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*Measuring the Business Environment for Entrepreneurship:  
SMEs, Quality of Institutions and Development*

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PROVINCIA AUTONOMA  
DI TRENTO

# **Measuring the Business Environment for Entrepreneurship: SMEs, Quality of Institutions and Development<sup>1</sup>**

## **Abstract**

This paper aims to contribute to understand the role of entrepreneurship in fragile states, which despite the practical interest and relevance has been somewhat disregarded in academic research. Given the necessity to support policy formulation with appropriate and relevant measurement of entrepreneurship and the business environment, the primary focus in this paper is to scrutinise existing international indicators, in particular the World Bank Doing Business Indicators (DBIs) and ask whether they are able to capture entrepreneurial dynamics and constructively guide policy making towards entrepreneurship in fragile state.

The paper argues that DBIs give a partial picture of the nexus between institutional context, policy reforms, entrepreneurship and economic development. In particular, DBIs analysis fails in addressing three pivotal aspects: first, the process through which individuals become entrepreneurs, second, industrial cooperative and competitive relationships both intersectoral and across different sectors of the economy, and third, the characteristics of workers employed in enterprises.

Consequently, DBIs are not able to capture innovation and changing processes, and miss some pivotal features of both the internal and the external environment of the enterprise. The paper maintains that these shortcomings are particularly serious when referred to fragile countries and discusses how and to what extent DBIs lead to adverse-effect policy recommendations, being inadequate for policy planning in fragile areas.

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# **Measuring the Business Environment for Entrepreneurship: SMEs, Quality of Institutions and Development**

*Chiara Guglielmetti*

## **Introduction**

More than a billion people live in around fifty developing countries that have been described as ‘fragile states’ (Naudé et al. 2008). In fragile states, governments lack the authority, legitimacy and often the willingness to promote economic development. According to Binzel and Brück (2007: 5) fragility refers to ‘the existence of persistent, systematic, significant and interrelated social, political and economic uncertainties’. Many fragile states are mired in conflict, or just entering into a post-conflict phase, or have histories of long and deep conflict. Understanding the dynamics of development in such states have become a defining global challenge, as there is agreement that little progress will be made in terms of achieving progress in the areas of global public goods such as addressing security, climate change and migration unless the issue of fragile states are addressed.

Increasingly, donors and international development agencies are turning to private sector development where state capacity is lacking. Promoting entrepreneurship in fragile states, and in conflict and post-conflict situations, have therefore assumed high importance in strategies dealing with fragile states (Naudé 2009).

This paper aims to contribute to understanding the role of entrepreneurship in fragile states, which despite the practical interest and relevance has been somewhat disregarded in academic research. Given the necessity to support policy formulation with appropriate and relevant measurement of entrepreneurship and the business environment, the primary focus in this paper is to scrutinise existing international indicators, in particular the World Bank (WB) Doing Business Indicators (DBIs) and ask whether they are able to capture entrepreneurial dynamics and constructively guide policy making towards entrepreneurship in fragile state.

The paper argues that the DBI gives a partial picture of the nexus between institutional context, policy reforms, entrepreneurship and economic development. In particular, DB analysis fails in addressing three pivotal aspects: first, the process through which individuals become entrepreneurs, second, the relationships between enterprises, both intersectoral and across different sectors of the economy, and third, the characteristics of workers employed in enterprises. In doing so, DB is not able to capture innovation and changing processes, which are the essence of an entrepreneurial economy and fails in capturing both the internal environment of the enterprise and the economic, social, political environment of which the entrepreneurship is a part. These shortcomings are particularly serious when referred to post-conflict countries. DB approach and design disregards context-specific variables which are critical in the process of reconstruction and development. The paper lists some methodological limitations to the Index. In particular, six areas are considered relevant for business environments which are not measured by DB: proximity to large markets, quality of infrastructure, security, macroeconomic stability, corruption, the labour skill of the population, the underlying strength of institutions (DB07 2008; 2009). This notwithstanding, the aforementioned partial approach leads to a distorted analysis of the characteristics of the policy environment because the DB index is explicitly normative. This paper discusses how and to what extent DB indicators lead to ‘adverse-effect’ policy recommendations, being inadequate for policy planning in fragile states and post-conflict areas.

The remainder of the paper will proceed as follows. In the next section a conceptual framework is presented to relate the business environment in fragile and post-conflict states to entrepreneurship. Then, the DBIs will be discussed, and related to the circumstances in fragile and post-conflict states.

## **The business environment in fragile and post-conflict states: a conceptual framework**

In fragile and post-conflict states, the following aspects are pivotal to understand the business environment. First, the role and the strength of formal and informal institutions have to be

emphasized. This is important for a number of reasons. Post-conflict countries are in particular need of a comprehensive public effort to recover war-damaged infrastructures and to provide a larger amount of public goods, in order to re-create an environment able to convey dispersed resources.

Moreover, institutions can play a major role in creating a more secure, stable and predictable environment. As Stiglitz (2006) stresses, conflict *can be seen as an extreme form of breakdown of the society*. During the transition from war to peace, the socioeconomic, political, formal and informal institutional environment is atypically unpredictable and can be highly unstable<sup>1</sup>. The implications for economic and non-economic incentives to become an entrepreneur are manifold.

As far as private portfolio decisions are concerned, the willingness to make long-term investments or irreversible and process-dependent investments is particularly low (Alesina et. al. 1992; Alesina and Perotti 1993), and private portfolios are made up of a considerably greater amount of liquid assets than in 'normal' conditions. Moreover, as a war-economy has been short of investments for a long time, economic agents are prone to mainly invest in easy-tradable goods which are likely to offer a high return (Collier and Gunning 1994). Therefore, there is a high risk of adverse selection behaviours by private agents, which can lead to a sub-optimal amount of those investments that foster sustainable growth and a more stable environment.

Moreover, conflicts and state fragility offer remarkable possibilities for profits and rents. In this scenario, the role played in a possible relapse into conflict by incumbent or new economic agents cannot be underestimated. As a matter of fact, post-conflict economic recovery implies restructuring the basis of a competitive market as well as the re-allocation, or the repression, of misallocated resources.

Second, the issue of a productive allocation of entrepreneurial resources, which is important in any economic system, acquires a specific relevance in post-conflict dynamics.

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<sup>1</sup> Collier and Gunning (1994) identify three kind of insecurities affecting private economic agents in the aftermath of African civil wars: micro-level insecurity, (...) *because civil warfare leaves a legacy of an armed population desensitized to violence*; macro-insecurity, which is the *fear that the state will be overthrown by insurrection* (Collier, 1994), and *large fiscal shocks*.

Fragile and post-conflict countries are characterized by the necessity of structural adjustment in terms of the reallocation of resources. The shift from war to a peace economy implies scaling back military spending, which may mean the need to redirect production and, more often, acquisition from external suppliers. The so-called and often overemphasized ‘peace dividend’, a buzzword in European and US political debate during the post cold-war period, needs to be seen as being closely connected to the overall strength and capability of institutions and to be considered in a long-term perspective. The state has to face increased sources of expenditure. In comparison with non-conflict affected situations, the country has less possibility to make use of domestic debt instruments, as private agents are less prone to invest in an uncertain political environment.

Economies in transition from war to peace are characterized by the presence of individuals who have been out of economic processes as they have been exiled, displaced or engaged in military activities. Therefore, during the transition there are possible working or entrepreneurial resources – veterans, exiles – that must be productively re-allocated, or allocated, in a peace economy.

Another common aspect of post-conflict states is the different role played by women during war-time. Even though strictly connected to war context dynamics, a twofold aspect, can be evidenced which is noteworthy in our perspective. On one side, women are, and remain during conflict, definitely vulnerable economic agents (USAID 2007). On the other, war is likely to modify gender relations, affecting the male breadwinner family structure where it exists. In post-conflict dynamics women can acquire importance as economic agents, with possible strong implications for the economic structure. Nevertheless, this shift does not necessarily imply increased economic or political power and can also lead to a more uneven playing field.

The types of barriers which individuals face in fragile states are both harsher and more diversified. As far as the allocation of economic resources is concerned, a crucial aspect to be considered is the individual necessity to adapt to a changing environment, re-calibrating knowledge, personal endowments and capabilities. This is important for entrepreneurs and enterprise employees both from a personal and a social point of view.

