

## TAPPING HIDDEN FORTUNES

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Billions of dollars in potential profits are lost each year in emerging democracies and economies threatening to derail political and economic transitions worldwide. These losses result from ill-designed, complex laws and regulations that exclude millions of citizens from the political and economic system and unnecessarily raise the cost of doing business in the formal sector. High business costs force entrepreneurs of modest means to survive by operating low-income, low-growth activities in the informal sector, squandering their economic potential. Moreover, costly business regulations encourage investors to flock to more hospitable business climates causing other countries the loss of millions of dollars in badly needed investment. These factors greatly hinder competitiveness, profit-making and overall economic growth. They also impede a country's ability to benefit from globalization. As a result, many citizens feel that they have not benefited enough from democratic and market-oriented reforms and oppose further reform initiatives. In some countries, widespread demands to reverse past reforms are mounting. Unless barriers to political and economic participation are removed in the near future, democratization and market-reform could unravel across the globe.

A key barrier is the cost of doing business in the formal economy. Entrepreneurs who want to become and remain formal must spend time and money to:

- obtain a business license
- acquire land titles or leases
- hire employees
- comply with government laws and regulations—pay taxes, for example
- obtain credit
- hook up and maintain electricity and telephone services
- enforce contracts, and so forth.

How expensive these procedures are fluctuates wildly from country to country. Exorbitant business costs are found in nations where business people must follow burdensome laws and regulations and deal with inefficient, corrupt government agencies which offer few benefits. High costs force entrepreneurs to make calculated decisions as to which rules they will respect or violate based on what they can afford without having to go out of business, what they expect to receive in return, and the cost of noncompliance. Many entrepreneurs producing legitimate products lower their business costs by operating informally without proper permits and legal status. Hence, they are called the informal sector or “informals.”

Every economy—developed or emerging—has an informal sector. New York City sweatshops are notorious examples of informality in the US. What is alarming is that the already large informal sectors in many emerging democracies and economies continue to grow. A recent IMF study reveals that about nine trillion dollars—roughly a

third of the GDP of emerging markets—was produced informally. Similarly, 1999 International Labor Organization figures indicate that 17% to 84% of the urban labor force in developing countries work informally.

### **What's wrong with high business costs and large informal sectors?**

To begin with, a large informal sector weakens democracy, hinders necessary reforms and contributes to misguided policies. Informals, if given the opportunity, are likely to suggest useful policy changes that would reduce the cost of doing business and level the playing field. Yet, their illegality prevents them from voicing their concerns to government officials and holding them accountable. As a result, reforms that would increase private sector activity and growth are not implemented. Moreover, because informal sector activity is unreported, policymakers don't have the necessary information to make good decisions. Unsound macroeconomic policies can seriously harm an economy.

High business costs also damage an economy because they lower productivity and competitiveness and encourage informality. This happens in several ways. One is through costly business licenses that grant rich, but not necessarily efficient, producers an unfair advantage over potentially productive start-ups with limited funds. Another is through stringent, costly labor codes. Formal businesses reduce labor expenses by overusing scarce capital and under-employing available labor; conversely, informal entrepreneurs rely too heavily on informal labor and not enough on cost-effective capital. Either way, resources are misallocated, productivity is stunted and workers suffer. Formals lose hard-won benefits whereas informals are forced to accept low wages, unstable jobs and poor working conditions.

More familiar causes of low productivity and informality are complex and costly taxation and regulatory schemes. Many entrepreneurs avoid the time, money and headaches of burdensome regulations through tax evasion and noncompliance. This lowers government revenue to finance essential business-related goods and services such as the court system, administrative agencies, roads, and health care. As a result, their quality declines as does entrepreneurs' productivity levels, unleashing a vicious circle. Poor quality services discourage even more entrepreneurs from paying taxes and business-related fees which, in turn, further decreases government revenues and quality of service levels encouraging informality and corruption.

Informality and corruption waste vital resources and weaken political and economic institutions. Because informals are illegal, they don't benefit from law enforcement services such as the courts and the police that could offer them protection and reduced business risks. Some informals survive without these services by signing short-term, small-scale agreements with known partners. Yet, this greatly lowers their productivity and flexibility. Other informals bribe government officials to obtain services or escape costly punishment for their illegality. Corruption pads the pockets of officials, robs the government of much-needed revenue for essential services and raises the price of

goods and services. Moreover, routine violation of government laws and regulations erodes their credibility and scares investors.

Complicated, costly and insecure property rights systems are equally harmful to economic performance. Assets lacking secure property rights tend to remain in the informal sector because they can't be converted into "productive economic currency" such as collateral for reasonably priced loans to start or expand a business or shares in incorporated companies. Without legally protected property rights, entrepreneurs will have difficulty attracting investors and will have little incentive to train personnel or purchase capital (such as computers or high-tech machines) in order to undertake large-scale, long-term investment, specialize and be competitive. As a result, the economic potential of assets worth trillions of dollars is squandered in small-scale, short-term, low-surplus generating informal sector activities.

