

# Chapter 1

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## Evaluation Highlights

- The Doing Business (DB) indicators provide consistent cross-country data annually on 10 specific aspects of a country's regulatory framework.
- DB indicators are based on research that associates better regulations with an improved investment climate, and thence with economic growth—but this research is still nascent.
- Seven DB indicators presume that less regulation is better.
- Five emphasize aspects of debt enforceability and availability of collateral.
- DB argues that regulatory reform will encourage informal businesses to formalize.
- DB indicators do not aim to capture the potential benefits of regulation. Users must be mindful of what the DB indicators measure and what they do not.



Woman standing outside restaurant, Keur Moussa, Senegal. Photo reproduced by permission of Philippe Lissac/Godong/Corbis.

# The Ideas Behind the Indicators

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This chapter situates the DB indicators in the context of investment climate and private sector development. It introduces the main principles that shape what the indicators measure and how they are constructed.

## Role of the Investment Climate in Private Sector Growth

Private sector growth is essential for developing countries to create jobs and raise incomes. The rate and nature of private sector growth in a country is affected by many factors, including macroeconomic and political stability, traditions and culture, physical infrastructure, availability of capital, and human resources. Institutional, policy, and regulatory factors also play an important role. They are often grouped together under the rubric of “investment climate,” as depicted in figure 1.1.

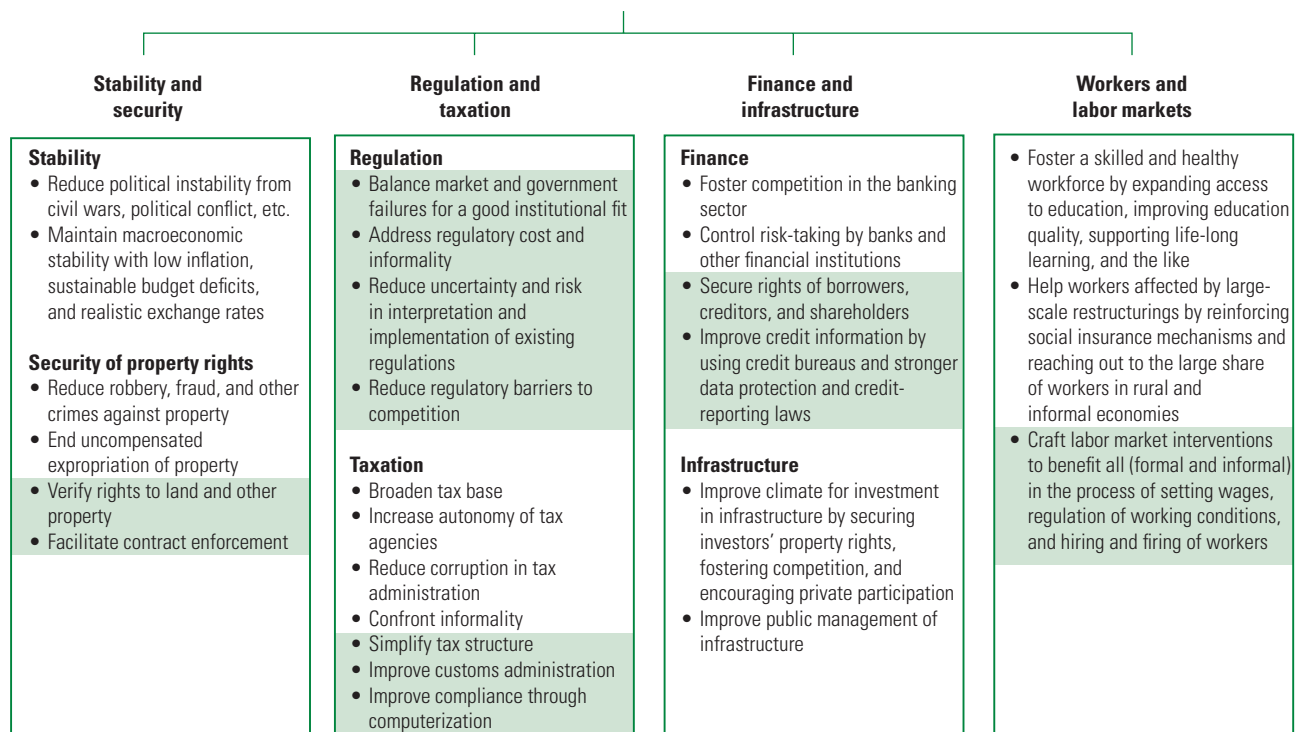
DB measures selected aspects of the investment climate—namely, the laws and regulations governing how firms do business (see shaded areas of figure 1.1). Research suggests, broadly speaking, that the regulatory framework does matter for economic outcomes, but it is inconclusive about which regulations matter most, and how much they matter compared with other determinants (Dollar, Hallward-Dreimeier, and Mengistae 2005).

