

Benito Arruñada*

How *Doing Business* Jeopardizes Institutional Reform

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Abstract

Simplifying business formalization and eliminating outdated formalities is often a good way of improving the institutional environment for firms. Unfortunately, the World Bank's *Doing Business* project is harming such policies by promoting a reform agenda that gives them priority even in countries lacking functional business registers, so that the reformed registers keep producing valueless information, but faster. Its methodology also promotes biased measurements that impede proper consideration of the essential tradeoffs in the design of formalization institutions. If *Doing Business* is to stop jeopardizing its true objectives and contribute positively to scientific progress, institutional reform and economic development, then its aims, governance and methodology need to change.

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* Department of Economics and Business. Pompeu Fabra University. Trias Fargas, 25. 08005-Barcelona (Spain). E-mail: benito.arrunada@upf.edu. I thank Jesús Alfaro, Dragos Aligica, Veneta Andonova, Manuel Bagüés, Petar Balachev, Wade Channell, Victoria Elliott, Luca Enriques, Nicolás Nogueroles, Fernando de la Puente, Xosé H. Vázquez and Giorgio Zanarone, as well as workshop participants at Bologna, CUNEF, Instituto de Empresa, George Mason, Paris X and Pompeu Fabra Universities, and those taking part in meetings at the Rome Reflexive Governance group, the French *Conseil d'État*, the German Development Institute, the Millennium Challenge Corporation, the World Bank and the 14th ISNIE conference for relevant discussions on previous versions. Usual disclaimers apply. This study received financial support from the Spanish Ministry of Science and Innovation, through grant ECO2008-01116 and the European Commission through the Integrated Project CIT3-513420.

1. Introduction

Science requires measurement and the World Bank's Doing Business project (2003-2009; hereafter, DB) had the resources and held the promise for developing serious measurement, thus providing a better basis for institutional science. Xosé H. Vázquez and I saw the first DB report as a first step in the right direction, even though it contained numerous measurement errors and at best provided partial proxies of institutional characteristics (Arruñada and Vázquez, 2004). However, we already felt that its usefulness was limited because many of its initial assumptions prejudiced the results, mainly by measuring only *ex ante* and formally mandatory procedures (as explored more fully in Arruñada, 2007a). We concluded that a sustained effort was needed to improve its measurements and allow it to become a tool for policy. Things have developed very differently. DB's methods have been almost frozen but its indexes have been widely publicized by the media, heavily promoted as performance scores and often used for motivating policy and defining "best practices". Exaggerated claims have been also made about their consequences for foreign investment and economic development.

This premature success has been damaging. As DB measurements are biased, policy has often been misguided and contradictory with DB's aims. Many reforms in developing countries are accelerating formalization procedures that produce unreliable information, which is thus disregarded by judges and therefore does not reduce companies' transaction costs. Other reforms have been little more than window-dressing aimed at achieving a higher position in the rankings and attract aid funds without substantial or sustainable change. Moreover, DB's apparent success has obscured the need to improve its methodology and set more modest, feasible objectives.

The extensive evaluation of DB by the World Bank's Independent Evaluation Group (2008) was considered highly critical by the financial press.¹ The report pointed out, among other aspects, that the indicators relied on too few sources; that it was hard to estimate to

¹ *The Wall Street Journal* reported on the publication of the evaluation with the headline "World Bank Watchdog Panel Rips 'Doing Business'" (13 June 2008).

what extent the numbers were reliable; that there was no transparency about sources and changes in the data; and that country rankings merely presumed that less regulation was better, without assessing regulation quality. The IEG considered, for instance, that “a risk is created by the considerable reliance placed on the decisions of DB staff to accept, overrule, or select among informants’ replies, because this makes it difficult to verify or replicate the data” (p. 16); and that “the DB team has not indicated the reasons why information supplied by informants in prior years is subject to retroactive correction” (p. 17). However, with respect to DB’s effects on policy, its conclusions were less critical and even ambiguous. In fact, the IEG asserted that it “did not find evidence that the DB indicators have distorted policy priorities” (p. xvii); also that “there is little evidence that the DB indicators have distorted policy priorities in the countries or in the Bank Group’s programs” (p. 53). Consistent with this benevolent judgment, the 2009 issue of DB continued to act as promoter and judge of “good” policy.

This article argues that DB does distort policies in the key “Starting a Business” area. The article proceeds as follows. After summarizing the criticisms posed to DB’s methodology in Arruñada (2007a),² Section 3 evaluates DB’s responses to them, and Section 4 argues why DB’s methodology is jeopardizing DB’s own objectives in some specific policies, most of which, if a different approach were used, could be beneficial. Finally, Section 5 outlines three sets of changes that need to be introduced in DB’s aims, governance and methodology.

