Uses and Abuses of *Doing Business* Indicators

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Executive Summary

The World Bank's *Doing Business* Reports are one of the most exciting developments in years for business environment reforms. By providing clear, transparent information about the state of business regulation in the countries of the world, policy makers can compete more effectively to improve the business environment and attract investment. Although the rankings can be controversial, they are, in the end, effective at inspiring and prioritizing needed reforms.

The use of the indicators, however, is often beset by poor understanding, leading to misuse. *Doing Business* numbers reflect symptoms of underlying problems, but do not diagnose the actual problems nor the cure. Because of this, reformers sometimes opt for the wrong responses. These include:

- Addressing only the symptom, not the underlying cause
- Changing the *Doing Business* ranking without improving the business environment
- Mistaking low scores for a lack of problems

Better understanding of the role of the indicators – and the nature of business – permits more effective reforms. Businesses succeed when their revenues are sufficient to cover their costs and risks. The substantive areas covered by *Doing Business* – Starting a Business, Enforcing Contracts – all deal with the costs and risks of doing business in a country. Therefore, they point to places where reformers can reduce unnecessary costs and risks caused by improper regulation.

Once this is understood, the *Doing Business* indicators are an invaluable resource. They point out areas that are in need of reform and allow for deeper analysis of the causes of the underlying problems. With this analysis, policy makers can more effectively reduce the costs and risks of business and thereby improve the business and investment climate.

The reforms generated are important, but expectations need to be tempered. Reforms can take time, which means they may not be reflected immediately in the annual *Doing Business* reports. Moreover, the rankings are competitive, so that if neighbors also make changes, the relative rankings may stay the same, even though all of them have improved their business climates. Finally, reformers should not expect that better scores will immediately attract foreign investment, but should see instead that a better business climate leads to better domestic investment and prosperity, key elements of eventually attracting foreign business.

Uses and Abuses of *Doing Business* Indicators

By Wade Channell, Esq.[1]

Introduction: Exciting Developments

The World Bank's *Doing Business* reports have been one of the most exciting developments in years for business environment reform. The reports provide clear, quantifiable indicators of strengths and weaknesses in business regulation, allowing reformers to focus their efforts on identifiable problems. By ranking countries according to their business environment, *Doing Business* has inspired extensive competition between and even within countries to improve the business enabling environment. Indeed, last year African reforms placed the region third for most positive changes adopted.

The popularity of *Doing Business* is counterbalanced by controversy. Many leaders have challenged the accuracy of the report, either because there can be some play in the calculations, or because the calculations placed them behind their rivals. When the 2006 report placed Croatia last in the Balkans, the Prime Minister issued a formal diplomatic protest against the World Bank. The Croatian business community, however, cheered the transparency that showed how poorly the government was handling business climate reforms.

This controversy is one of the healthiest products of the reports. It has opened discussions between public and private sector leaders on the needs of the business community, with useful, transparent data to support arguments for reform. The indicators have pointed out areas of concern that must be addressed, not by improving the measurement, but by improving the environment. Unfortunately, the indicators do not indicate what should be done. Understanding this fact is essential to proper use (and avoiding misuse) of this valuable tool.

Limits of the Indicators: Symptoms or Disease?

Imagine receiving a phone call that one of your family members is ill with a high fever and aching joints. Treatment is clearly needed. But what treatment? You could start a course of antibiotics, apply ice packs, or even operate, but no physician would dare do any of these without further analysis. Why? Because symptoms are not the problem, they are merely indicators of the problem, and treating them may leave the disease untouched. Better to treat the disease and manage the symptoms.

Doing Business indicators measure basic regulatory health. Like symptoms, they tell us that something is wrong, but not necessarily what is wrong. Instead, they are proxies for deeper issues, some of which require systemic approaches. It is not enough to change an indicator directly – such as lowering the number of days to register land – if that is merely a proxy for much more significant problems – such as an undeveloped land market.

Because of the competitive use of *Doing Business* rankings, some governments have been tempted to lower indicators without addressing the real issues of over-regulation. It is relatively easy to lower the

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costs and delays of starting a business, but that does not necessarily make it worthwhile for an investor to do so. For example, Equatorial Guinea currently charges about $350 to register a business, and the process takes approximately six months. These are not particularly high barriers to business entry (although they certainly should be improved), yet there are less than 100 registered companies in the country. Clearly, the "Starting a Business" indicators are not the problem. More likely, there are severe anti-competitive constraints, high regulatory burdens, or simply no perceived benefits to registration. Treating this symptom will have no impact on the real problems.