Business laws and regulations are intended to generate benefits to society at large, but they also inevitably impose costs on the individual firm. Some regulations on firms may deliver an important public good—for example, the prohibi-

tion of child labor. Others—such as requiring multiple official stamps on a document—deliver little or no public benefit. They simply provide officials with opportunities for rent-seeking. The policy maker’s challenge is to find the level of regulation where the desired level of public good—say, tax revenues or worker safety—can be obtained with the minimum loss of efficiency to affected firms. Some countries may be over-regulated; others may be under-regulated. The level of regulation in any country should reflect a country’s preferred trade-off between public goods and private (firm) benefits (see box 1.1).

Substantial research literature has established an association between the characteristics of the business regulatory environment and the performance of firms, and thence to macroeconomic outcomes (see Acemoglu and Johnson 2005; Botero and others 2004; Djankov and others 2002; Hall and Jones 1999; Kaufmann 2002; Kaufmann and Ziodo-Lobaton 1999; Kaufmann, Kray, and Mastruzzi 2006; Knack and Keefer 1995; Rodrik 2004). DB’s Web site contains a comprehensive bibliography of this research, to which the DB team itself has contributed.<sup>1</sup> Generally, this work uses cross-country comparisons to show that various proxy indicators for governance or business regulation are associated with the size or performance of

*The DB indicators are premised on research that associates characteristics of the investment climate with growth, and the effects of laws and regulation on the investment climate.*

**Figure 1.1: DB Measures Selected Aspects of Investment Climate**

Source: World Bank 2004.

Note: Shaded areas are those the DB indicators attempt to measure.

the private sector or overall macroeconomic outcomes.<sup>2</sup>

Business is affected not only by laws and regulations, but also by a host of other variables outside the scope of the DB indicators. The Bank's Investment Climate Assessments (ICAs)

and Business Enterprise Surveys and the World Economic Forum's Global Competitiveness Reports ask business leaders to rank the most important constraints they face. In this evaluation's 13 case study countries, these assessments note 12 important constraints (see table 1.1).<sup>3</sup> Business leaders most often mentioned

### Box 1.1: A Good Investment Climate Balances Private and Societal Interests

The *World Development Report 2005: A Better Investment Climate for Everyone*, addressed the trade-offs between private and social interests:

*At the heart of the problem lies a basic tension. . . . Most firms complain about taxes, but taxes finance public services that benefit the investment climate and other social goals. Many firms would also prefer to comply with fewer regulations, but sound regulation addresses market failures*

*and can therefore improve the investment climate and protect other social interests [p. 6].*

*A good investment climate is not just about generating profits for firms—if that were the goal, the focus could be limited to minimizing costs and risks. A good investment climate improves outcomes for society as a whole. That means that some costs and risks are properly borne by firms [p. 2].*

access to and/or cost of financing, corruption, lack of infrastructure, inefficient government bureaucracy, and tax rates. Four of these 12 constraints are reflected in the DB indicators: inefficient government bureaucracy (that can include regulatory constraints); tax rates and tax administration; and restrictive labor regulations.<sup>4</sup> Interviews with Bank Group staff and stakeholders broadly confirm this analysis: they rated lack of infrastructure, access to and cost of credit, and a shortage of human capital as the three most important constraints to private sector development.<sup>5</sup>

The DB indicators—confined as they are to a subset of these factors—do not and cannot be expected to identify priority action areas across the business climate as a whole. For example, in low-income and post-conflict countries, such as Burundi, political insecurity was an overarching constraint. As a standardized cross-country data set, the DB indicators also cannot elicit any one

country's idiosyncratic issues. Nor can the DB indicators be expected to help determine policy actions, because they cannot situate the regulatory constraints within a country's policy context and macro-economic framework. ICAs and other surveys are better suited to playing both these roles.