² Complementary criticisms are to be found in, among others, Kaufmann (2004), who shows how the difficulties involved in starting a business according to the formal constraints measured by DB have a low correlation with subjective perception of the same difficulties by entrepreneurs; Ménard and du Marais (2006), who argue that DB does not capture the real properties of legal systems and suffers ideological bias; Berg and Cazes (2007), who review the policy implications and point out problems of selection, coding, weighting and ranking in DB’s “Employing Workers” index; Davis and Kruse (2007), who argue for greater transparency and a more plural approach to the theoretical underpinnings of DB, and recommend that the indicators should not be used for either policy or benchmarking; Svejnar and Commander (2007), who find little relationship between measured institutional constraints and firm performance; Drachenfels, Altenburg and Krause (2008), who emphasize that DB does not measure the benefits of regulation; and Høyland, Moene and Willumsen (2008), who show the weak discriminating powers of DB indicators and also point it out DB’s lack of transparency. There have even been calls for closing down DB (Panagariya, 2008).

2. DB failures

The “Starting a Business” index of the *Doing Business* project incurs five sets of failures:

1. *Flawed reform priorities.* DB’s Starting a Business index considers only the costs incurred by entrepreneurs for the initial formalization of a company, disregarding all other costs, as well as the value of such formalization services. Consequently, it leads reformers to reduce the average time and cost of initial formalization when the priority in many developing countries should be to achieve *functional* business registers. Registers are functional when their information is reliable enough for judges to use it to decide in litigation. This means that contractual parties can rely on such information for contracting, thus reducing their information asymmetry and facilitating impersonal transactions, which are the hallmark of developed market economies (North and Thomas, 1973). Register information is a public good (see Hayek, 1979, p. 412) but, if left to market forces, may be underprovided in terms of both quantity and quality. Therefore, in order for a register to produce reliable information, it must be independent of the parties and free of corruption; not only the relatively mild corruption that leads to speeding up the processing of documents but the much more serious practice of faking the date of registration in incorporations and representation powers, which makes register certificates useless as proof, or introducing false information about identities and addresses, which makes firms invisible to the tax authority and potential creditors. Such practices are destructive because they make formalization services useless, forcing parties to rely on relational contracting—and, therefore, to miss out on possible trade opportunities—and forcing the tax authority to open specialized tax registers, with the duplication of costs that this involves.

2. *The DB methodology prejudices essential tradeoffs in institutional design.* This is the result of several of DB’s simplifications: (1) The exclusive focus on the ex ante cost of business formalization, which impedes considering the tradeoff between ex ante and ex post costs, including the reduction in future transaction and administrative costs. (2) The exclusive focus on mandatory procedures, which precludes the comparison of the costs of mandatory and formally voluntary procedures. (3) The exclusive focus on the private costs paid by entrepreneurs, which obscures the costs incurred by the State for providing better formalization services. (4) Disregard of “private facilitators” (intermediaries between entrepreneurs and public formalization agencies), which impedes consideration of the

relevant tradeoffs when determining the optimal degree of public and private involvement—that is, how much of the formalization process should be vertically integrated in the State. In particular, it prejudices the choice between public and private solutions, favoring instead public, vertically-integrated one-stop shops.

3. *The DB methodology precludes local adaptation.* DB’s emphasis on the average cost of a specific transaction (the incorporation of a mid-size, limited liability company) favors capital-intensive solutions apt to achieve low average costs when reaching economies of scale, and impedes adaptation of institutional design to local circumstances—for instance, to the predominance of small firms and the abundance of labor in developing economies. Similarly, it means institutional design cannot be adapted to the characteristics of the legal system (for example, the tradeoff between ex ante and ex post control of legality) and, in particular, the judiciary (that is, its capacity to control legality ex post).

4. *Mistakes in evaluation and measurement distort judgment.* DB declares as successful reforms that are in fact failures or exist only on paper. Arruñada (2007a) judges as failures the reforms in Afghanistan, Colombia, El Salvador and Spain that DB claimed to be successes. DB indexes also contain serious measurement errors. For instance, DB methodology has been mistakenly applied for measuring the Starting a Business index in the USA. If correctly applied, it would have brought the USA down in the 2007 DB ranking from positions 3-5, alongside Denmark and Iceland, to positions 57-60, alongside El Salvador, Lithuania and Sierra Leone (and later to positions 94-98 in *Doing Business 2009*).³

5. *DB’s marketing promotes misguided reforms and rent-seeking.* DB has presented its indicators as measures of performance instead of what they really are—imperfect proxies reflecting structural differences, many of which may be well-adapted to local circumstances. It has also exaggerated the merits of specific reforms as well as the false belief in cheaper formalization as a panacea for development. It has defined as “best practices” recipes that pay no attention to the costs and benefits left out of the indicators. It has used a sport-league

