



Cross-country and within-country differences in the business climate[☆]

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ABSTRACT

In this note we document how constraints in the business environment, as perceived by individual firms, differ both across countries and within each country, across firms. This finding is of key importance given recent theoretical models that suggest idiosyncratic distortions can have large aggregate effects. Not only do such distortions affect the behaviour of incumbent firms, but they also impinge on the selection of firms that enter the market or leave it. Empirical research should attempt to link idiosyncratic components of the business climate to firm selection and to distortions in the allocation of factors inputs across firms and, through these channels, to aggregate economic performance.

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A growing body of empirical research has been relating cross-country differences in key economic outcomes such as productivity or output per capita to differences in policies and institutions that shape the business environment. This research has been supported by the compilation of indicators measuring policy and institutional settings for a large number of countries. The analysis generally points to considerable cross-country variation in many different aspects of the business climate, such as the degree of financial development, regulations affecting the hiring and firing of workers, the costs of starting a new business, the cost associated with contract enforcement and the efficacy of bankruptcy procedures.

As an example, [Table 1](#) reports a sample of policy indicators for a range of developed and emerging economies. The reported cross-country differences in the indicators cannot be simply explained by differences in the overall degree of economic development. Indeed, while the degree of financial development tends to be higher in the

industrialized countries in our sample compared with the transition economies of Central and Eastern Europe and the Latin American countries, the other reported indicators vary more within the sub-sample of industrialized countries than by degree of economic development.

Much of the recent empirical literature attempts to identify the impact of the political and institutional environment on economic performance across countries using a difference-in-difference approach. The approach relies on the assumption that policy and institutions may have differential effects on different types of businesses, within a country, depending on some salient characteristics. For example, the pioneering work of [Rajan and Zingales \(1998\)](#) exploits within-country variation across industries to show that industries that depend more on external financing tend to have better growth performance in more financially developed countries. There are numerous other studies that use the difference-in-difference approach to assess the role of different policy and institutions on firm or industry outcomes. [Aghion et al. \(2007\)](#) found that financial development promotes not only the entry of small firms but also the post-entry expansion of the successful new businesses. [Klapper et al. \(2006\)](#) focus on micro data for a sample of European countries and show that financial development has a positive effect on gross firm entry in sectors that are more dependent on external financing while entry regulations tend to hamper entry of new firms. [Micco and Pages \(2006\)](#) and [Haltiwanger et al. \(2008\)](#) find evidence that

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Table 1
Business sector regulatory indicators.

Country	Financial development ^a	Rigidity of employment ^b	Starting a business (days)	Enforcing a contract (years)	Closing a business (years)
Denmark	0,73	17	5	0,5	3,0
Finland	1,04	48	14	0,6	0,9
France	1,22	56	8	0,9	1,9
Germany	1,29	44	24	1,1	1,2
Italy	0,7	54	13	3,3	1,2
Netherlands	2,36	42	10	1,1	1,7
Portugal	0,83	51	8	1,4	2,0
UK	2,26	14	18	0,6	1,0
USA	1,8	0	5	0,8	1,5
Argentina	0,4	41	32	1,4	2,8
Chile	1,27	24	27	1,3	5,6
Colombia	0,37	27	44	3,7	3,0
Estonia	0,56	58	35	0,8	3,0
Hungary	0,46	34	38	0,9	2,0
Indonesia		44	97	1,6	5,5
Korea, Republic of	1,86	34	22	0,6	1,5
Latvia		59	16	0,7	3,0
Mexico	0,51	38	27	1,1	1,8
Romania	0,1	51	11	0,9	4,6
Slovenia	0,34	57	60	3,7	2,0
Taiwan (China)		56	48	1,4	0,8
Average	1,01	40	27	1,36	2,38
Standard deviation	0,68	16	22	0,97	1,40

Sources: World Bank, Doing Business Indicators, 2007.

^a The synthetic indicator of financial development is the simple average of two sub-indicators: i) the ratio of domestic credit to the private sector to GDP (from the IMF International Financial Statistics); and ii) the ratio of stock market capitalization to GDP (from Standard and Poor's and World Bank's World Development Indicators). See Beck et al. (2000).

^b The average of three indicators: difficulty of hiring a new worker (Difficulty of Hiring Index), restrictions on expanding or contracting the number of working hours (Rigidity of Hours Index), difficulty and expense of dismissing a redundant worker (Difficulty of Firing).

stringent labour regulations, by raising labour adjustment costs, discourage labor reallocation and the entry of firms especially in sectors characterized by relatively high job turnover.