In our perspective, there are mainly three relevant characteristics of the entrepreneur. First, the Kirznerian (1973; 1979; 1985; 1992; and 2000) alertness and arbitrage of opportunities, which encompass both Schumpeterian creators (Schumpeter 1934) and individuals *acting entrepreneurially even when they might not be seen as Schumpeterian creators* (Kirzner 2009). Second, the creation and exploitation of opportunities by investments in new knowledge (Acs et al. 2009), as endogenous growth models suggest (Romer 1990; Aghion and Howitt 1992). Third, the Schumpeterian exploitation of existing knowledge, totally or partially unused by incumbent companies, through the transmission of *knowledge spillovers* (Acs et al. 2009; Audretsch 1995).

The rationale of shaping a ‘business friendly environment’, a regulation which does not hamper entrepreneurship culture and is not burdensome to entrepreneurs, is rooted in the very essence of the entrepreneurial function. As Kirzner (2009) highlights (...) *it does seem intuitively obvious that alertness can be ‘switched off’ by the conviction that external intervention will confiscate (wholly or in part) whatever one might notice (...) public policies that to any degree deaden the excitement inspired by the prospect of pure entrepreneurial profit must surely lower the level of entrepreneurial alertness.* These kinds of policies, i.e. cutting the red tape of a burdensome regulation, granting the rule of law and reducing taxes are, according to Naudé, *a necessary, but not sufficient condition for development* (Naudé 2007; 2009). Relying more on what Shackle called *judgment of possibilities* than on *a calculation of certainties* (Shackle 1982), entrepreneurship can hardly be considered as a by-product (Schramm 2004; Wohlmuth 2004) of a precise set of reforms, especially in post-conflict countries. Important literature has recently emphasized the pivotal role played by knowledge and skills in processes of innovation, development and catching-up, highlighting how competences are becoming a *conditio sine qua non* in all economic sectors in a global competitive environment. In the Knowledge spillover theory of entrepreneurship, recently introduced by Acs and Braunerhjelm, Audretsch and Carlsson (2009), the role of entrepreneurs in the process of intra-temporal knowledge spillover is investigated. The theory gives precious insights into the microeconomic foundations of the theory of endogenous growth and highlights the



endogenous nature of opportunities, regarded by the prevailing entrepreneurship literature as exogenous.

As far as company employees are concerned, the focus on labour market flexibility can lead to underestimating the importance of other firm dynamics which are fundamental in the perspective of an entrepreneurial economy (Audretsch and Thurik 2000; 2004; Carree and Thurik 2006; see also Acs et al. 1999; Wennekers and Thurik 1999 ). The diffusion of diversified competences at different company levels is likely to be undermined by a highly uncertain and fast changing labour market.

Another aspect of particular relevance in post-conflict countries is social mobility, which is important both for conflict and economic dynamics. As Stiglitz (2006) highlights, restricted social mobility is often a cause of civil strife. From an economic point of view, it constrains resource allocation with sub-optimal social outcomes. A consequence of conflicts can be a remarkable shrinking of the social mobility of specific groups of the population. The presence of displaced communities and of ethnic or religious minorities being persecuted or segregated by social, political and economic life, can have severe economic implications which cannot be underestimated. These dynamics are also likely to modify the equilibrium of the neighbouring countries.

In summary, at least five aspects of the complex process that turns individuals into entrepreneurs have to be considered: entrepreneurial capabilities, knowledge/skills, motivation, social mobility, and, of course, economic incentives.

Third, social ties and economic networks need to be re-built or created (Stiglitz 2006; Smallbone and Welter 2001). Post-conflict countries are characterized by a fractioned environment, in which social relations and networks among economic agents, both individuals and enterprises, have been abruptly interrupted. Lower cooperation and undermined company networks represent a severe problem as far as innovative and catching-up capabilities of developing countries is concerned. The nexus between the process of catching-up, policy and institutions has been contentiously approached by literature. Recent research (Fagerberg and Godinho 2005; Fagerberg et al. 2005) stresses that local innovation systems and networks are crucial aspects, in which of importance is

the space for institutional and political support. Cooperation among society's members, as Stiglitz (2006) stresses, can be fostered by the legal system and by a system of incentive rewarding cooperation.

Therefore, in fragile and post-conflict states the need to create, re-create and strengthen economic networks is particularly high (Cusmano et al. 2008; Fagerberg and Godinho 2005; Mazzoleni and Nelson 2007; Mytelka 2004; Niosi 2008) in order to develop new and fresh economic resources and to consolidate the transition towards a peace economy. The issue is crucial for rent-based economies (Stiglitz 2006). As a matter of fact, in a rent-economy incentives to cooperate are low and economic resources are likely to be seen as a fixed amount, with agents playing a zero-sum game. Moreover, the opportunity costs of conflicts are lower than in an investment-based economy. Therefore, company networks and cooperation among enterprises, along with a competitive market structure, represent an important aspect. In summary, fragile and post-conflict state policy priorities may differ from those of non-conflict-affected countries because the necessities *per se* are different, but also because problems are atypically severe and they are atypically sensitive to specific reform processes (Collier and Hoeffler 2002). Collier and Hoeffler (2002) analyse the effectiveness of aids in post-conflict areas and *whether and how priorities for the reform of policies, governance and institutions might differ in post-conflict societies from those in other developing countries*. The study stresses how growth is more sensitive to policy in post-conflict states and how social policies should be the key priority, while sectoral and macro policies should have *broadly the same priority than in other contexts*.

As shown below, DB conceptualization seems to lack awareness of these specificities and fails in understanding some pivotal aspects of post-conflict pro-entrepreneurship policies.

### **The doing business indicators**

The DBIs are designed to measure the factors determining the levels of entrepreneurial activity in a wide range of countries (181 countries, DB09), including countries that are the arena of conflict and

many post-conflict states, and to identify institutional and political reforms which can foster entrepreneurship. The WB has taken into consideration the highly specific characteristics of post-conflict states and their *atypical need of financial resources and policy advice* (Collier and Hoeffler 2002), as well as the risks of ignoring their peculiar features. About 23 out of 181 countries taken into consideration by DB are conflict affected, while 40 out of 181 can be considered post-conflict countries. This notwithstanding, the DBI does not explicitly deal with the impact of conflict or state fragility on entrepreneurship. As far as a mere linguistic analysis is concerned, the terms ‘conflict’ and ‘post-conflict’ appear once in DB09, for the first time in all the DB report series.

International indicators of the quality of institutions are becoming quite influential for policymakers and governments, mainly when addressed to fragile countries. In particular, the DB, of which six successive editions have been released up to now (IBRD, WB 2004; 2005; 2006; 2007; 2008a; and 2008c; see also 2002), is gaining momentum in the academic debate and the political arena. The relevance of DB is twofold: both positive and normative. DB reports claim transparency in providing updated and far reaching (unbalanced) panel data on 181 countries and ranking the countries according to 10 dimensions through a *new approach to the measurement* of the ease of doing business (DB04). The principal aim of the indicators, however, is *to guide reform of the scope and efficiency of government regulation* in order to foster entrepreneurship and thus promote economic, social and human development. The first DB report explicitly stresses the normative function of the index: the purposes of DB are to encourage reforms through country benchmarking, inform the design of the reforms, enrich international initiatives on development effectiveness and inform theory (DB04).

It is worth noting that the WB has been using DB data in establishing conditions towards its debtors and that the International Development Association (IDA) has set *Business Regulatory Environment* as one of the criteria in the country policy and institutional assessment<sup>2</sup>. Moreover, the

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<sup>2</sup> See the Assessment Questionnaire of the IDA, Business Regulatory Environment criterion (p. 16; CPIA, IDA 2007) and the case of Afghan reforms on procedures to start up a business, financed by USAID (DB2007)

Millennium Challenge Corporation<sup>3</sup>(MCC) also relies on DB data to build its six governance indicators<sup>4</sup> for the eligibility of assistance programmes and for the Millennium Challenge Account selection criteria (MCC 2003; 2004; 2005; 2006; and 2007).

Therefore, even though the indexes do not directly guide the economic behaviour of small and medium enterprises, they may indirectly condition their economic decisions in two ways: by guiding the choices of policymakers and governments, by establishing a reward logic as far as international aid is concerned, and by contributing to make a country *more appealing* for international investment. Moreover, DB role is likely to be more influential in the countries affected by political, institutional, economic and social fragilities.