³ The main reason is that, according to the New York State Department of Taxation and Finance (DB takes the main city of each country as reference), you “must apply for your certificate *at least 20 days before* you begin operating your business” (2007, p. 15, emphasis added). Contrary to facts, DB reports stated that NYC entrepreneurs had to register for taxes “within 20 days before the company starts operating”. *Doing Business in 2009* made things even worse by stating that NYC entrepreneurs had to register “within 20 days of starting operations” (World Bank, 2008). *Doing Business in 2009* acknowledged that firms must register “at least 20 days prior to starting business” (World Bank, 2009). It, however, kept computing these 20+ days as one single day.

format that encourages emotional reactions and has advocated linking the allocation of aid money to the scores.⁴ All these practices mislead reform in several ways, mainly by exaggerating its simplicity and benefits, enshrining a “one size fits all” policy that disregards local circumstances, and promoting different forms of rent-seeking, from lobbying DB to modify the scores, to introducing “window- dressing” reforms aimed at improving the indicators.

3. DB’s response

DB’s initial response to these criticisms (Djankov, 2008) showed once again that its narrow focus on certain costs and on rent seeking can damage reform efforts.⁵

1. *The rent-seeking trap.* DB takes opposition to reform by established interest groups as evidence that the reforms are going in the right direction. Definitely, many current procedures—though not all of them, as the DB logic seems to suggest—mainly help private vested interests. However, such emphasis on rent seeking not only distorts reform priorities but also makes it hard to manage the rent-seeking aspect of reform.

On one hand, as made clear in Arruñada (2007a), transactions costs in general, and rent seeking in particular, are just the price we pay for having specialized institutions. Reforms should aim for efficiency, which means that not only the costs but also the value of the services being provided must be considered. And this is especially so for institutions such as business registers, whose services act as catalysts in the economy.

On the other hand, without a proper understanding of the value side of such institutions, reformers are lost when managing the rent-seeking side. First, they are simply not prepared for dealing with professional interests, which enjoy obvious information advantages. Second,

⁴ See, e.g., *Doing Business 2007*, p. 7, n. 3.

⁵ Simeon Djankov’s response was accepted and published online by the *Journal of Comparative Economics*, and made available for several months at Science Direct (doi:10.1016/j.jce.2008.01.003). Publication in the *Journal* was withdrawn at the request of Mr. Djankov after the present author’s reply had been accepted for publication and was available as an accepted manuscript at Science Direct (doi:10.1016/j.jce.2008.04.001). Most of the reply is reproduced in this paper. It is also available at <http://tinyurl.com/5sjhbd>. Interested readers may access and participate in a discussion on these matters at http://www.arrunada.org/BlogComments.aspx?Id_Thread=52.

public-interested reformers are equally unprepared for managing the rent-seeking practiced by the reform industry itself—that is, the new bureaucrats in charge of the reforms, the consultants selling goods and services, or the politicians seeking rents from international aid agencies. Both factors help to explain why many of these reforms end up in a consensus in which old rent-seekers keep most of their rents as the price for letting reformers (including the new rent-seekers) show off some apparent results, such as speedier procedures, without tackling much more fundamental deficiencies, mainly the unreliability and uselessness of business registers in developing countries.

2. *Effect on legal certainty.* Focusing reform on minimizing the costs of initial formalization and avoiding rent-seeking is therefore too narrow an approach. The value of formalization services should also be improved, and misguided reforms can damage this goal. DB is also having a negative effect in this dimension:

First, business formalization is not an end in itself. It is valuable only if business registers produce reliable information, so that judges rule on litigated cases on the basis of such information and, therefore, private parties can rely on it when writing their contracts. For example, if, because of an unreliable register, register certificates are not taken as conclusive proofs by courts, the whole formalization system is of little help in reducing transaction costs. In such a case, parties have to rely on personal interactions, which drastically limits their trade and specialization opportunities. They also have little interest in formalizing their businesses because the only consequence of formalization is a bigger tax and regulatory burden. Djankov (2008) suggests that the opinion of judges is irrelevant and they should be treated only as rent seekers. One wonders how DB-minded reformers can understand the effect that these reforms have on legality and transaction costs when the key users of the institutions being reformed—judges—are systematically left out of the analysis and evaluation.

Second, Djankov (2008) also suggests that a low rate of refusal of registration is a sign of good quality. However, if business formalization is to provide a useful service, mechanisms have to be in place to make sure that the filed documents contain the legally required information, that they are preserved and, especially, that the date of filing, which is key for the legal effects of registration, is not subject to manipulation by parties. All entrepreneurs want registers to provide reliable information that all contractual partners can trust. However, given the public-good nature of register information, individually they prefer to contribute as little as possible—in terms of resources and, most importantly, in terms of information

accuracy. Consequently, the optimal rate of registration refusal is not zero,⁶ yet DB urges reforms to aim for such a zero rate.