But research overall is inconclusive about the direction of causation. While it is typically hypothesized that better regulations spur better economic results, causality may also run the opposite way, insofar as citizens in more advanced economies demand more efficient regulations. There may also be unidentified causal factors. For example, if cross-country analysis finds that higher labor productivity is associated with less onerous business start-up procedures, it may be that a third factor (such as the quality of human capital) is driving indica-

*Investment decisions also depend on other variables not measured by the DB indicators—notably, the cost and access to finance and infrastructure and labor skills.*

**Table 1.1: DB Covers Only Some of the Top Constraints to Business (Constraints mentioned by business leaders; those in bold are covered by DB)**

Top constraints	World Bank Group Investment Climate Assessments and Enterprise Surveys; <sup>a</sup> Global Competitiveness Report <sup>b</sup>
Access and/or cost of financing <sup>c</sup>	Algeria, Burundi, China, Moldova, Nigeria, Rwanda, Tanzania, Vietnam
Corruption	Albania, Algeria, Burundi, China, Moldova, Mongolia, Nigeria, Vietnam
<b>Inefficient government bureaucracy<sup>d</sup></b>	Albania, Algeria, China, Moldova, Mongolia, Netherlands, Peru, Spain
Infrastructure (such as electricity, transportation)	Albania, Netherlands, Nigeria, Rwanda, Tanzania, Vietnam
<b>Tax rates</b>	Albania, Moldova, Mongolia, Rwanda, Spain, Tanzania
<b>Tax administration</b>	Burundi, Mongolia, Peru
Anticompetitive or informal practices <sup>d</sup>	Albania, Peru, Spain
<b>Restrictive labor regulations</b>	Netherlands, Spain
Skills and education of available workers	Spain, Vietnam
Political instability	Burundi, Peru
Macroeconomic instability	Moldova
Economic and regulatory policy uncertainty	Peru

Sources: World Bank Investment Climate Assessments and Business Enterprise Surveys (2004–07); World Economic Forum 2007/08.

Note: Management notes that tax rates are the fifth most widely cited constraint by businesses. This highlights the importance of having a measure of tax burden in the *paying taxes* indicator. In all World Bank Enterprise Surveys done since 2006, 17 of 40 find the tax rate to be among the top 3 obstacles and 33 of 40 find them to be a bigger obstacle than tax administration.

a. Respondents were given a list of 18 factors and asked to rate them on a scale of 1 to 5: 0 = no obstacle, 1 = minor obstacle, 2 = moderate obstacle, 3 = major obstacle, and 4 = very severe obstacle. The top three factors—with the most respondents commenting that the factor was either a major obstacle or very severe obstacle—are displayed in the table.

b. Respondents were given a list of 14 factors and asked to select the 5 most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. Responses were weighted according to their ranking. The top 3 constraints by country are displayed in the table.

c. Includes several factors, such as access to banking and credit services, interest rates, as well as availability of collateral as measured by the DB indicators.

d. Constraint is not offered as a potential response in one of the surveys.

tors for economic performance and quality of public administration in the same direction (based on Altenburg and von Drachenfels 2006).

**Research affirms associations between outcomes and the regulatory environment...** Recent research has begun to test the links between the DB indicators and economic outcomes, although this research has been constrained by DB's short time series. Djankov, McLiesh, Ramalho, and Shleifer (2008) looked at reforms in *getting credit*, and found that credit rises after improvements in creditor rights and information. Commander and Svejnar (2007)<sup>6</sup> found little evidence that the DB indicators have a robust relationship with business environment constraints and firm performance, as measured by revenue efficiency.<sup>7</sup>

**...but suggests a need for caution in attributing economic outcomes to changes in DB indicators.** A background paper commissioned for this evaluation (Commander and Tinn 2007) found no statistically significant relationships between the 2004 DB indicators and growth rates. It found few significant relationships with intermediate outcomes.<sup>8</sup> For example, better legal rights for creditors and debtors were positively associated with private credit, capital inflows, and foreign direct investment, but not with private bank credit. There was a weak association between investment and *dealing with licenses* and *enforcing contracts*. No significant association emerged between *registering property* and construction, *trading across borders* and exports and imports, *starting a business* and the size of the informal economy, or *employing workers* and employment.

Finally, a recent analysis found no significant relationship between reforms as measured by changes in the DB indicators and aggregate investment and unemployment rates (Eiffert 2007). Because of the relative newness of DB data, as well as other limitations described in chapter 2, this research cannot be considered definitive, but it suggests a need to be cautious in attributing economic outcomes to changes in the DB indicators.

