Cluster Brief: Improving Regulatory Efficiency for Firms[1]

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In most emerging countries, small and medium firms constitute over 90% of all firms in the country, but achieve very limited growth through the life-cycle of their business (Hsieh & Klenow, 2014). There is a growing literature that discusses many factors that lead to this phenomenon, one of which is the role of government regulation (Bruhn & McKenzie, 2014). Government regulation has been used to promote business expansion, reduce fixed costs, increase access to efficient technology and reduce demand constraints in emerging markets (Criscuolo,, Overman, & Reenen, 2012; Ferraz, Finan, & Szerman, 2016). In each of these cases government policies are designed to achieve the dual role of protecting society and keeping the regulation costs low. This article discusses the potential limitations in business environment that could result in inefficient regulatory policy.

Five Mechanisms of Improving Regulatory Efficiency

Evidence from randomised control trial studies have found five possible ways to improve the quality of governance in emerging markets. Each of which are discussed below:

1) Lack of information. In some cases, poor governance is result of lack of adequate information among actors. For example, Peru's Building Safety Inspection (BSI) regulation study found that 90% of the firms that register required more than one visit as they did not pass the required standards in the first inspection. This resulted in a system where only 6 percent of 470,168 businesses complied with the required BSI (IFC, 2011). To address this issue Andrade et al (2013) provided a glossy brochure with information on registration. They find however, the firms are not more likely to register if provided a brochure. In a randomized controlled trail on business registration, De Girogi and Rehman (2013) gave registration information to firms in Bangladesh but also found negligible effects. All of which suggests the need to consider the role of costs and benefits of registration to a firm apart from just lack of information.

2) Lack of coordination. There are large transaction costs involved in starting a business if firms are required to go through systems marred by bureaucratic process and red-tape. A reduction in such process could result in lowering of transactional costs and an increase in the entry of firms. The Doing Business project of the World Bank found that 368 reforms took place in 149 economies, bringing the world average time to start a business from 50 to 30 days, and the cost of starting a business one-third of what it was previously (World Bank, Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises, 2013). Kaplan, Piedra and Seira (2011) found that the number of registered businesses increased by 5% after a one stop shop for registration process was created in Mexico. Bruhn (2013) found the rise in registration is due to new businesses being set up and not formalization of existing informal firms. While the reforms centred around lowering transaction costs can increase new participants, it does not seem to reduce informal ones as they continue to remain, suggesting the underlying benefits from registration are not large enough to act as an incentive.

3) Taking into consideration the distribution of firms. There are gains to be made taking into consideration the distribution of firms within a given business environment while framing regulatory policy. This can be

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seen, for instance, in the case of the Building Safety Inspections (BSI) in Peru. The potential costs of damage that could be caused by fire accidents vary by the number of persons working in a building and the size of the building. Given this information, it makes for a more efficient regulatory system to inspect firms with higher potential costs of damage than firms with lower potential costs of damage (World Bank, 2016). In the case of environmental inspections in India, Duflo et al. (2014) find that increase in audits has a varied impact on firms just above the threshold of permissible levels of emissions as compared to those with considerably higher levels of emissions – given the varied costs involved for the firm to make amends as per the regulatory norms. Exploiting such variation across firms into consideration while framing the policies can make them more effective and impactful.

4) Frequency of audits & weak enforcement. In many of the emerging markets, weak regulatory authorities are a product of infrequent audits, resulting in limited accountability systems. There are instances where the provision of information or the increase in audits has limited impact if it is not combined with some enforcement of sanction costs for non-compliance. An increase in the frequency of independent environmental inspections to meet the prescribed minimum without changing the enforcement of costly penalties for violations saw firms only marginally reduce pollution emissions (Duflo, Greenstone, Pande, & Ryan, 2014). The literature suggests that weak enforcement of the sanctions could prove to be an important impediment in achieving an efficient and effective regulatory system. Andrade et al (2013) find that providing information, waving all registration costs and sanitary inspections costs for the first year does not seem to increase registration of unregistered firms. This could possibly hint at the reduced benefits and increased ongoing costs as taxes being a disincentive.

5) Complex monitoring systems. In some of the studies, researchers have tested innovative audit and monitoring systems to effectively enforce the regulatory norms across stakeholders. Duflo et al. (2012) find that providing financial incentives based on increased monitoring of government teacher attendance reduced teacher absenteeism. The authors find that the intervention worked because they were able to link the increased pay to a specific measurable outcome of performance. Using technological innovation to reduce leakage of payment for public works programme in India also found improvement in delivery. In one case, Banerjee et al. (2016) demonstrate how a minor restricting of the cash flow accounting process can reduce leakage of public funds. Similarly, Murlidharan et al. (2014) show how using technology to better identify the beneficiary is able to reduce leakage. Each of them exemplify an innovation that could address the concerns surrounding leakage and increase transparency in the system.

Cluster of Impact Evaluations on Improving Regulatory Efficiency for Firms

ComPEL works closely with government representatives and World Bank project teams to provide technical and financial support to incorporate impact evaluations into programs that improve regulatory efficiency for firms. Our aim is to build a body of evidence that can better inform which interventions have proven to be impactful and which have not in this policy space. Sample interventions currently supported by ComPEL include: new business registration regimes, risk management solutions in customs, and one stop shop for investment agencies. More information about this cluster and its related impact evaluations is available in:
http://www.worldbank.org/en/programs/competitiveness-policy-impact-evaluation-lab#2

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