What are the DB Indicators that are most affected by post-conflict dynamics? How and to what extent can fragile states specificities hamper the effectiveness of the Indicators? Is DB capable of detecting the inputs of those entrepreneurial resources through which the market process can be set in motion (Kirzner 2009)?

DB measures different kinds of inputs of entrepreneurship development and ranks the countries according to 10 dimensions on the premise that an entrepreneurial private sector promotes economic growth and increases opportunities for poor people. Important literature (Audretsch and Thurik 2004; Kauffman Foundation 2007; Naudé 2007; 2009) has recently emphasized the importance of considering and supporting inputs of entrepreneurial economy, rather than only outputs (companies). This statement seems particularly relevant in post-conflict countries, where the legacies of pre-conflict and conflict dynamics may represent an obstacle to a productive allocation of economic resources.

Moreover, fragile states are likely to be short of inputs recognized as conduits of long-term entrepreneurial development. Whilst Audretsch and Thurik (2004) and Naudé (2007) stress the

<sup>3</sup> The MCC, a US government corporation established in 2004, is responsible for the stewardship of the MCA, funded by the Congress with the aim of channelling funds to developing countries.

<sup>4</sup> The *business start up* index (made up of the DB indicators *Costs to Start a business* and *Days to start a business* combined with equal weight) and the *days to register property* and *cost of registering property* indicators (two of the three indicators which make up *land rights and access* index) use as sources DB data.

fundamental role of knowledge and skills, the Kauffman Foundation (2007) indicates four policy subjects that are *of uppermost importance* to innovative entrepreneurs: ensuring a skilled workforce, reforming healthcare, promoting innovation and limiting overly burdensome regulation and liability litigation. As a matter of fact, DB relies mostly, if not only, on the latter. By analysing DB construction, the indicators adopted, data selection and policy recommendations, it is possible to discriminate between two broad categories of policies: policies aimed at establishing the rule of law – i.e. registering property, protecting investors and enforcing contracts – and policies focused on the elimination of barriers to entrepreneurship – i.e. starting a business, dealing with construction permits, employing workers, getting credit, paying taxes, trading across borders and closing a business. On the premise that *a vibrant private sector – with firms making investments, creating jobs, and improving productivity – promotes growth and expands opportunities for poor people and that in many countries (...) entrepreneurial activity remains limited, poverty high, and growth stagnant (...)* DB reports are based on the thesis that *although macro policies are unquestionably important (...) the quality of business regulation and the institutions that enforce it are a major determinant of prosperity (...)* (DB04: viii). This preliminary statement introduces two key issues on which the DB is constructed: the process through which entrepreneurship enhances social and economic development and the role played by institutions. The four following questions are therefore crucial in tracing the DB theoretical framework: what do DB mean by development, how do DB define entrepreneurship; which institutional assets and dynamics do DB consider to enhance processes of entrepreneurial promotion and, finally, which institutional assets and dynamics do DB consider favour the pivotal role of entrepreneurship in development?

DB reports omit any explicit definition and lack rigorous analytical answers to all four questions. There are two plausible reasons for this.

Firstly, DB data are meant to be transparent and, therefore, objective. As aforementioned, one of the aims of the DB is to *inform theory, producing new indicators(...)* facilitating *tests of existing theories and contribute to the empirical foundation for new theoretical work on the relation*

*between regulation and development* (DB04). Thus, one of the purposes seems to present empirical evidence on business regulation which justify an *ex post* adherence to theoretical positions.

Secondly, a number of key concepts are regarded as unquestionable and automatically interacting with each other. But concepts do matter, both when positive and normative statements are concerned. Different assumptions may lead to different conclusions, determining which aspects of a phenomenon are measured. Lack of clarity on definitions and on assumptions hinders critical analysis of the results presented and the full awareness of the objectives pursued by policy recommendations<sup>5</sup>.

This section deals with the potential relevance and shortcomings of DB to the specific circumstances represented by post-conflict countries, singling out a number of aspects which need to be taken into consideration and eliciting DB theoretical framework from indicator analysis.

The indicators which analyse policies aimed at establishing the rule of law address crucial aspects of post-conflict dynamics. Macro-insecurity is actually likely to substantially undermine reliance on public services. For example, contested property rights are a legacy of civil wars (Collier 1994). At the same time, regulations which protect investors are likely to help stabilize an uncertain environment, increasing the opportunity costs of not investing. Therefore, the development of Indicators such as Enforcing Contracts, Registering Properties, Protecting Investors, as well as Getting credit, is useful in addressing some pivotal aspects of those market-supporting institutions which need to be reconstructed and strengthened in a conflict affected environment. It is also worth noting that the two exceptions to an approach drastically against public intervention in market processes are related to two of these indicators: in the background paper of the *getting credit* indicator, the authors stress the importance of public credit registries for the development of credit market institutions in developing countries, highlighting how this can be considered as *a rare example of an apparently successful state intervention* (Djankov et al. 2006: 26). Moreover, the

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<sup>5</sup> The issue of the neutrality of the data cannot obviously be analysed in this paper, whose objective is simply to highlight the unavoidable implicit theoretical choice at the basis of any empirical research and the risks of mystifications of an excessive emphasis on de-contextualized quantitative data.

background paper on *protecting investors* indicator (Djankov et al. 2006)<sup>6</sup>, is explicitly against a *laissez-faire* approach in the stock market, and stresses the necessity of an active public sector whose pivotal role is to regulate the playing field enforcing private actors as far as both access to information (through extensive disclosure, approval by disinterested shareholders) and power to act (voting and litigation) are concerned. Fines and criminal sanction, on the other hand, seem not to benefit the stock market.

The more relevant indicators dealing with barriers to entrepreneurship will be considered, namely starting a business, paying taxes, employing workers and dealing with construction permits.

It has been already stated that DB does not address the issue of conflict-affected countries at all. Even in regional or national reports, DB does not consider any context variables. The DB approach is based upon a standard vision of the globalisation process, according to which progressive interaction and integration of economies lead to a convergence of institutional and political solutions, practices and standards. The criticism this paper makes of this approach is twofold. Firstly, the interaction between convergence, measurement and simplification in DB risks becoming a race to the bottom in a number of crucial institutional and political features; secondly, a different vision is upheld, according to which development process is traced by the interaction between forces that generate a progressive convergence, and national and local specificities. The interaction is therefore a process that changes, influenced by the interacting of local, national and global actors and forces. Thus the analysis needs to consider how local actors and forces respond and cope with institutional and political reforms and to discriminate strategies accordingly. DB upholds a strategy of development which neither contextualises information nor interprets it accordingly, disregarding the role of historical, institutional and cultural heritage, which is often only anecdotically evoked. The necessity of a full recognition of the unique characteristics of emerging economies is strongly stated in recent literature (Bruton et al. 2008), which criticises the extension of existing theory and emphasises the importance of developing new theories in order to understand entrepreneurship in

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<sup>6</sup> In which an anti-self-dealing index is calculated.

different contexts. DB identifies different solutions in relation to the stage of development of a country in just two precise cases. The good practice of private inspections in the procedure of issuing building licences (introduced in Finland in 2004) is regarded as unworkable in developing countries. The reason is that, in developing countries, courts are likely to be less efficient and the risk of revocation of professional licences is likely to be poorly effective in inducing private inspectors to act correctly. As far as closing a business is concerned, while rich countries have developed complex bankruptcy procedures, which need high institutional and administrative capabilities, developing countries should focus on less formal methods to enforce payment of the secured debt.

A *one size can fit all* (DB04) development strategy, which is made up of a number of predefined steps that foster entrepreneurship, comes from this perspective. The assumption is that improvements in a business environment occur through a precise set of *de novo* reforms. The one size fits all perspective, whose failure has been emphasized by important literature (Easterly 2001; Acs et al. 2008), becomes even more dangerous in fragile and post-conflict areas, as discussed below.

## **Critical Assessment**

### **General Assessment**

The assumptions and theoretical statements used to make businesses comparable across countries identify a specific target of DB indicators: a *vibrant private sector* (DB04) mainly made up of domestic, small and medium size enterprises regarded as a fundamental engine for growth, employment and development, i.e. entrepreneurial SMEs.