This basic idea that differences in the business climate across countries may have different effects on different types of industries has natural appeal. However, we think this approach likely captures only part of the story of the impact of business climate across businesses within the same country. Recent theoretical models as well as empirical evidence suggest that, within countries and industries, there is an idiosyncratic component to the business climate. That is, it is not simply that the same policy has differential effects on different types of industries, but individual firms within industries face differing obstacles to their operation. The theoretical work of Banerjee and Duflo (2005), Restuccia and Rogerson (2008), Hsieh and Klenow (2009) and Bartelsman et al. (2009) emphasizes that idiosyncratic distortions to the business climate can have large aggregate effects.

The basic argument is straightforward but has important implications for empirical work, if not for the design of (optimal) policy. Consider an economy where potential entrants differ in some important dimensions that impact profitability and productivity according to a draw from a known distribution, say $G(A)$. Suppose also that firms face differing policy-induced distortions, drawn from a distribution that may or may not co-vary with A ; say $T(A)$. Once the draws are revealed – say, after paying an entry fee – firms decide whether or not to produce and conditional on producing, how much to produce. The set of firms that produce, $M(A,T)$, is comprised of firms that actually are observable in the data and therefore are the only ones available to assess the effects of policy on firm outcomes. Thus, idiosyncratic policy impacts aggregate outcomes through two effects. First, it may alter the composition of the industry by selecting operating firms $M(A,T)$ from the ex-ante distribution $G(A)$. Among the firms that do produce, the idiosyncratic

distortions further may further affect the efficiency of business activity and outcomes, $X(A,T|M(A,T))$.

In benchmark models of economies with heterogeneous firms, businesses that are productive will survive and grow while businesses that are less productive will contract and exit. However, if profitability depends not so much on market fundamentals like productivity and product demand, but also on whether or not the business faces idiosyncratic obstacles or advantages in conducting its activity, then the efficient allocation of resources can be distorted. It is these issues that are explored in the recent literature on distortions and allocative efficiency. In considering the impact of such distortions it is important to emphasize that the adverse consequences may be both on the mix and the scale of firms that produce. For example, Bartelsman et al. (2009) emphasize the resource costs of excess churning of entering and exiting firms due to distortions while Bartelsman et al. (2010) show how exit costs may select against entry of firms into high-risk innovative industries.

This selectivity is an important issue in estimation of the effects of policy on economic outcomes and makes it difficult to identify such effects with firm-level data from a single country. Using cross-country data on idiosyncratic distortions and assumptions on functional forms gives some hope of retrieving G from M , and allowing a full evaluation of the effects of policy. For policy makers, the endogeneity of the 'base' needs to be taken into account along side the partial effects of policy on the behaviour of current incumbents.

Is there evidence that there is an idiosyncratic component to the distortions that businesses face? Collecting comparable data to address this question should be a high priority for empirical research. However, recent surveys provide useful insights into this issue.¹ Using data from the Investment Climate Assessment Surveys of the World Bank (World Bank, 2004), Fig. 1 shows the differential impact of different institutional and policy factors on the operation and growth prospects of firms of different size within countries.² In particular, the figure reports the percentage point difference in the perceived constraint of a particular aspect of the business environment for medium-size (20–100 employees) and large firms (more than 100 employees) relative to micro firms (fewer than 20 employees).³

The estimates are obtained from firm-level probit regressions that, beyond size, also control for age, ownership, industry, country, export orientation as well as whether the firms has recently adopted a new technology or upgraded its production process. The constructed binary dependent variables (one for each aspect of the business environment) equals 1 if a firm perceives that aspect of the business environment to be a major or very severe constraint on its operation and potential growth, and 0 otherwise. A probit model is used to estimate the relationship between these dependent variables and a set of explanatory variables.

Fig. 1 reports the average constraint by size class for two regions (Europe and Central Asia, ECA; and Latin America and the Caribbean, LAC).⁴ There are a number of interesting facts emerging from the figure. In particular, there are considerable differences in the way

¹ A recent paper by Pages et al. (2007) provides a detailed analysis of how firms with different characteristics are affected by different business environment constraints.

² The effects of policy and institutions also vary significantly across firms of different ages or sectoral affiliation.

³ The different perception of firms about the constraints to their operation and growth prospect may arise from the fact that, *de jure*, certain regulations only apply (or apply differently) to firms above a certain size. For example, regulations affecting the hiring and firing of workers are most stringent for firms above a certain threshold in a number of countries (see e.g. Venn, 2009). Alternatively the policy-induced constraints may vary across firms because of their *de facto* varying degree of enforcement as a result of favoritism or arbitrary and capricious behaviour associated with problems of graft, corruption and rent seeking by the public administration or other entities.

⁴ The ECA sample includes the following countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Germany, Greece, Hungary, Ireland, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Macedonia FYR, Moldova, Poland, Portugal, Romania, Russian Federation, Serbia and Montenegro, Slovak Republic, Slovenia, Spain, Tajikistan, Turkey, Ukraine, Uzbekistan. The LAC sample includes the following countries: Bolivia, Brazil, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Nicaragua and Peru.

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