So the first "abuse" of *Doing Business* indicators is in addressing only the simple terms of the indicator, not the underlying problem. A second abuse occurs in prioritization. Because it is possible to improve competitive rankings by changing indicators, some officials look for the easiest reforms, which are not necessarily the most important for business or the economy.

"Trading across Borders" separately measures the costs and delays of imports and exports to create a single indicator. Improvements to import restrictions are easier and can improve the indicator, even if exports stay the same. Exports, however, are likely to have greater economic impact: recent studies suggest that delays in exports from Africa have the impact of tripling the burdens placed by tariffs. That is, improvements in export constraints – transportation, customs, and ports – can have far greater economic impact than reduction of external tariffs. Taking the easy route of addressing import delays without addressing export delays will improve the indicator, but may have little impact on the export market.

A final abuse occurs when potential reformers assume that low scores mean that there is no problem. For example, Afghanistan has scored very well on "Starting a Business" (17th in the world in 2007) because the laws have strict requirements on timing and costs. The Afghan business community, however, notes that these findings hold true only for those who pay significant fees for expediters to register the company – for SMEs, registration is still a nightmare. Even worse, many of the problems of opening a business have now been moved to after registration, so that it still takes more than a year to begin operations. Reform is still greatly needed to bring practices in line with laws and to clean up other obstacles that have sprung up in new places. Moreover, systemic changes are needed to maintain constructive dialogue between the public and private sectors to maintain reform.

Focus of the Indicators: Why *Doing Business* Matters

The *Doing Business* indicators are very effective in identifying symptoms of danger in the business environment. To identify the best solutions, however, it is necessary first to understand the nature of the problem: why burdensome regulation hurts business.

Business people invest their time and resources to create goods and services that they can sell. When they are successful, they can employ more workers, invest more capital, pay more taxes and otherwise improve the economic environment around them. But success requires that they make more than they spend, otherwise the business will collapse.

In more traditional terms, success requires a reasonable return on investment. This is accomplished only when revenues exceed the costs and risks of doing business. When either risks or costs go up, a business – whether a multinational enterprise or a corner kiosk – must raise prices. As prices go up, the risks of failure also rise, because fewer people can then afford the product being offered. Thus high costs and risks fuel a vicious cycle of failure, which leads to less business and less investment.

Doing Business measures a number of factors that affect the costs and risks of business. Even a cursory glance makes clear that poor scores in Registering a Business, Dealing with Licenses, and Employing Workers indicate high costs that may make it difficult to compete with other countries. Protecting Investors, Enforcing Contracts, and Closing a Business indicate risk factors. In fact, each indicator has a bearing on both costs and risks. (See Annex 1: Costs and Risks in *Doing Business*).

Poor scores on *Doing Business* indicators – especially for countries that score badly on numerous indicators – provide two important insights. First, they tell potential new investors that the country may simply be too dangerous for investment and that it is better to seek another location. Second, they help explain the lack of economic development in that country: low scores and low per capita income (especially after controlling for mineral wealth) correlate very closely. Consistently positive scores give the opposite messages. Indeed, it is not unusual to find wealthy people from low score countries investing most of their wealth in high score countries. They know better than anyone how unsafe it is to do business at home.

Potential of the Indicators: Using *Doing Business* for Maximum Impact

Doing Business indicators allow reforms to pinpoint areas in which costs, risks or both are out of line. This allows governments to make reforms that reduce the dangers and facilitate growth of business and commerce for economic development. They do this not by changing the indicators, which may not fix the problem; instead they fix the problem, which will then fix the indicators.

Each indicator points to areas in need of reform. This is the starting point. From there, reformers need to analyze what is causing the poor scores: is there a systemic problem, or merely a regulatory issue that can be quickly fixed? Sometimes it is necessary to go through a series of reforms in order to improve the business environment effectively.

