certificates are not taken as conclusive proofs by courts, the whole formalization system is of little help in reducing transaction costs. In such a case, parties have to rely on personal interactions, which drastically limits their trade and specialization opportunities. They also have little interest in formalizing their businesses because the only consequence of formalization is a bigger tax and regulatory burden. Djankov, however, starts his response by suggesting that the opinion of judges is irrelevant and they should be treated only as rent seekers. One wonders how DB-minded reformers can understand the effect that these reforms have on legality and transaction costs when the key users of the institutions being reformed—judges—are systematically left out of the analysis and evaluation.

Second, Djankov suggests that a low rate of refusal of registration is a sign of good quality. However, if business formalization is to provide a useful service, mechanisms have to be in place to make sure that the filed documents contain the legally required information, that they are preserved and, especially, that the date of filing, which is key for the legal effects of registration, is not subject to manipulation by parties. All entrepreneurs want registers to provide reliable information that all contractual partners can trust. However, given the public-good nature of register information (Hayek, 1979, p.412), individually they prefer to contribute as little as possible—in terms of resources and, most importantly, in terms of information accuracy. Consequently, the optimal rate of registration refusal is not zero,[1] yet DB urges reforms to aim for such a zero rate.

Djankov also argues that three elements found in some reforms (Internet registration, electronic signatures and standard incorporation forms) enhance "legal certainty". However, the

[1] For instance, the rejection rates in Canada and the UK are 3 and 8%, respectively (World Bank, 2007, p. 13).

effects of these three elements depend on the specifics of the reforms—mainly, the safeguards adopted for electronic access and communication. Moreover, electronic filing is often accompanied by a dilution of the compliance review standards practiced by the register. Overall, these three elements may improve the speed at which data enters the register, but neither its reliability nor its preservation. If the system being reformed was not functional and produced unreliable information, these three elements will be of little help: it will produce equally unreliable information, only faster.

4. Unfounded claims of successful reform

DB also exerts a negative impact by repeatedly publicizing as successful reforms that are in fact failures. My 2007 article negatively assessed reforms in Afghanistan, Colombia, El Salvador and Spain that DB had previously judged as successes.

Instead of revisiting these cases, Djankov now offers a new success story: the 2008 reform in Bulgaria, which has also followed DB recommendations. However, as with previous success stories, this Bulgarian reform also turns out to be flawed. The new Bulgarian business register has introduced new formalities,[2] and has been plagued with delays and accusations of corruption (*Sofia Echo*, 2007). A month after the new register was inaugurated, in an open letter to the Minister of Justice, the Bulgarian Industrial Association (BIA), headed by the same Bojidar Danev that Djankov cites as supporting the reforms, described the situation as “complete chaos”, with the result that “businesses are being punished” (Beekman, 2008). Consideration has even been given to the possibility of closing the new registry (Koinova, 2008).

Since DB covers 178 countries, it is only reasonable for it to make some mistakes. But reform evaluations appear to be conforming to a pattern, erring always in the same direction. Policies all around the world are being damaged when badly designed and clumsily executed reforms are repeatedly presented as exemplary.

5. How DB methods jeopardize its goals

Djankov also praises seven changes which are common in reforms of business formalization. These changes in themselves are not problematic, but DB is having a perverse effect on their design. Again, the issue under discussion is not the merits of policy but the negative impact that DB has on policy.

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[2] After the reform it is still necessary for Bulgarian entrepreneurs to have the bylaws drafted by a lawyer, because the standard forms are too general to be useful; and to have some incorporation documents notarized. (Articles 13(3) and 21(4) of the Register Act state that all the documents that accompany the registration application should comply with the unmodified laws that regulate them and these require notarization). Furthermore, all existing companies have to register again within the next three years, creating legal uncertainty for the estimated 30% of companies with duplicated names; and have to present a certificate that the company applying for re-registration is an operating entity. In addition, the business register has not been entitled to ask parties to rectify minor flaws in the documents filed. So, if the business register rejects an entry, the case enters the usually slow judicial procedure, while the old system made it easier to correct such minor defects.