3. *Unfounded claims of successful reform.* DB also exerts a negative impact by repeatedly publicizing as successful reforms that are in fact failures. Arruñada (2007a) negatively assessed reforms in Afghanistan, Colombia, El Salvador and Spain that DB had previously judged as successes. Instead of revisiting these cases, Djankov (2008) offers a new success story: the 2008 reform in Bulgaria, which has also followed DB recommendations and has also been praised by *Doing Business 2009* (pp. 4 and 10-11). However, this Bulgarian reform also turns out to be flawed. The new Bulgarian business register has introduced new formalities,⁷ and has been plagued with delays and accusations of corruption (*Sofia Echo*, 2007). A month after the new register was inaugurated, in an open letter to the Minister of Justice, the Bulgarian Industrial Association (BIA), headed by the same Bojidar Danev that Djankov cites as supporting the reforms, described the situation as “complete chaos”, with the result that “businesses are being punished” (Beekman, 2008). Consideration has even been given to the possibility of closing the new registry (Koinova, 2008).

Since DB covers 181 countries (as of 2008), it is only reasonable for it to make some mistakes. But reform evaluations appear to be conforming to a pattern, erring always in the same direction. Policies all around the world are being damaged when badly designed and clumsily executed reforms are repeatedly presented as exemplary.

4. *The econometrics: evidence or mirage?* Djankov (2008) also asserts repeated DB claims that low-cost business formalization provides all sorts of macroeconomic benefits, increasing investment, entrepreneurship, employment, productivity, education and gains from trade liberalization, as well as reducing informality and corruption. This exaggerates the

⁶ For instance, the rejection rates in Canada and the UK are 3 and 8%, respectively (World Bank, 2007, p. 13).

⁷ After the reform it is still necessary for Bulgarian entrepreneurs to have the bylaws drafted by a lawyer, because the standard forms are too general to be useful; and to have some incorporation documents notarized. (Articles 13(3) and 21(4) of the Register Act state that all the documents that accompany the registration application should comply with the unmodified laws that regulate them and these require notarization). Furthermore, all existing companies have to register again within the next three years, creating legal uncertainty for the estimated 30% of companies with duplicated names; and have to present a certificate that the company applying for re-registration is an operating entity. In addition, the business register has not been entitled to ask parties to rectify minor flaws in the documents filed. So, if the business register rejects an entry, the case enters the usually slow judicial procedure, while the old system made it easier to correct such minor defects.

macroeconomic benefits of reducing the cost of initial formalization, which is just a tiny component of total entry costs. Entrepreneurs remain informal mainly because formalizing their businesses increases their tax burden without—in many developing countries—reducing their transaction costs. In addition, empirical tests using DB indexes are of little help as they have severe limitations.

More effective—not merely low-cost—business formalization should have beneficial effects by reducing transaction costs and facilitating taxation and regulation. The efficiency of these beneficial effects, however, depends on many factors, including the cost of achieving more effective formalization, the extent of the demand for the sort of impersonal trade that stands to benefit most from reducing transaction costs and, in the public area, proper use by the State of its additional taxation and regulatory powers. The evidence available, however, focuses on a few of these aspects and has weaknesses that make it hard to evaluate the policy implications.

First of all, most of this evidence uses DB data that at best measures the private cost of mandatory procedures in initial formalization, without considering other costs and benefits or the structural characteristics of formalization systems (e.g., the extent and location of control). Econometric models relying on such data strive to control for some of these other factors. This inevitably makes results inconclusive, as some other variables remain uncontrolled. This is the case, for example, of the quality and enforcement of taxation and regulation, the cost and effectiveness of other public services, including the courts, and the efficacy of civil and criminal liability in punishing wrongdoers.

It is also difficult for such models to identify causal effects and the influence of hidden variables on both formalization cost and the regression outcomes cannot be ruled out. In particular, cross-country regressions cannot control for many unobservable country characteristics that might drive the results. For instance, economies with good institutions or more developed financial markets tend to perform well in all dimensions, making it hard to estimate the impact of a particular institutional variable. In these circumstances, the significance obtained by the parameter associated with the cost of initial formalization is likely to represent something else and therefore provides no guide for policy.

Cross-industry cross-country studies, which follow Rajan and Zingales' methodology (1998), only resolve some of these problems. For instance, Klapper, Laeven and Rajan (2006) use industry-level USA data as a reference for optimal rates of industry entry, but they rely

on country incorporation data for measuring industry effects, even though much entry regulation is industry-specific. They find that, in countries where incorporating a company is more expensive, fewer companies are incorporated, especially in industries for which a high incorporation rate is observed in the USA. However, industry-specific entry constraints vary significantly across countries (e.g., Nicoletti and Scarpetta, 2003) and might be related to the general costs of business formalization and the potential of entry in each industry. Many variables, from politics to administration failure, could thus be causing both costlier formalization procedures and tougher entry constraints in all industries or high-entry ones. The evidence cannot therefore reveal whether the observed effect is due to the cost of general formalization procedures (e.g., company incorporation) or to specific industry constraints (e.g., regulations for opening retail outlets). Consequently, it cannot indicate whether reform should restructure formalization procedures or relax industry constraints.