Problems in the business environment are normally systemic. They arise from historical reasons, ranging from colonial experience to ideological commitments. Frequently, the original design of the business environments in Sub-Saharan Africa was not business friendly: colonial powers created systems that created a few elite "winners" without regard for potential investment by the local population. These designs were sometimes then made worse through adoption of authoritarian or ideological reforms that concentrated business and trade into an even smaller group of privileged owners, or into the hands of the state, which was unable to run the business effectively. As a result, the business environment may suffer from serious design flaws on a systemic level.

Using the *Doing Business* indicators provides an opening into deeper problems and an opportunity to change the underlying design. For example, Kenya recently began to attack problems in "Dealing with Licenses" by adopting the "guillotine" approach to reform. Under this approach, reformers change the system that produced unnecessary licensing requirements, while also getting rid of unnecessary licenses. By reforming the system, they make sure that problems do not simply spring up in new places.

In Ethiopia, a deeper look at "Getting Credit" last year showed that credit information and collateral registries were not the primary constraint on credit. In fact, there was a series of problems, from lack of competition in the banking industry, to overreaching regulations, to weaknesses in the insurance industry. While there are plans to improve collateral lending, reformers now have a more comprehensive view to guide reforms.

The US Agency for International Development (USAID) recently revised its diagnostic tools for legal reforms to address the issues raised by *Doing Business*. Recognizing that the indicators were an invaluable tool for reformers, USAID reconfigured its commercial legal and institutional reform methodology in accordance with the subject matter areas of *Doing Business*. (In August, this new approach was used for the first time in Africa during an assessment of Tanzania. The report will be available shortly at www.bizlawreform .) The new methodology uses each indicator as a starting point, then expands the analysis to cover the many inter-related areas that affect the business climate.

Today, it has become much easier to move from a poor *Doing Business* score to a meaningful set of reforms. Some of these reforms can take years. For example, changes to "Enforcing Contracts" often require systemic reform of the court system, improved enforcement capabilities, and introduction of new commercial dispute resolution techniques such as mediation and enforceable arbitration, along with extensive retraining of judges, ongoing education for lawyers, and revision of law school teaching materials.

The strength of *Doing Business* is that it points reformers not to a simplistic change in one indicator measurement, but to systemic needs in an entire area of business regulation that have negatively affected the costs and risks of business activities. It also highlights the cross-border nature of some of these problems.

Uganda (160) and Rwanda (175) were among the worst countries last year in "Trading across Borders." Unfortunately for them, they are landlocked and must go through Kenya (145) to export abroad. Unless these countries take a regional approach to reform, gains in one can be nullified by the need to transverse a less reformed neighbor. The result is higher costs and risks for the region. Southern Africa recently completed reforms that eliminated excess documents and innumerable delays by adopting a regional transport document. They have cut days off of transport times between countries, leading to lower costs and risks in cross-border trade.

By identifying the starting points for reform, *Doing Business* offers a guide to improved business environments. Yet there are still dangers, even when using the indicators properly. The dangers arise from inappropriate expectations.

Impact of the Indicators: Refining Expectations from *Doing Business* Reforms

When reformers commit resources – including their own reputations – to solve a problem, they rightfully expect results. When results are delayed, ensuing frustrations can have negative repercussions for both the reforms and the reformers. It is therefore critical that expectations are properly managed based on a proper understanding of the reforms and their impact.

A number of countries have been dismayed to find that their reforms were not immediately reflected in the *Doing Business* indicators. There are two reasons for this. First, some reforms take place after the *Doing Business* team has done its surveys. Much of the diagnostic work is done in February and covers only those reforms *that are already adopted in practice.* Passing a law in June 2007, even if it is put into practice immediately, will not be captured in the report produced in 2007. Second, reforms take time to be implemented. Some of the *Doing Business* indicators measure the actual practices used, not simply the law. It can take several years for a law to be converted into new practices. Reformers should not

lose hope when their changes are not reflected in the scores; they should simply recognize that it takes time before the scores can be captured.

Another danger for reformers is criticism when their country does not improve in its rankings compared to others in the neighborhood. This is harder to deal with politically, but need not be. *Doing Business* rankings are competitive: a country's ranking will change only if it makes more reforms than those lower in the ranks. For example, in 2006, Senegal was ranked 152 and Tanzania was 150. In 2007, Senegal's reforms moved it up to 146, ahead of Tanzania, except that Tanzania improved even more, and achieved a rank of 142. Both improved, but one was relatively stronger than the other.