Unfortunately, there is insufficient space here to analyze how DB damages the seven policies mentioned by Djankov (see, for a full account, Arruñada, 2008). Let us, however, examine what is, according to the World Bank (2007, p. 12), the most common reform, perhaps because it "can show results quickly": the introduction of one-stop shops for business start-up. DB's methodology harms policy on one-stop shops in several ways. First, by considering only the private costs directly paid by entrepreneurs, DB tends to disregard the cost of implementing the new systems, which is often paid for out of the State budget without any attempt at recovering it via higher fees.

Second, by assuming that entrepreneurs perform all procedures by themselves, DB disregards the private "facilitators" that mediate between entrepreneurs and the formalization bureaucracies. DB's methodology thus ignores how the market helps to solve the formalization problem and just replaces it, adding yet more bureaucracy in the form of the one-stop shop.

This disregard of facilitators precludes the alternative, more adaptable and often more reasonable solution of *private* one-stop shops. The administrative facilitating industry, composed not only of lawyers but also accountants, tax agents and administrative specialists, is organized with a mixture of franchising, subcontracting and referral structures. This suggests that decentralized service providers should be given powerful incentives of the sort that public bureaucracies are seldom able to accommodate. It also suggests that, rather than a fully integrated formula, the optimum structure for mediating between firms and public bureaucracies is probably a variety of more or less specialized intermediaries with different degrees of vertical and horizontal integration.

A sensible policy would therefore focus reform on developing open interfaces with the bureaucracies in charge of the public core of formalization services while allowing the market to organize a multifaceted intermediate sector, comprising all sorts of intermediaries offering entrepreneurs a variety of more or less integrated services. Unfortunately, such a solution is hard to imagine when, as in DB, the emphasis lies on public full-service and zero-price one-stop shops, and facilitators are seen only as rent seekers instead of as service providers.

6. The econometrics: evidence or mirage?

Djankov also claims that low-cost business formalization provides all sorts of macroeconomic benefits, increasing investment, entrepreneurship, employment, productivity, education and gains from trade liberalization, as well as reducing informality and corruption.

More effective—not merely low-cost—business formalization should have beneficial effects by reducing transaction costs and facilitating taxation and regulation. The efficiency of these beneficial effects, however, depends on many factors, including the cost of achieving more effective formalization, the extent of the demand for the sort of impersonal trade that stands to benefit most from reducing transaction costs and, in the public area, proper use by the State of its additional taxation and regulatory powers. The evidence available, however, focuses on a few of these aspects and has weaknesses that make it hard to evaluate the policy implications.

First of all, most of this evidence uses DB data that at best measures the private cost of mandatory procedures in initial formalization, without considering other costs and benefits or the structural characteristics of formalization systems (e.g., the extent and location of control). Econometric models relying on such data strive to control for some of these other factors. This inevitably makes results inconclusive, as some other variables remain uncontrolled. This is the case, for example, of the quality and enforcement of taxation and regulation, the cost and effectiveness of other public services, including the courts, and the efficacy of civil and criminal liability for punishing wrongdoers.

It is also difficult for such models to identify causal effects and the influence of hidden variables on both formalization cost and the regression outcomes cannot be ruled out. In particular, cross-country regressions cannot control for many unobservable country characteristics that might drive the results. For instance, economies with good institutions or more developed financial markets tend to perform well in all dimensions, making it hard to estimate the impact of a particular institutional variable. In these circumstances, the significance obtained by the parameter associated with the cost of initial formalization is likely to represent something else and therefore provides no guide for policy.

Cross-industry cross-country studies, which follow Rajan and Zingales' methodology (1998), only resolve some of these problems. For instance, Klapper, Laeven and Rajan (2006) use industry-level USA data as a reference for optimal rates of industry entry, but they rely on country incorporation data for measuring industry effects, even though much entry regulation is industry-specific. They find that, in countries where incorporating a company is more expensive, fewer companies are incorporated, especially in industries for which a high incorporation rate is observed in the USA. However, industry-specific entry constraints vary significantly across countries (e.g., Nicoletti and Scarpetta, 2003) and might be related to the general costs of business formalization and the potential of entry in each industry. Many variables, from politics to administration failure, could thus be causing both costlier formalization procedures and tougher entry constraints in all industries or high-entry ones. The evidence cannot therefore reveal whether the observed effect is due to the cost of general formalization procedures (e.g., company incorporation) or to specific industry constraints (e.g., regulations for opening retail outlets). Consequently, it cannot indicate whether reform should restructure formalization procedures or relax industry constraints.