But entrepreneurial function does not acquire a distinct, specific role in DB reports: *entrepreneur*, *manager* and *owner* of an ongoing business are often regarded as synonymous. Even though they



often appear to partially overlap in practice, they are nevertheless functionally and theoretically distinct (Baumol 1968). This distinction has both analytical and political implications.

The choice by DB of measuring entrepreneurship by focusing on the number of registered enterprises<sup>7</sup> partly depends upon the availability of comparable statistical data, but the implications are nevertheless important as far as DB explanatory power is concerned, especially in post-conflict dynamics.

Data concerning business death rates, business churn, net business population growth and survival rates seem pivotal in connecting *the act of doing business* with an *entrepreneurial function* and in assessing long term sustainability and development potential of the private sector, along with its potential to influence the welfare and growth of a disrupted country<sup>8</sup>. The issue is taken into consideration by the principal indicators of entrepreneurship, such as GEM, which places particular stress on innovation, and the Kauffman Index of Entrepreneurial Activity (2008). The latter, for example, relies on the creation of new businesses as well, measuring new US business owners in their first month of significant business activity. The approach of the Kauffman Foundation aims at capturing the qualitative aspects of business activity, presenting separate estimates for gender, demographic groups, States, metropolitan statistical areas, sector of activity. The aim here is obviously not to compare the two indexes but to outline the possibilities offered by different approaches.

Thus two issues arise. The first concerns what DB indicators really measure? Entrepreneurship or business? If the index only had descriptive and analytical purposes, the focus would be on correctly presenting the data, which are undoubtedly a unique source of precious information on doing business worldwide. The second issue is based upon the normative approach of DB. On the premise that *what gets measured gets done*, to clarify what is actually measured acquires a normative value.

<sup>7</sup> See the *Starting a business* indicator methodology and the background paper on the *Paying Taxes* indicator (Djankov et al., 2007), in which entrepreneurship is measured by the *business density measure* (defined as the number of registered establishments per 100 members of the working population) and the *business registration measure* (defined as the average 2000-2004 ratio of business registrations over the number of business establishments).

<sup>8</sup> OECD *SME and Entrepreneurship Outlooks* and the General Entrepreneurship Monitor have developed an analysis framework which encompasses these kind of data, but the concrete availability of this sort of cross sectional information is quite poor at the moment (see also OECD 2001b, 2003, 2007a, 2007b, 2008).

The problem is acknowledged by the Independent Evaluation Group (IEG), a unit within the WB in charge of the assessment of IFC work towards the private sector: ‘*the DB indicators deal with the part of the regulatory regime that governs the start-up, operation, and growth of businesses (...) DB assesses the burden of regulation on firms without aiming to capture the social or economy-wide benefits that regulations yield, such as safety, environmental protection, worker protection, or transparency. DB offers a consistent yardstick for comparing countries on regulation as seen from the firm’s private point of view. But a complete appreciation of the quality of the business climate must also measure the quality of infrastructure, labour skills, competition policies, and other determinants and outcomes of investment and profitability*’ (IEG, 2008). The explicit normative function given to the DB since the very beginning seems to sharply contrast with the statement that is necessary to **keep in mind** (...) *the context and the perspective of what DB really measures* (IEG 2008)<sup>9</sup>.

The DB entrepreneur is a standard economic agent. His choices are predictable because they are guided by an individualistic view, according to which the main purposes are to maximize profit and to optimise the choice between regular or irregular economy. The DB approach seems therefore to follow the approach to entrepreneurship of neoclassical microeconomics, which is based upon short-run market equilibrium and on standard, rational maximizer agents. According to the mainstream approach, economic agents act in perfectly competitive product markets, in which technology is given and individual workers and entrepreneurs are price takers (Parker 2004).

This perspective fits particularly well the *one size can fit all strategy* and disregards a number of aspects that are pivotal in research on entrepreneurship. Research on entrepreneurship has not developed a *dominant paradigm* up to now (Grégoire et al. 2001): in its history it is possible to identify a number of *swarms*, which Landström (2004) links to different economic development stages. At the same time, different strands can be singled out in future development of entrepreneurship research (Corbetta et al. 2004). It is possible to elicit from different conceptions of

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<sup>9</sup> Author’s emphasis.

function and origin of entrepreneurship some common aspects which allow one to discriminate between neoclassical economics on one side, and entrepreneurship research in a stricter sense on the other (Baumol 1968; 1983; 1993; 2004; and 2005; Barreto 1989; Casson 1987; 2003; Kirchoff 1991; Metcalfe 2004; Parker 2004; Rosen 1997).

As a case study the DB reports use a domestically owned limited liability company, which operates in the country's most populous city and employing between 10 and 50 national employees,. The representativeness and comparability of the example chosen varies significantly both in respect to different countries and to different regions within the same country. Not only *may* this choice *not be representative of regulatory practices in other parts of the country* (DB04 2005; 2006; 2007; 2008), but it also disregards how deeply local and regional conditions influence entrepreneurship development and how policy enforcement may be better in the capital city. For example, a common feature of developing countries is high interregional inequalities in terms of income *per capita*, labour demand and development of entrepreneurship.

As far as post-conflict dynamics are concerned, five aspects need to be considered: transaction costs, environmental insecurity and uncertainty, sources and role of innovation, in particular knowledge and skills and firms networks, and social mobility.

The theme of security of property is pivotal in the DB approach, of which the Coase theorem seems to be one of the pillars. But, if the reports keep stressing the fundamental role of well defined property rights in determining efficiency, they tend to disregard the presence of transaction costs. And yet, conflict dynamics remarkably increase transaction costs, bringing about social fragmentation and jeopardizing transactions (Collier 1994). For example, the *starting a business* indicator only takes into consideration compulsory costs and not the time needed to acquire information, *the entrepreneur being aware of all entry regulations and their sequence from the beginning* (DB09). Assuming there is complete information, the risk becomes very high of unreliable results<sup>10</sup> and of a biased comparison among non-conflict and conflict affected countries,

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<sup>10</sup> Real costs and time differ from data estimated, as the case of US procedure for registering sales tax testifies see Arruñada, 2007

in which the concrete possibility of gathering information can dramatically differ. An unstable policy environment that changes often creates an uneven playing field. In such a situation those who have privileged access to information can make strategic choices, while others have to try to develop despite hostile external conditions (Smallbone and Welter 2001).

The indicator, on the one side, lacks any concern about the qualitative characteristics of entrepreneurs and businesses that are created (Smallbone and Welter 2001), and, on the other, develops an incomplete analysis of the process which leads to start-ups, focusing on a partial consideration of the economic incentives to entrepreneurship.

What prevents an individual becoming an entrepreneur in a post-conflict country can significantly differ from non-conflict affected countries. As Smallbone and Welter (2001) note for transition countries, it is likely, under an unpredictably changing environment, that the aim of individuals is to protect themselves from uncertainties. A defensive more than entrepreneurial attitude, with cash flows utilized for raising general living standards and not for developing enterprise, and the amount of long-term and irreversible private investments is likely to be sub-optimal if the state does not subsidize investment choices (Collier and Gunning 1994).

The DB approach, moreover, completely disregards the sources and the role of innovation in development processes and seems rather focused on a static and traditional manufacturing economic system. As Fagerberg and Godinho (2005) highlight, *the need to develop a system which is capable of innovating has become more difficult as the progressive technologies have become less 'congruent' with the economic conditions (particularly skill-base and R&D infrastructure) that prevail in many developing countries*. As far as catching-up processes of developing countries are concerned, links with the technology frontier and with markets and supply of needed skills are crucial aspects to consider (Fagerberg and Godinho 2005). In post-conflict countries the problem is likely to be harsher. Policies aimed at fostering personal skills and capabilities are a fundamental part of pro-entrepreneurship strategies, even though the relation between diffusion and commercial exploitation of knowledge is not straightforward, and the learning and creation of knowledge is not

measurable (Smith 2005). This is true both for education, which can be evaluated only from a long-term perspective, and for economic knowledge<sup>11</sup>. As already highlighted by Arrow (1962), knowledge strongly differs from other factors of production. Traditional indicator of innovation, i.e. R&D expenditures and data on patents, seem to miss the very essence of the issue. On the one hand, as research on innovation has shown, R&D is not the principle type of expenditure in innovation. Since the seminal work of Rosenberg (1976; 1982) and Kline and Rosenberg (1986) and constantly confirmed by research on innovation, non-R&D input of innovation (training, design, market exploration, equipment acquisition and tooling up) is to be considered central in innovation processes (Smith 2005). On the other, data on patents tends to capture invention rather than innovation. Precious insights have been given by multi-indicator approaches and by innovation surveys, both focused on technological innovation and firm level innovation activities (see OECD, 1992; 2001a; and 2002). This notwithstanding, these aspects seem unavoidable in assessing post-conflict economic recovery and entrepreneurial promotion.