**Seven of the 10 DB indicators exhibit a preference for less regulation—3 most notably: employing workers, paying taxes, and dealing with licenses.**

### Three Principles Underlying What DB Measures

The DB model is anchored in the research described above that associates firm performance and economic growth with characteristics of the regulatory environment.<sup>9</sup> DB puts these associations into a normative framework by selecting 10 categories of laws and regulations to be measured, devising a procedure (discussed in chapter 2) for rating and ranking countries, and deriving diagnoses and recommendations for policy makers to use (see chapter 4).

The content of the DB indicators as a group embodies three important ideas:

**1. Less regulation is preferable** across all parts of the distribution and in all countries.<sup>10</sup> 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<sup>11</sup> and is especially prominent in the following 3 indicators:<sup>12</sup>

**Employing workers:** The fewer the restrictions on hours of work and the more easily a firm can lay off redundant workers, the better the ranking. The 10 top-ranked countries include 5 developed countries with high-quality labor laws, but also 5 small island states, some with inadequate labor protections (see box 3.6). Thus the indicator cannot capture the possible offsetting benefits of job protection.

**Dealing with licenses:** The fewer the steps needed to get a permit to construct a building,<sup>13</sup> the higher the score. Possible benefits from safety and environmental checks are not considered.

**Paying taxes:** The lower the overall tax rate as a share of a firm's profit, the higher the score. Among the 10 top-rated countries on this indicator are Maldives, Oman, Singapore, and the United Arab Emirates. Each of these has special characteristics that make it an unsuitable role model for other countries seeking an optimal level of corporate taxation (see box 3.5 in chapter 3). For instance, Maldives derives almost all of its revenue from resort leases. The indicator overlooks each country's fiscal requirement to raise revenue, as well as the

**Table 1.2: The 10 DB Indicators and Their Components**

Indicator	Subindicators	Indicator	Subindicators
<b>Starting a business</b>	Procedures (number) Time (days) Cost (% income per capita) Minimum capital (% income per capita)	<b>Getting credit</b>	Strength of legal rights index (0–10) Depth of credit information index (0–6) <i>Public registry coverage (% of adults)</i> <i>Private bureau coverage (% of adults)</i>
<b>Dealing with licenses</b>	Procedures (number) Time (days) Cost (% income per capita)	<b>Enforcing contracts</b>	Procedures (number) Time (days) Cost (% of claim)
<b>Employing workers</b>	Difficulty of hiring index (0–100) Rigidity of hours index (0–100) Difficulty of firing index (0–100) Firing cost (weeks of salary) <i>Nonwage labor cost (% salary)</i>	<b>Trading across borders</b>	Documents to export (number) Time to export (days) Cost to export (US\$ per container) Documents to import (number) Cost to import (US\$ per container) Time to import (days)
<b>Registering property</b>	Procedures (number) Time (days) Cost (% of property value)	<b>Paying taxes</b>	Payments (number per year) Time (hours per year) Total tax rate (% of profit)
<b>Protecting investors</b>	Extent of disclosure index (0–10) Extent of director liability index (0–10) Ease of shareholder suits index (0–10)	<b>Closing a business</b>	Recovery rate (cents per dollar) <i>Time (years)</i> <i>Cost (% of estate)</i>

Note: *Italicized items are measured but not included in calculating the ease of doing business (EODB) ranking.*

equity implications of alternative sources of revenue (Maldives government 2007).

Defining the point at which the costs of regulation exceed the benefits is difficult. It is likely that some developing countries impose more regulations than would be optimal for economic development. Some level of regulation is helpful for ensuring a supply of social goods such as health and safety, environmental protection, and transparency of business dealings. Regulations may even have benefits for individual firms—insofar as they ensure a level playing field with competitors, for example. Yet seven of the DB indicators, taken to their logical conclusion, would give the highest ranking to countries with the least regulation.<sup>14</sup>

**2. Property rights and debt enforceability are important determinants of lending and investment.** Five of the 10 indicators include measures of the en-

forceability of debt contracts and availability of collateral.

**Getting credit:** The fewer the restrictions on what can be counted as collateral (and the more information lenders can obtain about borrowers' credit histories), the more likely lenders are to make loans and to be able to collect on them.

**Enforcing contracts:** The more efficiently the court system operates, the more easily a firm will be able to collect on a debt.

**Registering property:** The easier it is to register a property, the more likely the owner can use it as collateral for a loan, and the more likely the lender will collect on a bad loan.

**Closing a business:** The easier it is to close a business through formal bankruptcy (instead of simply ceasing operations), the greater the likelihood that creditors can collect on their loans.