Costly, insecure property rights damage economic performance in other ways as well. Obtaining water, electrical and telephone services usually requires a property title. Entrepreneurs without property titles can gain access to these services only through illegal tapping. Widespread siphoning forces providers to charge regular subscribers more. Higher prices, in turn, harm the competitiveness of companies that use these services.

### **Where do high business costs and large informal sectors come from?**

The answer is from badly designed laws and regulations and poor quality government services that stack the deck against the entrepreneur of modest means. This is particularly the case when entrepreneurs are locked out of the policymaking process and thus can't tell government representatives which policies help or hurt their business activities. As a result, laws and regulations are made by a handful of individuals for the benefit of themselves and/or their cronies, and may not encourage overall, long-term economic growth. The failed crony capitalist systems in Asia illustrate just how disastrous such arrangements can be. Such crises also show that those who created or have adapted to such a system stubbornly defend it because significant changes will be costly and risky for them. As a result, poorly designed institutions often enjoy extended life spans.

There are plenty of examples of ill-designed rules and regulations. Among the most common are taxation and labor policies. High tax rates and poorly administered taxation systems reduce profit margins encouraging tax evasion and informality. Similarly, restrictive labor regulations impose substantial, fixed burdens on firms (especially low income-earning ones) and make hiring informal workers attractive.

In some countries, setting up a business is akin to a multi-year marathon. One of the first hurdles is acquiring legal property titles for assets such as land or scientific discoveries. Complex and lengthy titling procedures can prevent even the most determined entrepreneurs from setting up shop. Examples from Hernando de Soto's recent book, *The Mystery of Capital*, illustrate just how burdensome obtaining legal

real estate titles can be in some countries: in the Philippines it requires 168 bureaucratic steps, involves 53 public and private agencies and takes 13 to 25 years; in Egypt it requires 77 bureaucratic procedures, involves 31 public and private agencies, and takes five to 14 years; and in Haiti it requires 111 bureaucratic hurdles and takes approximately 12 years.

Even with property titles in hand, entrepreneurs are often confronted with ridiculously expensive and complicated license and permit requirements. The Harvard Institute of Economic Research recently published a survey of the official requirements to set up a business in 75 countries. The results indicate that the process entails, at best, two steps, two days, and US\$280 in Canada; at worst, 20 steps, 82 days, and US\$2,696 days in Bolivia; and, on average, 10.2 procedures and 63.1 days.

Entrepreneurs' headaches and high costs do not disappear once their business is finally registered. Now they must comply with a whole host of administrative and operative regulations ranging from paper filing requirements to price, interest rate, and import and export controls. In Peru, 73% of the cost of remaining formal came from following administrative rules. In Brazil, entrepreneurs must abide by over 50 sets of filing and payment requirements and must comply with endless record-keeping demands including filing four copy slips per sale.

Complying with numerous laws and regulations becomes even more overwhelming and costly if government agencies lack adequate financial, technical and human resources to administer and enforce them quickly and correctly. When it takes five months to get a business license or resolve a contract dispute, economic opportunities are lost. Paying bribes to speed up the process or avoiding the hassles altogether by operating informally become tempting solutions.

Remaining formal is exacerbated by unclear, unknown, conflicting, and frequently changing laws and regulations. This forces government officials and entrepreneurs to spend time and money figuring out which laws and regulations apply or risk noncompliance fines. It also breeds corruption by enabling government personnel to use their power to control the pace and the outcome of administrative and enforcement processes in return for illicit payments. A startling example is the Brazilian state and local safety codes that indicate different heights for fire extinguishers. A clever businessman put two sets of brackets per extinguisher and switched the extinguisher according to inspector. His scheme was foiled by conspiring inspectors who arrived together so that they could cite a violation and extract a payment.

Poor quality and/or nonexistent infrastructure can also bleed entrepreneurs' pocketbooks dry. Business costs rise significantly if entrepreneurs must travel long distances on unpaved roads or wait years to get a telephone line or electricity. Similarly, insufficient technological infrastructure hinders the creation and maintenance of business-related databases that contain essential information such as credit reports. Without credit reports, creditworthy borrowers can't benefit from lower interest rates.

## **How can business costs be lowered?**

Lower business costs and economic revitalization are within reach thanks to a handful of policy recommendations. These entail reforming specific laws and regulations and decision-making practices as well as government agencies' operating procedures.

