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Determinants of Doing Business Reforms

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This note identifies the quality of democracy and the amount of natural resources as important determinants of Doing Business reforms. Reforms are more likely in countries with better democracy and less reliance on natural resources. Differences across countries in overall development as measured by income per capita; initial quality of business environment; and ethnic, linguistic, and religious fractionalization within a country have little to do with the proclivity to reform. Additionally, there is no evidence of reform fatigue. In fact, past reformers are much more likely to reform in the future than nonreformers.

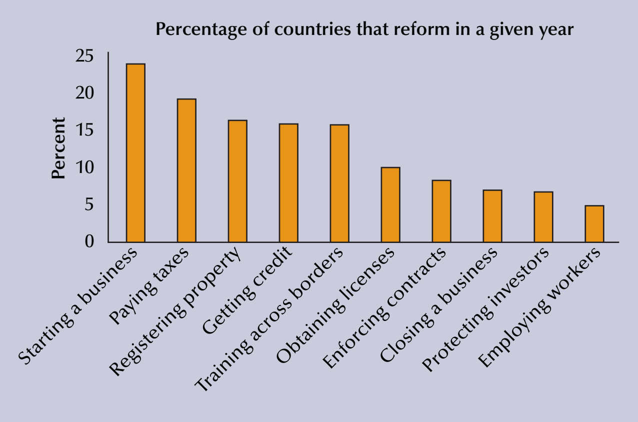
The World Bank's Doing Business (DB) project has inspired a number of countries to implement reforms that make it easier for private businesses to start, operate, and close. As defined by DB, 1,300 major business regulatory reforms have been implemented to date; over the period of 2003-2009 for each of the ten indicators, on average 13% of countries reformed (figure 1). These reforms are welcome, as they are likely to have a positive effect on income and employment levels and overall economic development (Berseghyan 2008; Klapper, Laeven, and Rajan 2006).

What sorts of countries reform more than others? This note attempts to answer this question, in part, by highlighting the key impediments to reforms. In what follows, a country is said to have reformed in any given year if it implements a major positive reform (as defined by DB) in at least one of the 10 DB indicators. According to this definition, over 58 percent of the countries have reformed on average each year over the period from 2003-09 for which data are available.[1] The rest of this note uses country-year data from the Doing Business 2004 through 2010 reports, i.e. if a country reforms at all in a given year (for DB-measured reforms captured in years 2003-09)

Democracy promotes reforms

Amin and Djankov (2009a), examining the democracy-reforms relationship, finds that democratic countries are more likely to reform. The finding is important given that the broader literature dealing with macroeconomic stabilization and structural reforms has failed to reach a consen-

Figure 1 Distribution of Major DB Reforms



Source: Doing Business.

sus on the democracy-reforms relationship (see, for example, Williamson 1994, Rodrik 1996) .

As this literature suggests, reforms are often unpopular because they tend to reduce living standards in the short run. Even reforms that increase overall prosperity may be unpopular if compensation schemes for the losers are not credible, as is often the case; this is especially true when the costs of reform are immediate whereas their benefit will be far into the future.

Potential drawbacks to the regulatory reform process in democracies are compounded by the fact that democracies offer greater channels for protest and influence on policy making to subordinate groups than authoritarian regimes do. In contrast, authoritarian governments have less need to respond to either popular opinion or to vested interests and therefore may be better able to make long-run plans than democratic governments tied to electoral cycles.

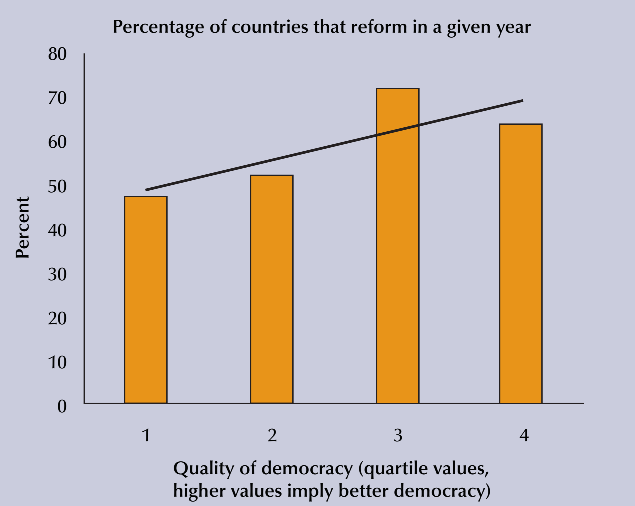
These apparent "advantages" of authoritarianism to reforming regulations are not without their drawbacks. For example, to the extent that policy information and feedback are vital to the design of reforms, democracies may have an advantage. Authoritarian regimes do not have to worry about re-election and hence it is not clear what their incentive to reform is, whereas losers from reform in a democracy may comply with defeat because they believe the institutional framework organizing democratic competition will permit them to advance their interest in the future (Przeworski 1991).