It seems pivotal to monitor and assess policies aimed at creating and strengthening firms' networks and at increasing information and knowledge sharing, all elements more and more necessary to foster innovation (Mazzoleni and Nelson 2007; Mytelka 2004; Niosi 2008). Moreover, in post-conflict areas the environment is highly uncertain and rapidly changing and information is scarce and costly. These conditions make it more difficult than normal to identify reliable suppliers and customers. In the long process of post-war recovery, missing institutions are 'substituted' by long-term relations between economic actors, as McMillan and Woodruff and 1999a; 1999b; 2002) have shown in the case of transition countries: *longer and more repeated are the relationships between firms, suppliers and customers, greater are the incentives to cooperate* (Stiglitz 2006).

Social mobility acquires in a fractioned environment a particular relevance. On the one hand, addressing the economic potentialities of women is of major importance. The role of women role is

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<sup>11</sup> The distinction between economic knowledge and knowledge in a broader sense has been emphasized by Arrow (1962). As Carlsson and Fridh (2002) and Acs et. Al. (2009) remember, only 1-2% of the inventions are successfully commercialized and between 10% -20% of licences yield significant income.

remarkably disregarded by DB: despite the declared intention (DB08) of the development of an indicator measuring ‘opportunities for women’, DB09 does not address the issue at all. If included, such an indicator would substantially modify rankings (see for a proposal Hampel-Milagrosa 2008). On the other, the DB entrepreneur is assumed to be *national*, a strong assumption that acquires more relevance in post-conflict dynamics. The role of (ethnic or religious) minority and immigrant entrepreneurs (Naudé 2007) must be analyzed. The same can be said for entrepreneurs in diaspora and for return migration; recent literature (McCormick and Wahba 2001; Taylor 2006) has considered the role of the latter on the development of skilled entrepreneurship in their country of origin.

Doing Business, therefore, fails to stress the variety and the complexity of ways through which government can influence the productive allocation of entrepreneurship, failing in capturing fundamental inputs of entrepreneurial development.

### **Assessment of the starting a business indicator**

*Starting a business* ranks the countries according to four sub-indicators, the weighted average of which<sup>12</sup> forms the indicator: the number of procedures, time, cost and paid-in minimum capital necessary to start and legally run a business. Fewer procedures, and less time, cost and capital, increase the score a country acquires (Table 6.1).

The outcomes of easier and faster procedures to starting up a business are, in the DB approach, more start-ups, less informal economy, with consequently more protection of employees and higher productivity caused by increased entry pressure, which in turn leads to more competitiveness between enterprises.

In post-conflict countries start-ups play an important role for a number of reasons. Firstly, as Naudé (2007) highlights, they are likely to have fewer legacies with conflict dynamics. A major task that must be dealt with in post-conflict economic recovery is the necessity to re-allocate into peace and

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<sup>12</sup> 25% each indicator.

productive activities entrepreneurs who have been active during the conflict. The question is, on one side, to convey entrepreneurial resources, which need to adapt, to a new environment. On the other, during the first post-conflict period, societies are particularly unstable and the possibility of a relapse into conflict remains extremely high<sup>13</sup> (Azam et al. 1994; Collier 2000; 2006; Naude 2007). The role played by economic agents in this phase cannot be underestimated. A major issue that must be tackled is dealing with those entrepreneurs that have gained economic and political power because of the conflict and therefore represent a force prone to increase instability and social, political and economic fragmentation. Even though the dynamics among forces in a fragile area tend to reproduce themselves, it can be stated that, according to Mcmillan and Woodruff's (2002) analysis of the role of SMEs in transition economies, new SMEs can contribute to create a business environment more conducive to a productive allocation of entrepreneurship.

Secondly, even though the evidence of a better performance of *de novo* companies in respect to the private sector as a whole are not uncontroversial (McMillan and Woodruff 2000; 2002 for transition countries), recent literature (Audretsch and Keilbach 2003; Audretsch et al. 2002; 2006) has emphasised the positive effect of start-ups on employment and growth. As outlined above, in post-conflict countries there is a necessity to reallocate, or allocate economic agents that have been out of the economic process during the conflict.

Therefore, in this perspective, the DB focus on start-ups seems to properly address a specificity of post-conflict countries. Nevertheless, there are two aspects which need to be considered. First, the question that must be coped with in post-conflict countries is not the lack of entrepreneurial resources, but their productive allocation (Naudé 2007). This issue will be analysed in the next section. Second, procedures for starting up a business are equated to entry barriers which obstruct entrepreneurship and private investment. This statement is drawn from public choice theory on regulation and from the hypothesis that two procedures are *sufficient for business registration: notification of existence and tax and social security registration* (DB04: 17 and 21;

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<sup>13</sup> The World Bank estimates 44% possibility within 5 years.

DB05: 19)<sup>14</sup>. As noted by Arruñada (2007), *use of this simile* (i.e. procedure for starting up a business and entry barriers) *leads to omission of the fact that, by incurring certain formalisation costs today, transaction costs in the future will be reduced, whereas conventional entry barriers do not generate this kind of positive effect*<sup>15</sup>. The perspective is a company's short term private point of view, mainly considering private costs while the social and long-term private benefits of regulation are often disregarded. Regulation of entry is analysed merely from an entrepreneur's perspective, taking into account only quantity and not quality and therefore disregarding the costs borne by other agents, namely public administration and courts (to whom registration formalisation provides necessary information) and other companies (due diligence) in the case of poor quality registration services. DB firmly upholds the elimination of minimum capital requirements and reliance on private contracts between creditors and debtors, which would substitute capital rules. This position is in line with an approach that mainly relies on the market as a source of efficiency, besides highlighting an element that supports the efficiency of common law.

The basic hypothesis on which the reports are implicitly built is Baumol's thesis of the fundamental role of institutions in influencing the allocation of entrepreneurship resources. According to this thesis, what varies most among countries is not the number of entrepreneurs or *the nature of their objectives*, but the *relative pay offs society offers* (Baumol 1990) to entrepreneurial activities. It is therefore possible, and desirable, to modify the reward structure in the economic system in order to enhance a productive allocation of entrepreneurial resources. So, what is the role of regulation in a DB perspective? The background study (Djankhov et al. 2002) on which the *starting a business* indicator is methodologically and theoretically based, in accordance with De Soto's work (1986; 2000), provides evidence<sup>16</sup> that *the countries with more open access to*

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<sup>14</sup> While statistical registration, environmental permits, health benefits registering *seem to be socially desirable* and local chamber of commerce approval *can limit* competition (DB2004, p.21), any other procedure for starting up a business has *dubious purposes* and negative social outcomes (*prevent people from getting out of poverty*, DB2008).

<sup>15</sup> Arruñada (2007) comments the negative consequences as a result of reforms undertaken in El Salvador, Spain, Colombia, Afghanistan and praised by DB reports (DB2005, 2007). See also Bath, 2007; Blanchet, 2006; du Marais, 2006 and du Marais et al, 2006.

<sup>16</sup> The empirical research was conducted in 85 countries with 1999 data. The analysis takes the number of procedures, the official time and cost into consideration.



*political power, greater constraints on the executive, and greater political rights have less burdensome regulation of entry (...) than do the countries with less representative, less limited, and less free governments.* This statement is presented as an *ex-post* and evidence-based adherence to public choice theory. Entry regulation is set up in order to benefit regulators, who seek to gain rents exerting unjustified control on private entrepreneurs, according to the *toolbooth* strand of public choice theory developed by McChesney (1987), De Soto (1986; 2000), Shleifer and Vishny (1993, 1998). No efficiency or public interest reasons justify the majority of entry regulations; no empirical evidence support Pigou's public interest theory of regulation. based on eight papers on pilot research on market regulation carried out by groups of researchers headed by Simeon Djankov<sup>17</sup>.

