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## Culture and the regulation of entry

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## ABSTRACT

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Does culture affect the manner in which a society regulates the entry of new firms? Our results suggest it does. We find more individualistic countries regulate entry more lightly. We investigate *how* culture matters presenting evidence of significant interactions between individualism and formal legal and political institutions. Individualism has a greater impact on entry regulation in societies with democratic political institutions or a common law tradition. This outcome is consistent with the idea that culture influences social preference for regulation, and political and legal institutions determine the degree to which those preferences are expressed as policy outcomes. *Journal of Comparative Economics* 000 (2016) 1–29. Department of Economics, Union College, 807 Union Street, Schenectady NY, 12308, USA; Department Finance and Economics, Box 9580, 312F McCool Hall, Mississippi State University, Mississippi State, MS, 39762, USA.

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## 1. Introduction

The regulation of entry by new firms varies tremendously across countries. For example, it takes half a day to start a business in New Zealand compared with 208 days in Suriname. Nineteen countries pay less than 1 percent of income per capita to register a business while eighteen countries impose fees that amount to over 100 percent ([World Bank Doing Business, 2013](#)). Furthermore, differences in the regulation of entry have important social consequences. In a recent review, [Djankov \(2009\)](#) finds 201 academic articles on the subject concluding that ‘easier regulation of start-ups increases entrepreneurship, raises productivity, and cuts corruption’ (p. 190).<sup>1</sup> For example, [Estrin and Prevezer \(2010\)](#) find that regulation of business in Brazil, Russia, India and China strictly favors existing firms and severely limits new business start-ups, contributing to a growing informal economy. [Klapper et al. \(2006\)](#) show that the number of entry procedures is negatively correlated with new firm development. [Djankov et al. \(2006\)](#) find that entry regulation is negatively associated with growth rates across countries.

Less work has been done on the determinants of entry regulation; however, the dominant approach gives formal institutions a central role. [Djankov et al. \(2002\)](#) show that countries with limited and representative government regulate

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<sup>1</sup> See [Clarke and Xu \(2004\)](#), [Crafts \(2006\)](#), [Aidis et al. \(2008\)](#), [Aidis and Adachi \(2007\)](#), [Bhaumik et al. \(2007\)](#), [Ciccone and Papaioannou \(2007\)](#), [Campos and Iooty \(2007\)](#), [Tian \(2007\)](#), [Campos and Estrin \(2008\)](#), [Barseghyan \(2008\)](#), [Fisman and Sarria-Allende \(2010\)](#), [Kaplan et al. \(2011\)](#), [Dreher and Gassebner \(2013\)](#).

entry less intensively. Thus, the pattern of entry regulation across countries is broadly in line with public choice theory: politicians and bureaucrats choose policies and regulations in keeping with their own private interest rather than with the public interest. Acemoglu (2008) provides a model of political institutions and entry regulation showing that in an oligarchy government capture may lead to high barriers to entry for new firms to protect incumbent elites. In contrast, entry barriers are lower under democracy. A second closely related literature, reviewed by La Porta et al. (2008), explores the association between legal origin and the regulation of economic and other activities, including the regulation of entry. Broadly speaking, this literature finds that countries with a civil law tradition tend to regulate more than those with a common law tradition.

We extend this work to consider the role of culture in determining the characteristics of a society's regulatory regime. In particular, we focus on the dimension of cultural variation associated with individualism and collectivism, a distinction that reflects the importance of social relationships and obligations in an individual's fundamental understanding of the self (Gorodnichenko and Roland, 2012). We focus on this dimension for several reasons. First, individualism is recognized as a key component of a country's cultural make-up. For example, Hofstede (2001) finds individualism-collectivism to be the most important dimension in explaining international variation in cultural values, and Gorodnichenko and Roland (2011) empirically show that individualism is the only dimension of culture that is robustly related to economic development. Second, individualism is credibly linked to the development of democratic political institutions (Licht et al., 2007; Klasing, 2013), suggesting a potential channel through which it might influence entry regulation. Finally, individualism is plausibly associated with a preference for lower levels of entry regulation, which matters if social preferences play a role in policy formation.

To measure entry regulation, we collect 2008 country-level data on the number of procedures, number of days, and the monetary cost to legally register a new business (World Bank Doing Business, 2014). Based on these three measures, we create an overall index to capture a country's propensity to regulate entry. Our primary cultural variable is Beugelsdijk et al.'s (2015) measure of individualism, which uses World Values Survey (WVS) data from 1981 to 2008 to update Hofstede's (1980, 2001) original individualism variable. Using this measure substantially increases the number of countries for which both regulation and cultural data are available.

We organize our investigation of individualism and entry regulation around three hypotheses. The first is simply that *culture matters* for entry regulation. In section four, we present empirical evidence of a strong negative association between individualism and entry regulation. This relation exists for time, monetary costs, and our composite index of entry regulation. This finding is robust to the use of alternative measures of individualism and to controlling for a wide variety of alternative cultural values and exogenous determinants of institutional quality. Furthermore, we employ instrumental variables to address issues related to the measurement and endogeneity of individualism. Specifically, we use three instruments for individualism identified in the culture literature, pronoun drop (Kashima and Kashima, 1998; Davis and Abdurazokzoda, forthcoming), rainfall variation (Davis, 2016) and genetic distance (Spolaore and Wacziarg, 2009; Gorodnichenko and Roland, 2010, 2011). All three instruments are significantly correlated with individualism. Based on the IV estimations, we find a strong negative association between the exogenous component of individualism and the regulation of entry. Thus, our evidence is consistent with the hypothesis that culture matters for entry regulation.

Having found that individualism is important for entry regulation, we investigate how it matters. That is, we attempt to uncover the channels through which individualism affects the regulation of entry, with particular attention to the association between formal and informal institutions. In particular, we argue that culture may affect regulation directly through its impact on preferences over social policy and indirectly through its effect on the development of democratic political institutions. This second channel derives from work stressing *the hierarchy of institutions*, e.g. North (1990) and Williamson (2000), in which informal institutions serve as the basis for the development of formal institutions. The second hypothesis we investigate is based on an admittedly extreme version of this idea that we call the *Strict Hierarchy of Institutions* hypothesis, which holds that individualism only influences entry regulation indirectly through its impact on political institutions. In section five, we test and reject the *Strict Hierarchy of Institutions* hypothesis. In particular, we find that culture plays an important role in determining the regulation of entry even after controlling for the quality of political institutions. These results are also robust to instrumenting for individualism.

Finally, we investigate whether culture and formal institutions interact in the determination of entry regulation, a proposition we call the *Interdependent Institutions Hypothesis*. The functioning of formal institutions may be sensitive to cultural values or social preferences in the determination of social policy. And, indeed, our findings in section six are largely consistent with this hypothesis. In particular, we find that democracy and the common law tradition magnify the influence of individualism on entry regulation. In contrast, cultural values appear to play a relatively minor role in societies with authoritarian political systems and civil law traditions. Similarly, political and legal institutions have little influence on entry regulation in collectivist societies. These results are consistent with theories that stress the particular ability of democracy and common law to aggregate and channel social preference in determining social policy outcomes.

The paper's primary contributions are that (1) individualism matters for the regulation of entry and (2) the magnitude of individualism's influence depends on a country's legal and political institutions. This analysis adds to a relatively small literature examining the role of culture in regulation. Stulz and Williamson (2003) present evidence of a causal relation-

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