For countries with an above average quality of democracy as measured by the Polity IV database (2003), 65 percent reformed whereas only 48 percent reformed among those with a below average quality of democracy.

Existing studies show numerous cases of reform under democratic as well as authoritarian regimes (see, for example, Williamson 1994). According to these studies, successful economic liberalization was achieved under military regimes in Argentina (1966 and 1976), Chile (1973), Brazil (1964), and Uruguay (1976) and under authoritarian regimes in China (1978) and Vietnam (1993). Reform was also achieved under democratic regimes in Australia (1983), Colombia (1986, 1991), New Zealand (1984), Spain (1977-78), Poland (1992) and Slovakia (1998-2000).

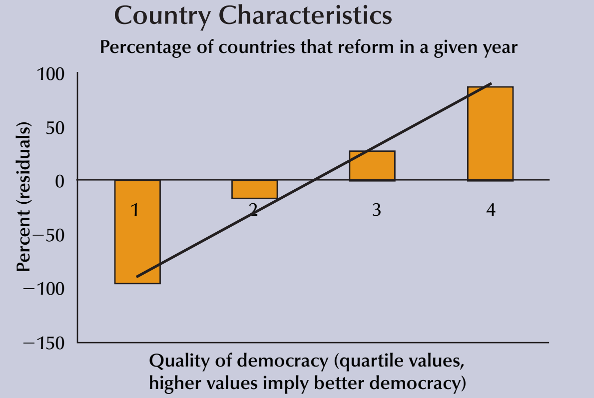
To what extent the above arguments hold for regulatory reforms covered by the Doing Business is an empirical question. The DB reforms data clearly demonstrate a greater proclivity to reform in more democratic countries (figure 2). For example, for countries with an above-average quality of democracy as measured by the Polity IV database (2003), 65 percent reformed, whereas only 48 percent reformed among those with a below-average quality of democracy. The positive relationship between democracy and reforms holds even when we allow for the

Figure 2 Democracy Promotes Reforms



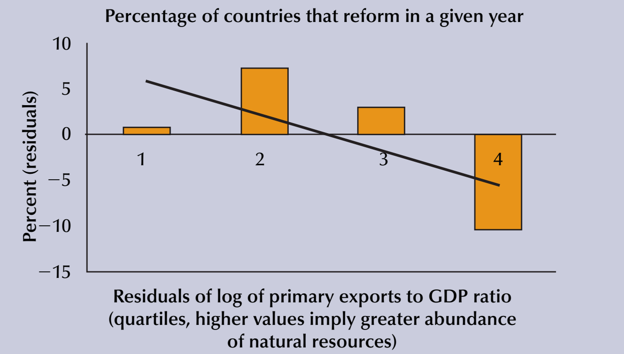
Source: Doing Business and Polity IV database. A Doing Business reform occurs if a country implements a reform in at least one of the 10 DB indicators in a given year (shown in figure 1). The democracy variable relates to the year 2003 and is taken from Polity IV database.

Figure 3 The Positive Democracy-Reforms Relationship Remains Even after Taking into Account Differences in Various Country Characteristics



Source: The figure is a partial scatterplot controlling for log of GDP per capita (Penn World Tables 2003); Rule of Law (World Bank 2003); Business Freedom index (Heritage Foundation 2003); degree of ethnic, linguistic, and religious fractionalization (Alesina et al. 2003); and the main religion (Catholic, Muslim, Protestant, and all other) of the countries (La Porta et al. 1999). Data sources for democracy and reforms are Polity IV database (2003) and *Doing Business*, respectively.

Figure 4 Abundance of Natural Resources Lowers Reforms



Source: The figure is a partial scatterplot of reforms on natural resource abundance controlling log of GDP per capita (averaged over 1998-2002 from WDI, World Bank), regional fixed effects (WDI, World Bank), and quality of democracy (Polity IV database, 2003). Share of primary exports in GDP (%, average over 1998-2002; log values). Primary exports include all exports in SITC (Revision 1) categories of 0, 1, 2, 3, 4, and 68. Source for primary exports is UN Comtrade and World Bank for GDP. Data for reforms are taken from *Doing Business*. The relationship shown is significant at less than 5% level.