*Five of the 10 indicators measure the enforceability of debt contracts and availability of collateral, but leave out some factors that affect firms' use of credit.*

**Dealing with licenses:** The easier it is to allow a constructed warehouse to be used as collateral, the higher the score.

DB's emphasis on collateral and debt enforceability derives in part from the work of Hernando de Soto, which posits that poor property owners are locked out of the formal economy because they lack legal rights to their land, so they cannot use it as collateral for loans to expand their businesses or improve their properties. De Soto's work, however, omits the many other factors that affect firms' actual use of credit, such as interest rates, value of the assets, degree of intermediation, culture, and the existence of viable entrepreneurial opportunities (see Galiani and Schargrodsky 2005; Commander and Tinn 2007). Peru's large-scale titling program, COFOPRI, did not induce the beneficiaries to solicit credit any

more frequently than nonbeneficiaries, and credit applications from beneficiaries were turned down more frequently than those from nonbeneficiaries (Webb, Beuermann, and Revilla 2006). In Peru, lenders proved interested in the applicant's repayment capacity, not whether they had collateral, which often has low resale value (see Morris 2004).

people and firms in the informal economy face severe entry barriers caused by their low skills, lack of access to capital, isolated location, and other structural factors. A recent review noted that "Empirical studies show that only a very small number of micro-enterprises ever manage to upgrade and grow into larger units. The reasons are manifold. Micro-entrepreneurs may, for instance, lack information, technical skills, managerial competence, entrepreneurial spirit, and capital. . . . To graduate out of informality is thus a slow and difficult process of cultural change" (Altenburg and von Drachenfels 2006, p. 406).

DB focuses on the idea that excessive regulation of private sector activity inhibits the transition from the informal to the formal economy. Although some research shows that "countries with heavier entry regulation have lower firm entry and lower growth . . . there is very little evidence on the actual effects of business registration reform" (Bruhn 2007, p. 1). Recent research in Mexico finds that simplifying business registration procedures was associated with an increase in newly registered businesses, although the new business owners were formerly wage earners rather than unregistered business owners (Bruhn 2007).

### Two Principles Underlying DB's Methodology

DB's methodology has two distinctive characteristics. It uses a set of discrete indicators to create an aggregate ranking, and it is applied exclusively to domestically owned firms in the formal sector.

#### *Discrete and aggregable indicators*

DB separately assesses discrete dimensions of the regulatory environment. This is aimed at providing policy makers with specific, actionable information. The 10 dimensions are not equally important in all countries. To illustrate:

- Protection of minority shareholders, as measured by *protecting investors*, was deemed less important in several client countries with more pressing constraints, such as lack of infrastructure and access to finance (see below).
- The rules measured by *employing workers* are

*The DB indicators argue that lighter regulation and less taxation encourage informal firms to move to the formal economy, but the literature is inconclusive about whether these factors can cause such change.*

### 3. Lighter regulation and taxation can encourage non-formal firms to shift into the formal economy.

**Starting a business:** Simpler procedures to start a business will encourage informal enterprises to formalize.

**Paying taxes:** The easier the tax-paying procedures, the more likely a firm is to actually pay, rather than evade, taxes.

**Employing workers:** The fewer the restrictions on hours of work (within limits) and the more easily a firm can lay off redundant workers, the more likely it is that firms will employ workers on formal rather than on informal terms.

The research literature is inconclusive about why the informal sector exists and persists. One explanation is simple tax avoidance. Another view is that

*DB aims to provide policy makers with specific, actionable information.*

more important in countries with substantial formal employment and in countries with organized labor groups than in those where most people are small farmers.

This evaluation asked Bank Group staff and country stakeholders to rank the importance of the 10 DB indicators to private sector growth in their countries. While there were significant variations between countries, in aggregate over half the respondents rated eight dimensions as very important or important to the growth of the private sector in their countries. Only two indicators (*protecting investors* and *closing a business*) were found to be slightly important or not important by more than half the respondents interviewed.

The indicators themselves cannot capture country context, precisely because they are designed to allow cross-country comparisons on the basis of uniform criteria. By the same token, not all reforms will have an equal impact, and the DB indicators are not designed to identify within-country priorities. Users require supplemental information to determine the importance of each indicator or reform in a particular country setting. Stakeholders interviewed for the evaluation stressed the DB indicators' limitations in helping countries select priority reforms (see chapter 4).

DB aggregates country rankings for the 10 discrete elements, weighted equally, into a

single composite ranking called the *The relevance of each indicator will necessarily vary by country.* *ease of doing business* (EODB). Like any composite index, the EODB obscures its component information.