From our perspective, two aspects are relevant here: on the one side, the role played by state in re-setting the rules of the game, in coordinating different economic actors, in facilitating economic exchanges and development, is substantially undervalued. On the other, the *manichean* view (Arruñada 2007) which supports the entire DB theoretical framework represents the influence between business environment and entrepreneurial behaviour as a uni-directional relationship between two homogeneous parties, preventing DB from investigating more complex dynamics. The relationship between *the institutions of the market place and the spectrum of entrepreneurial behaviour it engenders and supports* (Metcalf 2004) is widely recognised, both politically and academically. But, first, it is important to take into account the influence that a particular social and cultural *milieu*, in which entrepreneurship behaviour develops, may exert on political and institutional processes; and secondly, the dualistic vision, of institution and politics on one side and entrepreneurs on the other, does not take into account the spectrum of the heterogeneous forces involved. The response to the regulation of economic agents varies widely and does not often confirm the simplistic dualism regulation *versus* the free market. This holds particularly true as far as post-conflict dynamics are concerned. Moreover, the serious need for public intervention requires

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<sup>17</sup> Three studies by Djankov, Ganser, McLiesh; seven studies by Ramalho, Shleifer, four studies by Hart, La Porta, four studies by Lopez-de-Silanes, Freund, Pham, Botero (see also Djankov et al, 2002, 2003, 2006a, b, c, 2007, 2008)

an assessment of government level of corruption, effectiveness, capability to define a long-term strategy, all aspects disregarded by DB conceptualization, representing public intervention *per se* as a shortcoming in the economic system.

### **Assessment of the paying taxes indicator**

The indicator 'paying taxes' measures amount, procedural and time requirements of taxes and government mandatory contributions<sup>18</sup> a SME is required to pay in a fiscal year. The indicator is made up of three indicators: tax payments for a manufacturing company, time required to comply with three major taxes and total tax rate.

The rationale of the indicator is that corporate taxes and social and labour contributions lessen the economic incentives to engage in an entrepreneurial venture, having, consequently, negative effects on aggregate investments, FDI and entrepreneurship activities and leading to slower economic growth, more reliance on debt than on equity<sup>19</sup> and more irregular economy. In DB analysis, burdensome regulation causes economic agents to give up their economic activities regularly carried out (or even not to engage in a regular economic activity) and force them to choose the unregulated alternative, which DB reports define an *informal economy* and estimate as the percentage of activity that is unofficial or not registered (Djankov et al. 2007). The concept of informal economy in the DB reports seems to identify economic activities carried out against the rules posed by a system – i.e. irregular economy (Dallago 1990) – not activity of self consumption, criminal activity or simply unrecorded activity. Thus it is worth noting that the method of calculation chosen overlaps two conceptually and logically distinct phenomena, and that the reports do not clarify their definition of *informal economy*, a controversial concept which encompasses a number of different actors and aspects.

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<sup>18</sup> The profit or corporate income tax, social contributions and labour taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gain tax, financial transaction tax, waste collection taxes and vehicle and road taxes.

<sup>19</sup> These statements are presented as the results of the empirical research at the basis of *paying taxes* indicator (Djankov et al, 2007). The research data on 85 countries.

Several *caveats* are necessary as far as post-conflict countries are concerned.

Collier (1994) highlights the decay of *institutions and conventions of civil society* – the private sector has learned how to evade the state – and, consequently, the inadequacy of the state to effectively manage the tax-gathering system and to increase revenue without intensifying arbitrary actions. Moreover, the author states the necessity of setting low taxation on transactions in order to help the market recover. Nevertheless, returning to market implies a comprehensive effort aimed at restructuring the fundamental institutions, the formal and informal rules of the game, which can hardly be done by the interaction of private economic agents. A trade-off comes, in this perspective, between low taxes and a government budget capable of restoring and activating virtuous market mechanisms.

The DB approach conceives of underdevelopment as being the result of private underutilised social and economic potential, as a waste of opportunity due to institutional frameworks which inhibit economic agents. The roadmap to development therefore means freeing the private sector from bureaucratic and political ties which hinder growth.

Even though certainly *setting up and developing businesses results from the creativity, drive and commitment of individuals rather than as a result of government action* (Smallbone and Welter 2001), the role of public intervention in post-conflict dynamics seems pivotal for at least five reasons, which represent increased sources of public expenditure. First, there is room for substantial state intervention to help war-damaged infrastructures recover, which is necessary to foster market processes. As a matter of fact, these kinds of public interventions can have a rapid and positive influence on the index *trading across borders*, which records procedural requirements for exporting and importing goods by ocean transport. Second, the state needs to ensure security in an environment where micro-insecurity is considerably high. Post-conflict dynamics exert a remarkable influence on individuals' portfolio choices, which, as mentioned above, are more liquid than normal, and on entrepreneurs, who are likely to prefer reversible and short-term investments. Therefore, lower taxes, which decrease government budgets, are likely to produce more individual

savings rather than to foster private investments. Thus, public interventions which lessen micro-instability and ease market exchange are important. Third, the role of the state as a facilitator of knowledge creation and sharing, investments and spillovers seems pivotal. Research that sustains the effects of policy environment, specifically, corporate-income tax rates, minimum wages and bankruptcy law, on entrepreneurship across US has been presented (Garrett and Wall 2006). Nevertheless, what Schramm (2004) stresses is the necessity of taking into account the whole system that supports entrepreneurship. The author presents the US system as being characterized by a number of correlated aspects that, along with favourable business policies and regulations, encompasses both the role of universities which are strongly engaged in research and firmly linked with enterprises, and the fundamental role of the government in funding programs and research in firms and universities.

There are many conduits to entrepreneurial development which post-conflict countries are likely to be particularly short of: investments in R&D, the general level of knowledge, networks and relations among firms, high skilled employees who can detect and exploit opportunities, and social services, which can support and sustain entrepreneurial ventures by reducing individuals' exposure to social risks. At the same time, post-conflict countries can be unusually respondent, with unexploited human resources and capabilities which can be very productively harnessed. Therefore, what seems necessary for private sector development are broadly-based institutional interventions *aimed at supplying common goods such as training, technological capabilities and quality assurance (...)*. There is the *need for regulative interventions encouraging larger local and foreign enterprises to adopt more socially inclusive patterns of sourcing and subcontracting* (Schulpen and Gibbon 2001, for Sub-saharian Africa). Finally, the redistributive role of the state seems to be important in the phase of transition. Market disruption brings about a less competitive environment in which profit margins widen and there are more opportunities for rent positions; at the same time, opportunities for profits and rents, which would have been illegitimate in a non-conflict situation, arise (Collier 1994; Collier and Gunning 1994; Keen 1994). Thus, post-conflict societies are likely

to be characterized by high income inequality and weak social protection. Two consequences are relevant here: first, high income inequality increases vulnerability and internal conflicts, and makes difficult the restoration of normal conditions. Second, higher income inequality implies a market characterized by weaker demand and lower individual capability to engage in entrepreneurial ventures.

Another element which is worth noting about the *paying taxes* indicator is that social contribution and labour taxes are encompassed in order to measure all *imposed charges that affect business accounts* (DB09). The construction of the index is in line with the DB approach towards the dynamics between entrepreneurs and workers, focusing on two desired policy outcomes: increasing flexibility of labour regulation and decreasing costs. The implication of the DB perspective will be discussed in the next section.

### **Assessment of the employing workers indicator**

The indicator measures the regulation of employment, specifically how it affects the hiring and firing of workers and the rigidity of working hours (DB09), and is made up of five sub-indicators: difficulty of hiring, rigidity of hours, difficulty of firing, rigidity of employment and firing cost (Table 6.2).

In the background paper of the indicator, Botero et al. (2004) present the results of a comparative empirical study on regulation of the labour market (employment, collective relations and social security laws) in 85 countries. The paper shows how higher regulation is associated with higher levels of unemployment and a larger irregular economy, and is therefore harsher on the weaker part of the work force, i.e. women and young people, and thus causes a *de facto* weakening of the system of social protection<sup>20</sup>. The risk is to increase unemployment and to force individuals towards an irregular economy whilst trying to protect workers and regulate employment. If, in the DB

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<sup>20</sup> Moreover Bertola tests the reliability of the indicators and the empirical findings of Botero et al. (2004) and concludes that the evidence presented is *rough, far from clearcut* and supporting *simplicistic views of labour market institutions* Bertola(2005).

vision, public institutions often fail, reliance on the market leads to efficiency even in the labour market: *if business does not provide its workers with adequate conditions of employment, other companies will attract the workers* (DB04). DB therefore adopts a neoclassical approach to the labour market, in which real wages determine equilibrium, similar to what happens in any other market<sup>21</sup>. DB09 highlights how overly rigid labour regulation brings about difficulties in adjusting to demand, limits firm size and discourages both incumbent and possible entrepreneurship, increasing firm costs and decreasing economic incentives to become an entrepreneur.