These models also suffer from the possible presence of hidden costs and benefits, and difficulties for identifying the direction of causation. For instance, the estimated effects remain subject to caveats like “to the extent that ... other benefits—such as the provision of greater information to the authorities—can be captured even with reduced costs (for example, by automating the process)” (Klapper, Laeven and Rajan, 2006, p. 622). This ability to capture other benefits with reduced costs seems overly optimistic. Similarly, reliance on instrumental variables such as legal origins for identifying causality and correcting a possible omitted-variables bias is open to doubt, even for those who pioneered their use. According to La Porta, Lopez-de-Silanes and Shleifer, “legal origins influence many spheres of lawmaking and regulation, which makes it dangerous to use them as instruments” and “we do not recommend such [instrumental variables] specifications since legal origins influence a broad range of rules and regulations and we cannot guarantee that the relevant ones are not omitted in the first stage” (2008, pp. 291 and 293-4).

5. *How important is the cost of initial formalization?* In principle, one would expect small effects from the costs of initial formalization. However, many of the empirical studies estimate that the costs of *initial* formalization have great economic effects on macroeconomic variables, such as levels of formalization or entrepreneurship. This suggests that such costs of initial formalization are acting as a proxy for other, more fundamental variables.

To calibrate the low potential impact that initial formalization cost can exert, two common mistakes must be avoided, whereby the cost of registering a company is taken as the only factor of formality and as a main barrier to entry.

In fact, the cost of initial formalization is a minor part of the total cost of formality. Most informal firms remain informal to avoid taxes and regulation, not the initial formalization process. For a similar reason, many formal firms remain proprietorships instead of becoming corporations.⁸ Moreover, it is not only the cost of formalization but also its value that determine entrepreneurs' decisions, and both may be positively correlated. When little value is added, businesses tend to remain informal, as shown by the high proportion of companies that remain unregistered in developing countries. Furthermore, the link between initial formalization of companies and overall formality in the economy also breaks down because legalization of a firm does not preclude informality in many of its future transactions: e.g., most tax evasion in developed economies is carried out by formal firms. In addition, many informal firms are small, or comprise self-employed workers. However, the DB index measures the costs of formalizing mid-size companies, which are rarely informal. Lastly, the costs of formalizing a proprietorship or a company differ substantially because in most countries individual firms are not required to register with the commercial register and enjoy different tax treatment in terms of both rates and enforcement. Overall, the cost of registering a mid-size company can, at best, be a proxy of institutional quality, but not a main cause of key macro variables. Therefore, it is not the magic bullet for economic development that DB is selling.

Second, the cost of initial formalization is a relatively minor component of total entry costs. The use of the "entry" label for initial formalization costs, which is common in the startup literature, causes confusion. For example, the costs of business formalization or start-up play practically no role in Alesina *et al.* (2005), who "look at the effects of regulation on investment in the transport (airlines, road freight, and railways), communication (telecommunications and postal) and utilities (electricity and gas) sectors." To do so, they "measure regulation with different time-varying indicators that capture entry barriers and the extent of public ownership, among other things." These "entry barriers cover legal limitations on the number of companies in potentially competitive markets and rules on vertical integration of network industries." (p. 801). However, Djankov interprets that "Alesina et al. (2005) find that *business start-up reforms* have a significant positive impact on investment in

⁸ For example, the difference between personal and corporate taxes is statistically highly significant in determining incorporations in Klapper, Laeven and Rajan (2006), and the economic effect is likely to be several times greater than that of formalization costs.

the transport, communication, and utilities industries” (emphasis added). Lowering entry barriers should be a policy priority—focusing on trivial entry barriers is, at best, a distraction.

4. How DB methods jeopardize its goals

As mentioned in point 2 of Section 2, DB misses essential tradeoffs, mainly the one between the greater ex ante costs of more formalization and the greater ex post costs of less formalization. This omission is inconsistent with its objectives.

For example, DB reports praise Hernando de Soto and consider DB in the same spirit. However, the DB methodology implicitly precludes the type of reform inspired by de Soto, such as the reform financed by the World Bank in Peru since 1998. This reform initially eliminated notarial intervention and introduced a registration (“Torrens”) system: that is, it scrapped ex ante private control by notaries in favor of more substantive, ex ante public control of legality by the register. However, had the reform followed the DB approach, it would have favored a system of deed recording with minimum ex ante public control of filings, because in principle such a system offers lower ex ante mandatory costs. The likely consequence would have been much greater costs in terms of title searches ex ante and less secure property rights. But our aim here is not to weigh the merits of the two systems. The point is that DB precludes one of the two, and this precluded system is the one closest to DB’s declared objective of providing efficient access to legality.

