International Growth Centre

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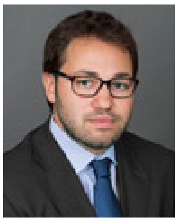

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Published on: 20 Aug 2015

Countries: Africa, Asia, International

Research themes: Entrepreneurship, Firms

Governing growth: How business regulations can foster productivity

The relationship between entrepreneurship and growth is both complex and varied. This blog explores how wide-scale regulatory reform has the potential to drive economic growth among the poorest countries.

Economic growth is an essential part of economic development and poverty reduction. Evidence shows that at times of economic growth the incomes of the poorest 40% increase at the same rate as the average for the overall population. This points at how – over the past decades – growth has been an effective tool for global poverty reduction and increases the need to better understand its driving factors.

Explaining the determinants of economic growth has been at the core of the economic science since its inception. Why do some countries grow at a faster pace than others? Why are there high-income countries and low-income countries? Many factors can contribute and have significant impact on growth.

Amongst these, business regulations are worthy of consideration for two main reasons. Firstly, they set the standards and rules of conduct which businesses should abide by while carrying out their economic activities. Business and firm productivity in particular deeply impact all economic activities. Regulations affect and shape the entire life cycle of businesses, from start-up activities (e.g. business registration, accessing electricity), through operations (e.g. obtaining credit, paying taxes, importing/exporting) all the way to insolvency procedures that kick in when they go bankrupt. Second, just like fiscal measures, monetary interventions and welfare programs, regulations are a direct instrument of government action. Policy makers can set rules that make bureaucracy more efficient and generate a friendlier governance system for entrepreneurship.

Measuring the quality of business regulation

Regulations matter for their quality and for their efficiency. The former relates to the strength of legal institutions relevant to business such as company laws, record disclosure requirements for related-party transactions, or civil laws governing commercial sale dispute resolutions before local courts. The latter refers to the complexity and cost of regulatory processes. In other words, the efficiency of achieving regulatory goals such as the fewest number of procedures needed to obtain building permits or reducing the time taken to grant legal identity to a permits or reducing the time taken to grant legal identity to a business.

Promoting firm creation

Good business regulations promote new firm creation. This link to growth is not new in the economic literature. Minimising business start-up regulations and reducing the time and cost required for firm registration are all found to increase the number of new businesses and jobs created. Simplified entry regulations may also to lead to the shifting of informal firms to the formal economy. **We** complement these studies by analysing business regulations beyond entry regulations and by testing the results over a large set of countries. Results show that countries that improve their overall business regulations experience higher rates of business creation. Interestingly, countries that improve in only one regulatory dimension – either on quality or efficiency – do not display increases in firm creation as strongly as the countries that implement wider-ranging reforms. This shows that having a combination of good regulations across different areas is very relevant for business entry.

Fostering growth

In addition to their impact on growth through firm creation, regulations also foster growth directly. While this is a much less explored territory by economists, some studies found that simpler business regulations are associated with higher long term growth and investment rates. **We** add to this existing literature. **Our** results show that small changes in the overall level of business regulations may have a negligible link to growth. This is not surprising since growth depends on many factors. And changes to specific or individual business regulations may prove too micro to have a significant macro effect. Focusing instead on the bigger reform programs, we find that the countries that improved their business regulations the most, experience a 0.8% higher growth rate relative to countries that changed no regulations, or countries that implemented either minor or negative changes to their regulatory frameworks. This is a significant impact given that the average growth rate in our sample is 2.7 %. **Our** result shows that large changes in business regulations do matter for growth, although small changes may have a negligible impact. We investigate this result further by looking at different combinations of regulatory reforms. Effective business entry and insolvency regulations have the strongest link to growth. So do credit market regulations such as secured transactions and contract enforcement laws.

Countries growth rates differ widely, understanding which factors and conditions produce the fastest and most sustainable forms of growth will require continued research and attention by policymakers and scholars alike. Improving the quality and efficiency of regulations governing business entry and expansion may offer a tangible avenue for the promotion of faster, more sustainable growth in developing countries. This study suggests that the biggest impact on growth will only come from countries that implement wide-ranging regulatory reforms.