From our perspective, six remarks are necessary. First, positive externalities of labour market regulation and of a well-funded social security system are disregarded: minimum wages, restriction of working hours, employment protection and restriction on the use of fixed-term contracts are considered barriers and sources of delay for business, in spite of the wide and controversial empirical and theoretical debate on these issues (see Becker 1964; Berg and Cazes 2007; Card and Krueger 1995; Eyraud and Saget 2005; Fox 2006; Lee and McCann 2007; Neri et al. 2001; Williamson 1995). The less a country regulates, the better the score the indicator assigns. Criticisms have been made that it is possible to change a DB ranking without improving business (Channel 2008). Empirical research on labour market has shown that it is possible to improve the DB ranking but making, at the same time, business and quality of life worse<sup>22</sup>. It seems relevant that DB08 highlights that *it is now possible*<sup>23</sup> *for an economy to receive the highest score on the ease of employing workers – indicating the most flexible labor regulation – and comply with all 187 ILO conventions* (IBRD and WB 2008b). For the first time DB09 recognizes the necessity of a good balance between worker protection and labour market flexibility and lists the countries that have ratified the four ILO conventions which are considered relevant for the indicator. This aspect, in any case, is not included in the assessment of the policy of a country. Consequently, not only does

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<sup>21</sup> see Lunghini, Silva and Targetti Lenti (2001) for a critical analysis to neoclassical approach in labour market.

<sup>22</sup> See the cases of Argentina and Bulgaria analysed in Berg and Cazes (2007).

<sup>23</sup> Emphasis of the author.

DB not value the compliance with ILO regulation, but also it does not establish any minimum regulation standards to meet.

Second, the index does not consider any interaction between regulation in different areas. For example, flexibility in labour market and taxes to finance passive and active labour market policies, are necessarily connected in flexicurity systems, which are *economically and socially superior to flexibility systems* (Auer 2007; Berg and Cazes 2007). Moreover, by stating that *Denmark, Hong Kong (China), New Zealand, Sweden, and the United States are among the countries with the most flexible labor regulation overall* (DB04: 83), the DB report completely decontextualises labour regulations from the overall institutional and political framework of a country, disregarding how dramatically welfare systems vary among the countries quoted.

A third remark is the narrow focus of the indicator on flexibility of the labour force. Critical for an entrepreneurial economy is the quality of the workers: the Kauffman Foundation (2007) stresses that *entrepreneurs tell us that perhaps the most significant constraint on their future growth, and on the growth of future entrepreneurs, is the difficulty finding and attracting 'talent' – highly skilled, entrepreneurial workers*. Fourth, in post-conflict dynamics, the above mentioned aspect is critically intertwined with the necessity to re-settle displaced working forces and to re-create an environment conducive to entrepreneurial development. It is worth noting that civil war creates an exodus of the most skilled human capital (Collier 1994); displaced communities need to be re-integrated and to find income-earning opportunities, while demobilized soldiers are likely to be unemployed. Notwithstanding the context specific nature of the situation, it is also plausible to hypothesize a substantial number of demobilized soldiers who are unskilled, or at least poorly-skilled outside the military sphere (Collier 1994 for the cases of Uganda and Ethiopia) and seriously needing to adapt their competences to a new environment.

Fifth, the position of working women in a post-conflict environment acquires particular aspects to consider. During conflicts, women are likely to have been wide employed in order to sustain the war-economy. It must also be considered that a substantial number of families are likely to rely on

working women in a post-conflict period. Given that an economy has to be shifted into peaceful activity, that women are typically vulnerable economic agents and that social services are likely to be weak in post-conflict countries, it is very necessary to assess the relative position of women in labour market and their possibility of being productively re-allocated.

Fifth, this remark leads us to consider the assumptions of the indicator: the worker is a full time, 42 year old, non-executive and male employee with 20 years of tenure in the same firm; he is a lawful citizen, *of the same race and religion of the majority of the country's population* and is not a member of a labour union, unless membership is mandatory (on the representativeness of this case study, see Berg and Cazes 2007). Particularly in this case, comparability and simplification risk disregarding crucial aspects in addressing and coping with social and economic development, not only, but especially, in post-conflict dynamics. DB does not deal with phenomena whose aftermaths are dramatic not only in social and legal but also economic terms. Ethnic and religious segregation, exodus, return migrations and the connected possible increase in working and entrepreneurial skills are all aspects which are not possible to disregard in tackling processes of entrepreneurial development in fragile states (Naudé 2007).

Finally, the possible trade-off between a highly flexible labour market and the development of workers skills and competencies (Antonelli 2009) is disregarded not only by the indicator here considered but also by academic literature. The relevance of this trade-off seems particularly severe in a fragmented environment in which the reconstruction of social and labour ties and the strengthening of individual skills is pivotal.

### **Assessment of the dealing with construction permits indicator**

DB policy recommendations on *dealing with construction permits* (until DB08 'dealing with licenses') focus on the simplification of procedures (i.e. give builders a step-by-step specific chart and do not mandate use of specific materials, DB06; discard obsolete licensing regulations every decade, DB07; make information easily available, introduce online licence applications and



consolidate project clearances DB06 2008), limitation of regulators' rent-seeking and corruption (i.e. reduce licensing requirements and *curb*<sup>24</sup> inspections, DB08) and on efficiency (i.e. update zoning maps periodically, DB06; adjust licenses and inspections to the size and nature of the project and involve the private sector, DB07). The greater amount of the licences issued, the cheaper and faster the procedures, and the better the score. The necessity of *cutting the red tape* of a burdensome administration represents a goal worth pursuing. But the risks of prioritizing policy reforms in accordance with this maxim are serious. From this perspective regulation of licensing, as well as labour regulation, being a barrier to business, is seen as a source of costs, delays and rigidity. The problem that DB perspective brings about is twofold: firstly, the automatic connection between less regulation of business and development is presented as evidence-based and therefore often regarded as unquestionable; secondly, DB does not establish minimum regulation standards to meet.

DB analyze procedures, time and cost of building a warehouse. The choice seems peculiar. The explicit rationale of this choice seems even more peculiar: *because warehouse do not house people, there are fewer safety concerns than with construction of offices and homes. At worst, a company's goods could be destroyed by fire, collapse or flooding. What would it take to build such a warehouse legally?*(DB06). The case study adopted leads to avoiding valuing any security, health or environmental regulation, omitting to deal with pivotal features of the phenomena analysed and compromising seriously the analysis. A common remark is that DB is likely to be beset by poor understanding, which can lead to misuse (Bakvis 2006; Channel 2008; Arnt and Oman 2006). The remark seems to miss the point, ignoring that the ranking system and the normative approach *de facto* tends to undermine the role of regulation in areas as security, health and environmental protection. The recommendation of *don't mandate use of specific materials* (DB06) in order to avoid the problem of not up-to-date buildings codes, seems here particularly relevant.

As previously mentioned, the DB theoretical premise and Baumol's theory on the supply of entrepreneurship converge regarding the crucial role played by institutions and policy in favouring

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<sup>24</sup> It is worth noting the linguistic choice: in DB 2006 the same recommendation was *introduce risk-based inspection*, a much more *neutral* expression.

entrepreneurship. They instead greatly diverge on the issue of the nature of entrepreneurship. The reports rely on the implicit hypothesis of an automatic positive relationship between what is defined as a *better business environment* and development. The question is therefore not addressed at all, taking for granted the productive function of entrepreneurship in society. On the contrary, Baumol's central message is that *the exercise of entrepreneurship can sometimes be unproductive or even destructive* (1990), and that the role of the rules of the game in the economic system is to induce a productive allocation of entrepreneurial resources. Therefore entrepreneurship can be productive, innovative, with a positive economic and social role or rent-seeking, parasitic or criminal. This statement has important policy implications: supporting existing SMEs does not necessarily imply supporting productive entrepreneurship, and adopting the point of view of the entrepreneur does not necessarily imply assuming a socially and economically sustainable perspective.