This type of inconsistency between DB’s objectives and its effects on policy is observable in many other areas. With respect to Starting a Business, DB methodology influences policy in such a way that even worthwhile changes in formalization procedures often end up being counterproductive and triggering a backlash. Let us examine the seven main changes repeatedly described as defining best practice in this area by DB reports:⁹

1. *Eliminating antiquated formalities.* Almost by definition, nobody could oppose this policy. The difficulties arise when judging which formalities are really antiquated, and to what extent “antiquated” is context-dependent. For example, reliance on paper might be

⁹ See, for example, *Doing Business* 2005 and 2008 (World Bank, 2004, pp. 21-23; and 2007, pp. 12-13). They were also mentioned by Djankov (2008).

considered antiquated but online company registration makes more sense in Sweden than in countries lacking reliable telecommunications. DB often fails here because, as explained above, it in fact promotes a one-size-fits-all view that precludes adaptation to local circumstances.

For instance, duplication of data collection at the tax agency may be costly and antiquated but in many countries is a lesser evil because the business register does not provide enough control for tax purposes. DB's disregard of the benefits of *ex ante* control leads reformers to forget that, if unification of data collection is to be sustainable, they must strengthen control at the business register.

2. *Standardizing incorporation documents.* Making it possible for companies to be incorporated following standard forms is in tune with the times because there has been substantial standardization of company contracts, both by mandatory regulation and voluntary practice. However, in countries with developed corporate law, incorporation forms could be omitted altogether by allowing company founders to incorporate on the basis of the terms defined by the law. This would avoid any risks arising from poorly-drafted forms. In addition, the need to reproduce the forms in the founding documents could be eliminated, thus making collation by the register unnecessary and reducing costs. These may seem simple requirements but DB's lack of attention to quality leads to their being omitted when evaluating reforms.

For instance, DB praised the SLNE (*Sociedad Limitada Nueva Empresa*) initiative in Spain (World Bank, 2004, pp. 17-18) which failed because, among other reasons, it did not respect such requirements.

3. *Cutting the minimum capital requirement.* Updating the treatment of legal capital is a valuable change (Arruñada, in press). However, its main benefits do not come from easing barriers to *initial* formalization (a trivial formality in most countries, given that all companies need both a bank account and some capital, and minimum capital requirements are usually low,¹⁰ at least for the simplest type of company).

¹⁰ There are exceptions and they do not only affect developing countries, as those mentioned in *Doing Business 2008* (World Bank, 2007, p. 12). For example, the 25,000 Euros minimum capital requirement in Germany, which has triggered a substantial incorporation of small German limited liability companies in the UK. See Becht, Mayer and Wagner (2007).

The main benefits come instead from facilitating corporate transactions in the future, which at present are often unnecessarily complex and require plenty of lawyering and repeated registrations to conform to rules protecting the formal integrity of legal capital, even though such rules hardly provide any effective protection. However, for these substantial benefits to be achieved, it is not enough for the reform to lower the required minimum paid-in capital. Instead, the whole treatment of legal capital by the law needs to be changed, which goes beyond DB's focus on initial costs and short-term results.

4. *Moving registration out of the courts.* Reducing the involvement of courts in running registers or checking the legality of transactions is often necessary to improve register service because many courts lack the required specialization and registers tend to be relegated in courts' priorities. Furthermore, putting some distance between courts and registers allows courts to be more independent when ruling cases about disputed registration decisions and contested appointments to the position of registrar. However, courts often provide an essential ingredient for effective formalization—*independence from parties and governments*—which alternative solutions often find harder to achieve. There is, therefore, a tradeoff here which must be managed. It is in the management of this tradeoff that DB's methodology and, in particular, its disregard for any attribute of value, may have a negative effect, whatever the alternative solution chosen. In some cases, even the very nature of the reform is changed—from simply moving control away from the courts to reducing the degree of control—without proper consideration of the consequences.

Three basic solutions are available: First, when registers are moved to a public agency, both service and independence hinge on the incentives of the agency and the qualification of registrars. For example, in the case of the recent move of registration from the courts to the new business register in Bulgaria, although it is obviously too soon to judge its effects, one consequence is that decisions are now being made there by badly-paid and poorly-qualified lawyers. This will likely reduce the effectiveness of *ex ante* control, a consequence that—whatever its merits—was not intended by Bulgarian reformers, and will likely increase the demand on courts for *ex post* litigation.

Second, when registers are moved to a private agency, such as a Chamber of Commerce, better service can be expected because such institutions are closer to entrepreneurs' interests. However, some worsening of control is likely to arise, especially in public dimensions that fall outside the interest of the firms represented by the Chamber. In practice, this solution is therefore more viable for registers providing only formalization services aiming at reducing

private transaction costs, as was the case of the historical merchant and company registers founded and run by trade guilds under the old Law Merchant. This solution comes up against difficulties, however, when controlling more public aspects, such as registering for taxes. This may endanger initiatives aiming to expand the register into a one-stop shop for all formalization services, as happened in the Colombian reform discussed in Arruñada (2007a).

