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Business regulations and economic growth: What can be explained?

***Boudhiaf Messaoud*[a], *Zribi El Ghak Teheni*[b,*]**

[a]*LIEI, Faculty of Economic Sciences and Management of Tunis, University of Tunis El Manar, Post box 248 - 2092 Tunis El Manar II, Tunisia*
[b]*Faculté des sciences économiques et de gestion de Tunis, Laboratoire d'intégration économique internationale, Université Tunis El Manar, Boite postale 248, Tunis 2092, Tunisie*

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ABSTRACT

This paper investigates business regulations-economic growth nexus in 162 countries over the period 2007-2011. It uses ten indicators of Doing Business and a set of control variables. The results provide a robust link between regulation indices and economic growth except Trading Across Borders and Dealing with Construction Permits indices. Regulation indices and control variables don't matter in term of growth induction in Africa. This finding suggests some policy conclusions that can help poor nations to grow faster.

* *Corresponding author.* Tel.: +216-23-729-094; fax: +216-71-870-277.
E-mail address: elghateheni@yahoo.fr

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1. Introduction

In the current economic climate, growth remains a key government priority. The literature on economic growth has turned to the effects of country's political, legal, economic and social institutions on wealth and long-term growth (Acemoglu et al. [1, 2], Dollar and Kraay[13], Easterly and Levine [15], Hall and Jones [17], Knack and Keefer [21], Mauro [26], Rodrik et al. [27], and many others).It is obvious that countries with better institutions grow faster. However, as noted by Rodrik et al. [20], it is difficult to identify which institutions matter and how does one acquire them. This is a question of some practical importance. In recent years, the proliferation of datasets aiming to measure a wide gamut of institutional reforms allowed economists to make progress in this area. In this context, the World Bank has been publishing a series of annual Doing Business reports since 2004investigating regulationsthat enhance business activity and thosethat constrain it. As a result, articles focusing on the effect of business regulations on economic growth appeared(Djankov et al. [12], Haider[19], Hanusch[20] and Loayza et al. [24-25]).

The objective of this paper is to contribute to the existing literature.In line with earlier studies, our paper takes a close look at how robust is the relationship between business regulations and economic growth, but with some differences. First, the data are drawn for a more recent time period.Second, Haider[19] and Hanusch[20] included a set of regional dummy variables, whereas this paper includes only the African dummy because the results from the empirical growth literature systematically show Africa with the largest unexplained growth underperformance. Therefore, it is interesting to focus on this region.Second, the choice of control variables is generally based on Djankov et al. [12], Hanusch[20] and Loayza et al. [24-25], but with view. Whileauthorsfocused on governanceamong the determining factor of growth, especially Loayza et al. [24-25], this paper differs in concentrating on financial development rather than wider governance issues, which enrich the analysis. Djankov et al. [12] and Hanusch[20] used an instrumental variable approach and OLS regressions to test the robustness of their results. The results generally uphold. However, from an econometric point of view, the OLS estimator is biased and inconsistent due to endogeneity of business regulations indicators, so we only use two-stage least regressions.Hanusch[20] explored his result by dividing the sample in two groups: poor countries and rich countries. Unfortunately, in our context, this will lead to a steep decline in the number of observations.

The rest of the paper is organized as follows. Section II reviewsliterature. Section III describes the dataset and the empirical strategy. Section IV assesses the effect of business regulations on economic growth. Section V concludes the paper and draws implications for sustainable economic policies.

2. Literature review

Numerous potential growth determinants have been identified over the years.Over the last decade, a body of literature has exploredthe relationship between business regulations and economic performance.

A number of studies does not deal with the effect of business regulation on economic growth directly but instead focuses on the effect of business regulation on one of the growth drivers (labourproductivity, investment, innovation, total factor productivity). Busse and Groizard[6]for example use a standard cross-country growth regression with regulation interacted with FDI inflows and other control variables. Regulation is measured by five components of the World Bank Doing Business Indicators. They find that FDI does not stimulate growth in economies with excessive business and labour regulations.

In a sample of more than 26,000 manufacturing establishments across 71 countries (both OECD and developing), Dutz et al. [14] find that the aggregate Doing Business indicator,as well as its sub-indexes, are positivelycorrelated with product and process innovationfor young firms in non-OECDcountries. These findingsstress the importance of businessenvironment in stimulating incentivesfor competition and innovation.

Using a panel of micro-data on firms from the European Union between 2002 and 2008, Dall'Olioet al.[8] investigate whether structural or firm-specific characteristicscontributed more to labor productivity growth. Resultsshow that improvements in the Doing Business indicators are positively correlated with increased labor productivity in manufacturingand services in EU-15 and EU-12countries, though the magnitude of thisassociation is larger in EU-12 countries.

Other studiessupplymore insight on direct links between business regulation and growth.Djankov et al. [12] for example investigate the impact of business regulations on growth in 135 countries during 1993-2002. They find that business regulations index and growth are consistently and positively correlated. Countries with less burdensome business regulations grow faster. The authors examine the magnitude by including dummies for each quartile of the business regulation index in the OLS regressions. The result shows that improving from the worst (first) to the best (fourth) quartile of business regulations implies a 2.3 percentage point increase in average annual growth. The main result remains robust after the inclusion of commonly used measures of institutional quality from International Country Risk Guide and Transparency International.

Also, Hanusch[20] discuss the potential role of the Doing Business indicators in the reform process.The choice of control variables is generally based on Djankov et al. [12], yet the data are drawn for a more recent time period, from 2003 to 2009, and a number of additional variables are used. Author reports results for five-year and 10-year average growth respectively. Data availability restricts the sample size to 175 countries. The evidence shows that focusing on indicators relating to credit and the enforcement of contracts is the most important. Indicators related to cost have the largest potential for fostering growth. Unlike Djankov et al. [12], the analysis isalso made for poor countries and rich countries separately (the sample was divided on median log GDP per capita). The doing business indicator coefficient is significant for only the developing country sample, both for 5-year and 10-year growth. The effect remains when removing the regional dummies.

In the same order of ideas, Loayza et al. [24]focus on two key measures of macroeconomic performance, namely the growth and volatility of real GDP. The sample covers 76 countries. The authorsinteract the regulation index with a governance proxy. In general, regulation tends to reduce growth. In most instances, better institutions help mitigate, and even eliminate, the adverse impact of regulation on macroeconomic performance.