As already mentioned, this statement is pivotal in addressing post-conflict strategies aimed at fostering productive entrepreneurship. As Cooper (2006) notes, economic war systems often don't reflect a specific and alternative system of profit, being rather deeply rooted both in pre and post-conflict economic structures. The DB premise, on the contrary, leads to disregarding quality and allocation of the entrepreneurial resources, giving fuel to a *one size can fit all strategy* (DB04) based upon a quantitative approach: there is a precise set of policies which exert a positive effect on the business environment and on the society as a whole and that can easily be applied to different contexts and the response of the recipients are predictable and evidence-based. The analysis depicts a sort of trickle-down effect which leads from a more 'business friendly' environment to development. As a result, DB policy recommendations often end in a focus on short-term horizons and on the relative ease in implementing the reforms. The statement at the basis of this position is outlined in one of the background papers (Djankov et al. 2007): not only institutional, geographical and historical factors, but also policies that can be modified *without enormous difficulty* exert a deep influence in economic development. From this perspective, regulation of licences and labour, being a barrier to business, is seen as a source of costs, delays and rigidity.

The precise roadmap depicted, the short-term horizons adopted and the normative approach, all lead DB to focus on a standardisation, simplification and speed of reforms in a sort of race in which the country which reforms the most gets the higher score (sport terminology is often used in DB reports, see, for example, WB, IFC, 2008). The focus is therefore on reforms considered easy to implement in different contexts. This approach is also reflected by the methodology of the construction of the index (WB, IFC 2008c; 2009). Following the logic of *what gets measured gets done* (DB05 2007, 2008), DB emphasises the number rather than the quality of the reforms undertaken, with the risk of decontextualised policy recommendations<sup>25</sup>.

Whilst conditions of building licences should vary according to the features and historical value of the building or the town, recent important literature (Kuesel et al. 2008) has highlighted the critical role of environmental concern in social and economic development.

The perspective adopted seems unable to cope with the problems and needs of a post-conflict environment: strong commitment in reconstruction of war-damaged buildings and infrastructures; presence of an uneven playing field, having the market become less competitive during war-time (Collier 1994), and the necessity of a comprehensive effort of town and infrastructure planning.

## **Concluding remarks**

The analysis carried out in the paper identifies three pivotal aspects of entrepreneurship development which need to be considered in fragile and post-conflict states and which are disregarded by DBI.

First, the ambiguous and ubiquitous role of entrepreneurship, which is neither positive or negative in essence. Second, the complex and intertwined legacies between pre-conflict, conflict and post-conflict economic systems. Lastly, the consequently central role played by incentives in economic systems, which cannot be reduced to lessen regulation and lessen room for public intervention.

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<sup>25</sup> For example, the poor results in the case of formalization of real estate property in Peru, analyzed in Morris Guerinoni (2004). See the analysis presented in Arruñada (2007).

DB indicators represent a precious source of information, testified by the widespread diffusion of DB reports and by the influence they exert in the political arena. In an assessment of DB pros and cons it seems necessary to discriminate between the positive and normative functions of the indicators, because the problems that arise and the policy implications are different.

As far as the descriptive power of DB is concerned, two kind of problems have arisen in the paper. The first question is about what the indicators are really measuring. The DB reports, as well as the background papers on which the indicators are constructed, lack definition of the phenomena analysed. The concepts of entrepreneurship and development implicitly assumed in the reports have been analysed, highlighting to what extent the measures chosen can hinder the explanatory power of the indicators, failing in addressing the multifaceted process through which individuals become entrepreneurs, especially in post-conflict areas.

A second issue concerns the short-term, private perspective adopted by the indicators. On the one hand, the indicators seem to measure aspects of business environment often linked to a short-term view of the business activity, disregarding a more sustainable perspective. The relationships between enterprises, both inter and intrasectoral, and the characteristics of workers are not considered. This approach disregards the sources and the role of innovation, which is the essence of an entrepreneurial economy. On the other, the risks of adopting only a private perspective are serious. Private and social benefits do not always converge and a multifaceted and more comprehensive view is extremely important in public policy analysis, design and implementation.

The perspective of the entrepreneur, which is crucial in the analysis, and the role of public institution are neither mutually exclusive nor incompatible.

The main problem with the DB indicators seems to be rooted in their explicit normative power. This aspect is particularly important as far as post-conflict countries are concerned. DB indicators draw a path that is not always consistent with the purpose they declare, disregarding context-specific variables which are critical in the process of reconstruction and development.

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Verlag: Münster.

Table 6.1: The starting a business indicator

INDICATOR	BACKGROUND PAPER	SUBINDICATORS	ASSUMPTION ON THE BUSINESS
Starting a business	<p><i>The Regulation of Entry</i> Djankov, La Porta, Lopez-de-Silanes, Shleifer (2002)</p>	<p>Number of procedures (any interaction of the company founders with external parties)</p> <p>Caveat: procedures that the company undergoes to connect electricity, water, gas and waste disposal services are not included</p> <hr/> <p>Time (days)</p> <hr/> <p>Cost (% of income per capita)</p> <p>Caveat: time spent on gathering information is ignored</p> <hr/> <p>Paid-in minimum capital (% of income per capita)</p>	<ul style="list-style-type: none"> <li>▪ limited liability company (if more than one, the most popular form)</li> <li>▪ operates in the economy's largest business city;</li> <li>▪ 100% domestically owned (5 owners, none of whom is a legal entity)</li> <li>▪ start-up capital of 10 times income per capita at the end of 2007, paid in cash;</li> <li>▪ general industrial or commercial activities, not foreign trade activities and not products subject to a special tax regime. No heavily polluting production processes.</li> <li>▪ leases the commercial plant, no real estate;</li> <li>▪ no investment incentives or any special benefits;</li> <li>▪ between 10 and 50 national employees 1 month after the commencement of operations</li> <li>▪ turnover of at least 100 times income per capita;</li> <li>▪ company deed 10 pages long</li> <li>▪ the entrepreneur is aware of all entry regulations and their sequence from the beginning but has had no prior contact with any officials.</li> </ul>

Table 6.2: The employing workers indicator

INDICATOR	BACKGROUND PAPER	ASSUMPTIONS		SUBINDICATORS					
		business	worker						
<b>Employing workers</b> (until DB2006, <i>Hiring</i> )	<i>The regulation of Labour</i> Botero,	limited liability company in the country's most populous city;	42 year old, non-executive, full-time, male employee	Rigidity of employment index	Difficulty of hiring index	fixed-term contracts for permanent tasks			
						max cumulative duration of fixed-term contracts			
						ratio of minimum wage for a trainee or first employee to the average value added per worker			
					100% domestically owned operates in the manufacturing sector	has worked at the same company for 20 years	Rigidity of hours index		night work unrestricted
									weekend work unrestricted
									workweek can consist of 5.5 days
									workweek can extend to 50 hours (for seasonal increase in production, 2 months a year)
					201 employees	salary plus benefits equal to the country's average wage during the entire period of his employment	Difficulty of firing index		paid annual vacation 21 working days or fewer
									redundancy disallowed as basis for terminating workers
									notify a third party to terminate 1 redundant worker
									notify a third party to terminate a group of 25 redundant workers
									approval from a third party to terminate 1 redundant worker
subject to collective bargaining agreements in countries where such agreements cover more than half the manufacturing sector and apply even to	lawful citizen, same race and religion of the majority of the								

<i>and firing workers)</i>	Djankov, La Porta, Lopez-de Silanes, Shleifer (2004)	firms not party to them  abides by every law and regulation but does not grant workers more benefits than mandated by law, regulation or (if applicable) collective bargaining agreement	country's population  resides in the country most populous city  not a member of a labour union, unless membership is mandatory		approval from a third party to terminate a group of 25 redundant workers
					reassignment or retraining options before redundancy termination
					priority rules apply for redundancies priority rules apply for reemployment
				Non-wage labour cost	All social security payments and payroll taxes associated with hiring an employee (% of the worker's salary)
				Firing cost	Cost of advance notice requirements, severance payments and penalties due when terminating a redundant worker