Finally, whether the register is run by a public or private agency, some decisions can be passed on not only to the registrar but also to either the lawyers intervening in the transaction or to the parties. In both cases, visible aspects of the service, such as speed, will probably be maximized but others, mainly the control of effects on third parties, will suffer. Some counter-balancing forces are therefore needed. Italy illustrates how professional monopoly can be used for this purpose. The Italian reform of 2000 took control of compliance with legality (*omologazione*) away from the courts, maintaining control by notaries.¹¹ This change might have speeded up registration, because notaries are chosen and paid by parties, but at the price of further entrenching notaries (by, for example, making it harder to liberalize their trade) and allegedly resulting in more lenient control of compliance (Pavone, 2001, p. 183). The statutory “declaration of compliance”, usually signed in the UK by solicitors responsible for company incorporation (or by founders), can be considered a similar solution, except that the counterbalance comes from having the register run by an independent body and providing for more effective liability.

As all these cases illustrate, the tradeoff is therefore more complex than DB assumes. More to the point: DB’s focus on ex ante costs means that this complexity is disregarded. Instead, it sometimes promotes naïve policies.

5. *Making the use of notaries optional.* Leaving parties to choose whether to rely on notaries, lawyers or other firms and professionals for writing and mediating in conveyance and corporation contracts, or even to do these tasks by themselves is now probably the best policy in most countries. The reason lies in both the development of public titling institutions and in market changes, such as the emergence of large firms and the prevalence of standard

¹¹ Contrary to *Doing Business 2005*’s (World Bank, 2004, p. 22) and Djankov (2008)’s descriptions, the register was not moved but continued to be run by Chambers of Commerce. Similarly, the company register has not been moved from the courts in Chile and Nicaragua. In Chile, it has always been run by a body of civil servants who are still (2008) appointed by the Supreme Court. In Nicaragua, it is run directly by the Supreme Court.

contracts (Arruñada, 2007b). However, liberalization should also affect the provision of formally voluntary legal services, at least in two directions.

First, in many countries, retaining a lawyer is not mandatory but lawyers are the only professionals that can provide legal assistance and, where there is restrictive self-regulation of the bar, in practice this self-regulation has similar effects to mandatory notarial intervention. This is so, for instance, in the 16 US states in which lawyers are the only professionals authorized to provide legal assistance in, for example, conveyance.

Second, in many countries, impartial lawyering (the key to the function of civil law notaries) is mostly precluded by a collusive agreement of the bar that prohibits lawyers from acting impartially for the several parties to a transaction. Both restrictions are as damaging and outdated as mandatory notarial intervention, as shown by the USA controversy on “non-authorized practice of law”. The exclusive focus by DB on formally mandatory procedures means that the costs imposed by these procedures which, despite being legally voluntary, are mandatory *de facto* are not measured. This leads DB to define its policy recommendations too narrowly.

6. *Introducing a one-stop shop for business start-up.* DB’s methodology harms policy in this area in several ways. Firstly, by considering only the private costs paid directly by entrepreneurs, DB tends to disregard the cost of implementing the new systems, which is often paid for out of the State budget without any attempt at recovering it via higher prices. Secondly, by assuming that entrepreneurs perform all procedures by themselves, DB measurements disregard the private agents that mediate between entrepreneurs and the formalization bureaucracies—which DB calls “facilitators”. DB’s methodology therefore ignores how the market helps solve the formalization problem and just replaces it, adding yet more bureaucracy in the form of the one-stop shop.

This disregard of facilitators precludes the alternative, more adaptable and often more reasonable solution of private one-stop shops. The facilitating industry, composed not only of lawyers but also accountants, tax agents and administrative specialists, is organized with a mixture of franchising, subcontracting and referral structures. This suggests that decentralized service providers should be given powerful incentives of the sort that public bureaucracies are seldom able to accommodate. It also suggests that the optimum structure for mediating between firms and public bureaucracies is probably a variety of more or less specialized

intermediaries with different degrees of vertical and horizontal integration, rather than a fully integrated formula.

A sensible policy would therefore be to focus reform on developing open interfaces with the bureaucracies in charge of the public core of formalization services while allowing the free market to organize a multifaceted intermediate sector, comprising all sorts of intermediaries offering entrepreneurs a variety of more or less integrated services. Unfortunately, such a solution is hard to imagine when, as in DB, the emphasis lies on public one-stop shops, and facilitators are seen only as rent seekers instead of as service providers.