The bad news is that this cannot be controlled – every reform in one country can be matched by reforms in another. The good news is that this competition leads to a better business environment in all of the countries. When countries in a region improve together, each country is better off than if it were the only one to improve.

The final danger in misaligned expectations arises when the purpose of the reforms is ill founded. At times, countries will adopt reforms for the primary purpose of attracting foreign investment. Normally, this is based on a misunderstanding of economics, a belief that the country can improve only if outside resources are available. Foreign investment can be of great benefit, but is not the point of business climate reform. The principal reason to reduce unnecessary regulation is to reduce unnecessary costs and risks for all businesses, not just foreigners. Foreign investors generally do not invest where locals do not invest. Moreover, foreign investment seldom makes up more than 10% of investment in a country, suggesting that the first priority is to promote the 90% domestic investment.

Business climate is important for attracting foreign investment, but it is not the only factor foreign investors examine. Business reforms will not overcome distance from markets, market size, or the presence of unstable neighbors. But enabling environment reforms will lead to a healthier overall business climate for all investors, which is an end in itself.

Conclusion: Better Reforms through Better Understanding of *Doing Business*

The World Bank's *Doing Business* reports have become an invaluable tool for identifying reform needs in a country's business enabling environment. They guide the way to underlying systemic problems by capturing symptoms of underlying faults through simple, understandable numerical indicators. These indicators and the rankings based on them have spurred invaluable reforms around the world, with increasing frequency in Africa.

The indicators are just that: indicators. They are a thermometer that indicates a fever but does not reveal the disease. They are not the answer, but they lead to the answer.

The indicators and the comparative rankings make for interesting reading and heated debates. But more than that, when rightly understood, *Doing Business* provides the springboard for reforms greatly enhance the business environment, reducing the unnecessary costs and risks of doing business, so that reforming countries can grow and prosper.

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Annex I

Costs and Risks of *Doing Business*

The purpose of business – large or small, foreign or domestic – is to serve human need by providing needed goods and services at reasonably affordable prices. Those who invest in business must earn enough from the investment to cover associated costs and risks, and earn a reasonable return. Prosperous businesses support economic growth through hiring employees, paying taxes, reinvesting their returns, and creating stability through their ability to absorb or adapt to unexpected changes in the economy. When costs and risks outpace revenue potential, however, they fail.

For new businesses, one of the greatest sources of non-market costs and risks is business regulation. A risky business environment repels stable investment and undermines growth. A costly environment reduces competitiveness.

The World Bank's *Doing Business* reports analyze ten areas of business regulations. Each of these areas ultimately affects the costs and risks of business activity, costs and risks that can be controlled and reduced by government. Some – not all – of these can be found below.

Doing Business Area	Impact on Costs and Risks
Starting a Business	• Costs -- start up fees (including notaries, lawyers), delays, effort • Risks -- denial of registration, demands for rents, unpredictable ad-hoc requirements, anti-competitive pressure
Dealing with Licenses	• Costs -- initial and annual fees, compliance • Risks -- unpredictable cancellations, burdensome inspections
Employing Workers	• Costs -- combined salary and benefits, bookkeeping, compliance • Risks -- inability to terminate for cause or economic necessity
Registering Property	• Costs -- preparation of documents, fees, taxes • Risks -- inadequate protection of rights and title, confiscation, hidden liens and claims
Getting Credit	• Costs -- higher fees and interest due to poor systems of security and risk management • Risks -- inability to attain affordable credit when needed
Protecting Investors	• Costs -- monitoring investment to ensure protection • Risks -- unexpected losses due to misuse of majority position
Paying Taxes	• Costs -- compliance time and effort, total tax rates • Risks -- abusive audits, uneven application of laws to benefit competitors
Trading across Borders	• Costs -- delays, documentation, fees, duties • Risks -- uneven application of laws, unpredictable duties, capricious enforcement
Enforcing Contracts	• Costs -- professional and court fees, delays • Risks -- lack of enforcement capacity, unpredictable results
Closing a Business	• Costs -- professional and court fees, reporting requirements • Risks -- personal (vs. corporate) liability, unpredictable results