The weights of the indicators are not important since the ranking does not change much with alternative weights.<sup>15</sup> Rather, the change in ranking for any country is driven largely by where a country is located on the distribution of countries on a specific indicator (discussed in chapter 2). Even within DB's own frame of reference, the composite indicator would more accurately (though less attractively) be named "index of regulatory burdens," since it does not capture all dimensions of doing business. (Other issues of nomenclature are discussed in chapter 3.)

#### **Covers formal, domestically owned firms**

The DB exercise gathers information about a particular subset of a country's private sector activity—the regulatory environment facing domestically owned firms operating in the formal sector. The scope of this subset is defined by the specific information that informants are asked to provide (for example, what the law requires as distinct from what may actually happen) and the characteristics of the hypothetical firms in the stylized cases (for example, ownership, annual turnover, or minimum number of employees). The DB reports appropriately explain the scope and limitations of this coverage (World Bank-IFC 2007b, p. 67).

*The DB reports explain the limitations of its approach.*

**Table 1.3: What DB Covers**

<b>DB includes</b>	<b>DB excludes</b>
Small and medium-size firms <sup>a</sup>	Microenterprises and state-owned enterprises
Enterprises in the formal sector	Enterprises in the informal sector
Domestically owned firms and investors	Foreign-owned firms and foreign investors
Official and legal transactions and processes	Illegal, corrupt, informal, and out-of-court transactions and processes
Firms in the capital city	Firms outside the capital city
Limited liability companies	Sole proprietorships

a. The size of the firm varies, depending on the indicator. It ranges from 20 employees for *dealing with licenses*, 50 employees for *starting a business* and *registering property*, 60 employees for *paying taxes*, to more than 201 employees for *employing workers*, *trading across borders*, and *closing a business*. Three indicators (*getting credit*, *protecting investors*, and *enforcing contracts*) do not specify firm size.

**Table 1.4: The Informal Economy Casts a Long Shadow**

Region	Number of countries	Shadow economy <sup>a</sup> (% GDP)
Africa	24	41
Asia <sup>b</sup>	26	26
Latin America	17	41
Eastern Europe and Central Asia	23	38
OECD	21	17

Source: Schneider and Klinglmaier 2004.

a. The shadow economy includes unreported income from production of legal and illegal goods and services, either for monetary or barter transactions.

b. This number is affected by the relatively low levels of informal activity in China (13.1 percent), Hong Kong (16.6 percent), Japan (11.3 percent), and Singapore (13.1 percent).

*Some regulatory constraints are likely to be relatively unimportant for informal and microenterprises . . .*

DB's coverage explicitly excludes some types of enterprises and transactions (see table 1.3). Some of the laws and regulations that apply to small and medium-size domestically owned firms may well apply to other kinds of businesses, such as large-scale enterprises or those with foreign ownership. But the regulatory constraints that DB measures are likely to be relatively unimportant for informal and microenterprises, simply because they are more likely to conduct business without recourse to courts, formal credit providers, and taxes.

*. . . which in some countries account for a significant share of private sector activity.*

In many countries, the informal sector accounts for a significant or even dominant share of private sector activity, especially in low- and middle-income countries (see table 1.4). Observers have criticized DB for not capturing the important constraints on nonformal and microenterprises. This observation, while true, is somewhat off the mark. As discussed above, DB is based on the view that informal firms and transactions should eventually enter the formal economy, and that this is more likely to occur if the burdens on firms in the formal sector are reduced.

In summary, the thrust of the DB is broadly consistent with credible research that more efficient business regulation is associated with better private sector performance, and thence macroeconomic outcomes. But the literature is necessarily partial, as it has not yet demonstrated the direction of causality. Furthermore, regulations deliver benefits as well as costs, and the policy choices countries make are necessarily based on the trade-offs between the two. What is good for a firm may not be good for firms as a group, or for the economy as a whole.

The DB exercise reflects these inherent trade-offs. As a cross-country comparison, DB is not intended to, and cannot, capture country nuances and nonlinear relationships. It notes the costs of regulation, but not the benefits.<sup>16</sup> Seven of DB's 10 indicators presume that reducing regulation is equally desirable whether a country starts with a little or a lot of regulation. While these limitations do not invalidate the exercise, they underscore the need to use the DB indicators cautiously and in conjunction with complementary tools, such as Investment Climate Assessments, when measuring a country's investment climate or related measures of development effectiveness.