7. *“Allowing” online registration.* This is often a worthy reform, but not always. It is not merely a matter of *allowing* online registration. Substantial investment is required that is only recoverable with a large number of incorporations.¹² Other requisites include reliable telecommunications, standardized forms, and, above all, the ability to make the system work, none of which are as simple as they may seem. Moreover, DB’s focus on building computerized formalization systems disregards costs, as with one-stop shops, but also distorts reform priorities: instead of restructuring formalization services, eliminating unnecessary formalities and introducing sounder incentives to ensure a functional register, all efforts focus on computerization. This is often carried out without any restructuring (as, for example, in the SLNE initiative, once praised by DB). In such cases, the inefficiencies of the traditional system tend to be repeated in the new system, a common outcome in developed countries. Worse still, if the old system was not functional and produced unreliable information that neither judges (nor, as a result, future contractual parties) nor public agencies trusted, the new system is likely to produce equally unreliable information, following the GIGO dictum of computer programmers, of “garbage in, garbage out”. In other cases, ex post control is eliminated with computerization, as in Bulgaria where, to the delight of fraudsters, the new technology has been affording unconstrained access to company founders’ personal data, including IDs and signatures.

Furthermore, overemphasis on computerization is compounded by the private interests of many participants. Donors prefer tangible expenses and, like politicians, tend to favor grand, modern technologies. Even established rent-seekers love computers once they realize that

¹² For example, the cost of the central processing unit for the SLNE initiative was 11.1 million Euros for the period 2003-2006, during which it processed information for 2,001 companies, at an average cost of 5,560 Euros per company (Arruñada, in press, section 8.6).

their privileges will be maintained by the reformers if they accept them. This entrenching of old monopolies in the Internet era can be seen, for example, in the privileged use by conveyancers of digital signatures, even though such technology could substitute their activities. Some of the newly-introduced systems are in fact little more than a modern form of window-dressing, helped by DB's tendency to consider reforms as complete while they are still in their infancy. The recent Bulgarian reform also exemplifies this point.

In summary, most of these reforms are sensible, but their intrinsic potential merit is not the issue under discussion here. Nor am I questioning the design and implementation failures often plaguing them. The real issue is that DB has been a contributing factor in such failures.

5. What the World Bank could do

Let me close this article with an optimistic coda. The World Bank has been successful in putting the reform of the business environment on the policy agenda. There is still time to redirect this success in a productive manner. This, however, requires substantial restructuring of DB's aims, governance and methodology.¹³

1. *Aims.* Measuring institutions is a nascent adventure. Goals should therefore be modest. Not only should DB forget about achieving short-term effects on policy—it should strive to avoid them until a truer picture of the institutions can be drawn. For this purpose, DB should stop marketing its indexes as performance indicators and offer them merely as preliminary and partial snapshots of institutional structures. The use of its indexes for allocating aid money should also be discouraged. Lastly, considering that institutional change is only observable in the long run, it would make sense to produce the indicators less frequently.

2. *Governance.* Measuring institutions in countries with different legal traditions requires appreciating that different legal structures suit different contexts. This would lead to

¹³ The Bank has started to be more flexible with respect to DB. In April 2009 it decided to drop DB's "Employing Workers Indicator" and develop a new "Worker Protection Indicator" after concluding that the first indicator "does not represent World Bank policy and should not be used as a basis for policy advice or in any country programme documents that outline or evaluate the development strategy or assistance programme for a recipient country" (Aslam, 2009). In line with the argument in this article, a meaningful indicator of the quality of employment regulation should consider not only workers' protection but other aspects, such as, most prominently, unemployment rates.

indicators that compare alternative institutional arrangements more fully, intendedly considering all their costs and benefits. Questions in institutional reform are mainly empirical, not theoretical, but to enlighten such empirical questions without prejudicing the answer, the theory of the institution needs to take all the possible solutions into account. DB's narrow emphasis on measuring ex ante private costs is the clearest example of the opposite. Broader, multi-disciplinary institutional knowledge is necessary.

3. *Methodology*. The changes should affect both what is to be measured and how to measure it. Firstly, on what to measure, proxies on the value of formalization must be considered as well as proxies on the basic tradeoffs in institutional design—at least, those between initial investment and variable costs, between public and private costs, between mandatory and voluntary procedures, and between ex ante and ex post costs and benefits. Information on these tradeoffs could be compiled either for the components of the tradeoff or at least for key variables influencing them, such as the scale of operations.

Secondly, on how to measure, the *user* concept should be expanded. Formalization institutions are functional and reduce transaction costs only if judges value their outputs. DB's current reliance on business lawyers for most of its information may be expedient and suitable for estimating private direct costs, but not for other costs or benefits. De Soto famously claims that even dogs know property boundaries (2000, p. 162). They know nothing about property rights, however. With due respect, lawyers often have a similarly limited view of the contractual and legal process. In this field, they may know the costs of local registration but little about the benefits of a functional register. And it is functionality that should guide our efforts.

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