Unsuitable laws and policies have a better chance of being reformed if entrepreneurs participate in and oversee policymaking. To this end, governments should make laws and regulations (draft and enacted), budgets and legislators' voting records available to the public by adopting and enforcing freedom of information laws. They should also ensure that decision-making procedures are transparent and inclusive so that citizens can easily comment on existing and draft laws or propose new ones. (For other ways of enhancing citizens' involvement, see the Sana'a Declaration: [www.cipe.org/ert/current/e35\\_15.php3](http://www.cipe.org/ert/current/e35_15.php3))

Streamlining legal and regulatory codes can greatly reduce business costs. This can be done by eliminating duplicative, outdated, complex, and conflicting laws and regulations and replacing them with ones that clearly define rights, responsibilities and compliance procedures. Property rights laws, for example, need to establish straightforward standards to identify asset owners and to indicate how property can be combined, leased, or exchanged. Tax codes and fiscal report requirements need to be simplified, and overall tax rates lowered. Similarly, labor codes should be revamped to eliminate outdated laws and to allow for more flexible employment contracts. Equally important are simple and well-publicized business registration requirements. Having a one-stop registration process that can be completed in every region of the country is one way to greatly reduce start-up costs.

Instituting corporate governance measures can work wonders for a country's business climate. What is needed is legislation that protects investors, shareholders and other stakeholders, requires transparent shareholder registries, and upholds the Organization for Economic Cooperation and Development's (OECD) Convention on Corporate Government and the International Standards Organization's (ISO) accounting standards. (For more information, see: [www.cipe.org/efn/governance.php3](http://www.cipe.org/efn/governance.php3).)

The same is true for regulations affecting the financial sector and government procurement. Implementing prudential supervisory mechanisms within the banking and financial sector can significantly reduce the risk of resources being drained by an "Asian flu." Similarly, fewer funds will pad the pockets of government cronies and their private sector pals if conflict of interest laws are clarified, Transparency International's government procurement codes are adopted, and OECD anti-bribery principles are upheld.

Overhauling government agencies can lower entrepreneurs' costs and improve the commercial environment. To this end, agencies' internal operating procedures need to be simplified and their performance regularly evaluated according to well-defined standards. Staff should be hired and promoted based on verifiable professional standards, and they

should receive appropriate salaries. Agencies, particularly the judiciary, should be provided with sufficient, yet well targeted, financial and technical resources to administer and enforce laws and regulations consistently, efficiently and fairly.

Maintaining adequate checks and balances between government branches helps minimize frequent, radical changes to the legal and regulatory framework. This reduces the burden on the judicial system and inhibits abuses of governmental power—especially in countries where commercial activities are governed by civil codes that can be overturned by decree.

Providing quality, efficient and cost-effective infrastructure substantially lowers business expenses. To this end, government should ensure a healthy degree of competition in these domains by privatizing inefficient state services or by subcontracting with private sector providers based on transparent guidelines. With cutting edge telecommunication systems and computer systems, the public and private sectors can maintain up-to-date, accessible databases of essential business-related information such as property title records, licensing and permit requirements and credit histories.

### **Converting ideas into action**

Knowing the types of measures that will reduce business costs, strengthen democracy and establish a level playing field for all entrepreneurs is only half the battle. Victory requires a well-designed reform platform and advocacy strategy. Developing a national business agenda is one way to promote legal and regulatory change effectively. The agenda sets reform priorities by indicating which laws and regulations need to be modified in the near future and provides concrete suggestions for change.

Formulating a national business agenda requires the private sector to take action. Heads of private sector business associations should take the lead by asking their members to indicate which laws and regulations raise the cost of doing business. Association leaders should collaborate to compile these in a single list. They should then get together to review the list and select reform priorities. Next, private sector leaders, alone or in collaboration with pro-reform think tanks, should draft a national business agenda.

The agenda should clearly identify which laws and regulations are being targeted for reform. Each should be described in straightforward terms. Each description should be followed by a simple presentation using basic charts or graphs that shows how the policy in question raises business costs and how alternative laws or regulations can reduce these expenses. This will provide powerful evidence that certain business costs are unnecessarily high and that solutions are within reach.

Spokespersons for the business community, allied with others in their communities, must take up the cause of reform and liberalization. Armed with the national business agenda, business people must make common cause with political leaders, journalists, academics, civic organizations, and others concerned with the

economic future of their country. Coalitions can be formed to advance reform based on a simple proposition: A country that denies its own citizens the right to entrepreneurship is jeopardizing the future of its children. It is the entrepreneurs who will create new technologies, new jobs and access to international markets. This message must become a national call to action, to reform.

### **Reducing barriers to participation strengthens democracy and economic growth**

Emerging democracies and economies are struggling to provide their citizens with better lives marked by political participation and economic prosperity. Yet, excessively high transaction costs hinder such efforts. Making this aspiration a reality hinges on instituting democratic governance in the public and private sectors. Such a change will contribute to more responsive policies and will increase efficiency, transparency, accountability, and growth, as well as reduce corruption. Moreover, if citizens are granted a greater voice in the reform process, they will gain a sense of ownership over reform measures. This will strengthen democracy and help to build a broader pro-reform constituency essential to consolidate political and economic reforms.

\*More information on the informal sector is available on CIPE's Web site at:  
[www.cipe.org/efn/informalsector/papers/](http://www.cipe.org/efn/informalsector/papers/)