These models also suffer from the possible presence of hidden costs and benefits, and difficulties for identifying the direction of causation. For instance, the estimated effects remain subject to caveats like "to the extent that … other benefits—such as the provision of greater information to the authorities—can be captured even with reduced costs (for example, by automating the process)" (Klapper, Laeven and Rajan, 2006, p. 622). This ability to capture other benefits with reduced costs seems overly optimistic. Similarly, reliance on instrumental variables such as legal origins for identifying causality and correcting a possible omitted-variables bias is open to doubt, even for those who pioneered their use. According to La Porta, Lopez-de-Silanes and Shleifer, "legal origins influence many spheres of lawmaking and regulation, which makes it dangerous to use them as instruments" and "we do not recommend such [instrumental variables] specifications since legal origins influence a broad range of rules and regulations, and we cannot guarantee that the relevant ones are not omitted in the first stage" (2007, pp. 12 and 16).

7. How important is the cost of initial formalization?

In principle, one would expect small effects from the costs of initial formalization. However, many of these empirical studies estimate that the costs of *initial* formalization have great economic effects on macroeconomic variables, such as levels of formalization or entrepreneurship. This suggests that such costs of initial formalization are acting as a proxy for other, more fundamental variables.

To calibrate the low potential impact that initial formalization cost can exert, two common mistakes must be avoided, whereby the cost of registering a company is taken as the only factor of formality and as a main barrier to entry.

In fact, the cost of initial formalization is a minor part of the total cost of formality. Most informal firms remain informal to avoid taxes and regulation, not the initial formalization process. For a similar reason, many formal firms remain proprietorships instead of becoming corporations.[3] Moreover, it is not only the cost of formalization but also its value that determine entrepreneurs' decisions, and both may be positively correlated. When little value is added, businesses tend to remain informal, as shown by the high proportion of companies that remain unregistered in developing countries. Furthermore, the link between initial formalization of companies and overall formality in the economy also breaks down because legalization of a firm does not preclude informality in many of its future transactions: e.g., most tax evasion in developed economies is carried out by formal firms. In addition, many informal firms are small, or comprise self-employed workers. However, the DB index measures the costs of formalizing mid-size companies, which are rarely informal. Lastly, the costs of formalizing a proprietorship or a company differ substantially because in most countries individual firms are not required to register with the commercial register and enjoy different tax treatment in terms of both rates and enforcement. Overall, the cost of registering a mid-size company can, at best, be a proxy of institutional quality, but not a main cause of key macro variables. Therefore, it is not the magic bullet for economic development that DB is selling.

Second, the cost of initial formalization is a relatively minor component of total entry costs. The use of the "entry" label for initial formalization costs, which is common in the startup literature, causes confusion. For example, the costs of business formalization or start-up play practically no role in Alesina *et al.* (2005), who "look at the effects of regulation on investment in the transport (airlines, road freight, and railways), communication (telecommunications and postal) and utilities (electricity and gas) sectors." To do so, they "measure regulation with different time-varying indicators that capture entry barriers and the extent of public ownership, among other things." These "entry barriers cover legal limitations on the number of companies in potentially competitive markets and rules on vertical integration of network industries." (p. 801). However, Djankov interprets that "Alesina et al. (2005) find that *business start-up reforms* have a significant positive impact on investment in the transport, communication, and utilities industries" (emphasis added). Lowering entry barriers should be a policy priority—focusing on trivial entry barriers is, at best, a distraction.

[3] For example, the difference between personal and corporate taxes is statistically highly significant in determining incorporations in Klapper, Laeven and Rajan (2006), and the economic effect is likely to be several times greater than that of formalization costs.

8. What Doing Business could do

Doing Business has been successful in putting the reform of the business environment on the policy agenda. There may still be time to redirect this success in a productive manner. This would, however, require substantial restructuring of DB's aims, governance and methodology. Otherwise, its marketing success will keep damaging business.

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