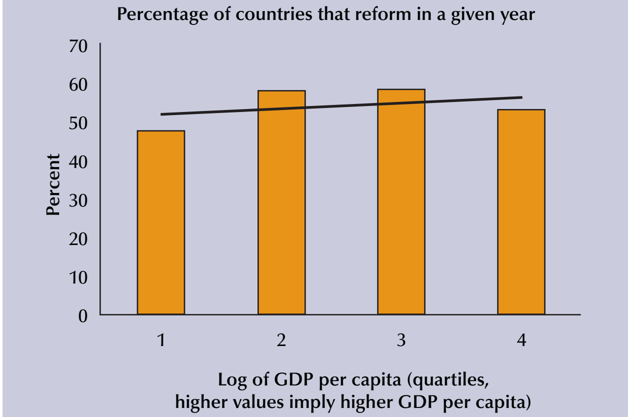
fact that democracies and nondemocracies may differ in income levels and the initial quality of the business environment (figure 3).

Abundance of natural resources hurts reforms

Using DB reforms, Amin and Djankov (2009b) show that reforms are less likely in countries that have a greater abundance of natural resources. First, governments in natural resource-rich countries are less dependent on public taxation for their revenue, which makes them less accountable to the people and less interested in reform. As Luciani (1987) succinctly puts it, rentier states do "not need to formulate anything deserving the appellation of economic policy." Second, the availability of large rents from the extraction of natural resources encourages rent-seeking activity at the cost of reform efforts. Third, the greater concentration of wealth that tends to accompany an abundance of natural resources works to erode social capital, a necessary ingredient for generating consensus on reforms.

Figure 4 demonstrates the likely veracity of the arguments above. A move from the 25th percentile value (Mexico) to the 75th percentile value (Indonesia) of primary exports to GDP ratio, a measure of natural resource abundance, lowers the probability of DB reform by about 9 percentage points (against the mean value of 60 percent). This finding holds true using alternative measures of resource abundance and accounting for other differences such as income levels between natural resource-rich and natural resource-poor countries.

Figure 5 Income Level Has Little Effect on Reforms



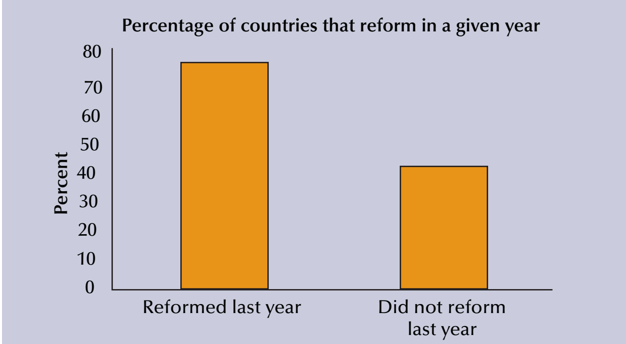
Source: Reforms data are from *Doing Business,* and GDP per capita data are from World Development Indicators, World Bank (averaged over 1998-2002).

Poor countries reform as much as rich countries

One concern could be that reforms in poorer countries may be hindered by lack of expertise or capacity to reform. However, the data show that relatively poor countries are as likely to reform as relatively rich ones (figure 5). The poorest quartile of countries show a somewhat lower proclivity to reform; however, the difference is not much nor is it robust. Similarly, there is little evidence that poorer initial quality of the business environment or the degree of ethnic, linguistic, and religious fractionalization within a country promotes or hinders reforms (Amin and Djankov 2009a, 2009b).

Relatively poor countries are as likely to reform as relatively rich ones.

Figure 6 Reformers Last Year Are More Likely to Reform in the Current Year



Source: Doing Business. For a country and in any given year, a Doing Business reform occurs if the country reforms in one or more of the 10 Doing Business indicators (shown in figure 1).

There is no reform fatigue

Figure 6 shows that countries that implemented reforms in the previous year are also more likely to implement reforms in the current year. One reason for this could be that countries that have greater capacity or incentive to reform are more likely to reform in all years than the rest. Alternatively, past reforms may help break the status quo, thus paving the way for future reforms. Either way, past reformers are more likely to increase their lead in the future over nonreformers.

Evidence suggests that democracy promotes reform while an abundance of natural resources hinders it. Rich and poor countries are equally likely to reform. The same holds for countries at different levels of regulation and differing overall quality of the business environment. Thus, across the years, DB-captured reforms are not happening solely among poor countries or among those with less dynamic business environments. This is further corroborated by the fact that there is a strong momentum to reform: past reformers are more likely to reform in the future as opposed to nonreformers.

Note

1. An alternative measure of reforms is the count of DB indicators on which a country reforms in a given year. Results presented in this note are qualitatively similar using either of these two measures.

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