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Effect of business regulation on investment in emerging market economies

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Abstract

This paper provides an empirical analysis of the business regulatory factors that influence investment in a selection of 29 emerging market economies. Both theoretical and empirical literature on the effect of the regulatory environment on investment is reviewed. A panel data analysis over the period 2003–2007 reveals that investment is influenced by secure property rights and the degree of business entry regulation. The results carry important policy implications for improving the investment climate of emerging market economies.

Keywords: Investment; Regulation; Emerging market economies

JEL classification: E02; E22; L51; O 50

1. Introduction

The World Bank (2004), *World Development Report 2005*, asserts that a good investment climate, which addresses the local institutional, regulatory and policy environment in which firms operate, stimulates economic growth by providing firms with the incentive to invest and improve productivity. Although economic theory suggests that there are numerous factors that foster long term economic growth, more recent studies affirm that encouraging private sector led growth has much broader ramifications on the economy as a whole. In particular, encouraging entrepreneurship and the development of firms is vital in addressing poverty and underdevelopment in developing economies.

The concept of a good investment climate is closely associated with the seminal work by Hernando de Soto (1990, 2000) on property rights and ownership. He argues that the economic success of a country like Japan can be attributed to a large extent to a clear system of property rights that was created after the Second World War. He provides evidence to suggest that people in developing countries lack an integrated formal property system, which results in informal ownership of land and goods. As a result the poor, in today's developing economies, find it difficult to leverage their current informal ownerships into capital as collateral for credit – a vital aspect of free enterprise. This argument is supported by other studies by Knack and Keefer (1995) and Rodrik (2000), who affirm that institutions and property rights not only influence the magnitude of investment, but also the efficiency with which inputs are allocated.

The World Bank has conducted numerous studies over the past decades aimed at developing better indicators for measuring institutional quality or performance and its effect on economic outcomes. More recently, the 'Doing Business' project was established, after numerous studies were undertaken, to monitor and benchmark the business regulatory environment of countries around the world. This project is a time-in-motion study that collects data on regulations that enhance and constrain business activity. A number of multilateral organisations now use these performance indicators as targets that developing countries must aspire to achieve in order to obtain donor aid and grants. However, there has been criticism about the validity of these indicators. There are those who contend that these indicators distort the role of the institutional environment by creating simplistic quantitative measures of regulations that are complex, integrated systems (Berg and Cazes, 2007; Davis and Kruse, 2007). Furthermore, there are those who assert that the methodology used in obtaining these indicators prejudices essential trade-offs in institutional design. For instance, the exclusive focus on the private costs paid by entrepreneurs obscures the cost to the state of

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providing better business or property registration services; yet developing economies require functional registries with reliable information that can be used in litigation (Arrunada, 2008).

The purpose of this cross-sectional study is to investigate empirically whether business regulations influences investment. Data from 2003 to 2007 on a selection of 29 emerging market economies from Africa, Latin America, Asia and Europe obtained from the 'Doing Business' database were used. These economies have been selected because emerging market economies are considered to be economies in transition that face similar constraints in encouraging domestic investment and attracting foreign capital flows. It is anticipated that the empirical analysis from this study will contribute to deeper understanding of the business regulatory factors that influence investment in these economies. Furthermore, this study will contribute to the on-going debate on regulation and its influence on economic performance outcomes.

The rest of this paper is organised as follows: Section 2 provides a review of the literature on investment, institutions and regulation. Section 3 provides a discussion on the theoretical aspects of the institutional factors identified as explanatory variables in this study. Section 4 describes the empirical strategy for the analysis of this study while Section 5.1 provides a description of the data. Section 5.2 presents and discusses the results of the empirical analysis and Section 6 summarises the findings of the research and provides final remarks.

2. Literature review

Institutions have been referred to in the literature as the 'rules of the game' in relation to economic performance. It is suggested that without them economies would not exist in the functional state in which we know them today. Institutions according to North (1991) are "humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions and codes of conduct), and formal rules (constitutions, laws, property rights)".

Their role in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction. According to North (1991), institutions affect the performance of the economy by their effect on the cost of exchange and production. Together with the technology employed, they determine the transactions and transformation (production) costs that make up total costs. Therefore, they determine the profitability and feasibility of engaging in economic activity. It is important to emphasise that institutions would not exist if human interaction consisted of only harmonious relations.

Even though institutions play a significant role in social interaction, understanding their effect on economic outcomes has evolved slowly over the past century. According to economic history, the initial neoclassical view assumed that exchange in the market arose spontaneously from the close interaction of self-seeking individuals. The goods that were traded in every market were assumed to be homogenous so that prices provided the only information needed to make decisions on production and purchasing (North, 1990; Williamson, 2000). Therefore, no individual had sufficient power to influence the market price since exchange was driven simply by utility considerations. In other words, they argued that competition arising out of the pricing system coordinated the transactions of the market and there were no cost implications.

It was Ronald Coase (1937) who questioned the notion of costless transactions. He argued that there were costs that arose out of negotiations during business transactions such as drawing up contracts and carrying out inspections. It was these costs that determined whether a transaction would take place or not. As he succinctly said, 'Business men in deciding on their ways of doing business and on what to produce take into account transaction costs. If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place and the greater production that would flow from specialisation would not be realized' (Coase, 1992:716). Furthermore, Coase (1960) argued that what were traded in the market were not, physical entities, but the rights to perform certain actions, and the rights which individuals possessed were established by the legal system. In essence if property rights and, contract enforcement – that are all influenced by the legal system – are vital aspects of the economic system of a society, then it makes little sense for economists to discuss the process of exchange without specifying the institutional setting within which the trading takes place since this influences the incentives to produce and the costs of transacting. Numerous contributions to the literature on the role of institutions and transaction costs and their effect on investment and economic growth (North, 1981, 1991; Knack and Keefer, 1995; Hall and Jones, 1999; Acemoglu et al., 2001; Rodrik, 2000) have been made since 1960. They all, to a large extent, suggest that institutions contribute to understanding cross-country differences in economic performance. However, the channel through which they influence economic performance is still largely disputed.

Excessive regulation is considered to be an outcome of inefficient institutions. More recent studies have focused on different aspects of regulation in product markets and their effect on investment and long-term economic growth. In an empirical study to investigate the effect of regulatory reform on investment in several sectors of 21 OECD[1] countries, Alesina et al. (2005) show that regulation is a significant determinant of investment. They provide sufficient evidence to show that product market regulation can influence the costs that existing firms face when expanding their productive capacity. Their overall assessment shows that regulatory reforms that substantially lower entry barriers encourage investment. Dawson (2006), using data on regulation from the Economic Freedom of the World Index (EFW),[2] was able to highlight significant findings that suggest that countries with less overall regulation have higher rates of

[1] Organisation for Economic Co-operation and Development.

[2] Economic Freedom of the World Index includes regulation as one of its five major areas. Others areas are: (1) legal structure and security of property rights, (2) freedom to trade internationally, (3) access to sound money, and (4) size of government expenditures, taxes and enterprises (Fraser Institute's Economic Freedom of the World Annual Report).