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The impact of regulation on economic performance

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Introduction

This issue paper focuses on regulations affecting businesses and their impact on economic performance. It provides a summary of some of the theoretical and empirical works that have been devoted to this issue, describes EU policies implemented in this specific field and gives an overview of the recent developments that have taken place in the EU Member States.

1. The impact of business regulation on economic performance: main conclusions drawn from the literature.

This section provides an overview of some of the theoretical and empirical works that have been devoted to the impact of regulations affecting businesses on economic performance. These analyses generally show that regulations affect both the business and the macro-economic performances.

Definition of regulation

There is no generally accepted definition of regulation applicable to the very different regulatory systems in the EU countries. The OECD defines regulation as “the diverse instruments by which governments set requirements on enterprises and citizens” (OECD report on regulatory reform, 1997). Regulations include laws, formal and informal orders and subordinate rules issued by all levels of government, and rules issued by non-governmental or self-regulatory bodies to which governments have delegated regulatory powers.

Regulations fall into three categories:

- . Economic regulations intervene directly in market decisions such as pricing, competition, market entry or exit.
- . Social regulations protect public interests such as health, safety, the environment, and social cohesion.
- . Administrative regulations are paperwork and administrative formalities — so-called “red tape” — through which governments collect information and intervene in individual economic decisions. Administrative regulations are important tools to support public policies in many areas such as taxation, safety and environmental protection.

Different sources providing data and analyses on both economic and administrative regulations exist. However, data and studies on social regulations and their impact on businesses and economic performance are rarer. For that reason, this note only focuses on the former types of regulations.

1.1 *Administrative regulations have a direct impact on business performance*

Business regulations, and especially business administrative regulations, can create benefits for enterprises by setting a pro-competitive and low cost environment in which commercial transactions can take place. However, as regulations have become more complex and information dependent, many regulatory costs have shifted to businesses in the form of filling out forms, asking for permissions, reporting information, notifying the government, and record-keeping. The cumulative effect of many administrative regulations and formalities from multiple institutions and layers of government impose direct compliance costs, which include time and money spent on formalities and paperwork necessary to comply with regulations.

Many studies present evidence that administrative regulations have a negative impact on enterprise performance (profitability, productivity, turnover)¹. Those studies generally conclude that an important reason for this negative impact is the administrative burdens enterprises have to cope with. This conclusion is also supported by results from surveys on SMEs conducted on a yearly basis by the ENSR (the European Network for SME Research) since 1999 which show that administrative regulations are considered by SMEs as an important constraint on their business performance. Other sources provide the same picture. For instance, the Dutch government estimated in 1998 that the burdens imposed to Dutch businesses amounted for about 7.5 billion Euro extra-costs. In Belgium, administrative burdens have been estimated to equal 2.6% of GDP.²

1.2 By changing the intensity of competition, economic regulations have an indirect impact on macro-performances.

The identification of the channels through which economic regulation and deregulation impact on macroeconomic performance has been largely debated in the literature.

Theoretical models suggest that regulations and reforms which liberalise or improve the working of product markets can affect economic performance. The underlying principle is that *product market deregulation (regulation) aims at facilitating (restricting) entries and thus translates into increased (decreased) competition*. The increase in competition resulting from a reduction of entry barriers is then likely to raise both productivity and investments.

Productivity is considered as being positively influenced by competition in a number of ways. Competition is likely to reduce incumbents' market power. As a consequence, prices are set closer to marginal costs and monopoly rents decline (allocative efficiency effect). To restore their margins and to remain competitive, incumbents firms that were previously sheltered from competition are incited to organize work more effectively, to trim fat and to reduce slack (productive efficiency effect). In addition, increased market opening through trade deregulation may have a positive impact on productive efficiency as well as firms can take advantage of scale and scope economies stemming from an expansion of the market size. Moreover, the effects of competition on productivity also stem from the fact that more product market competition can lead lower productivity firms to exit and market shares to move from lower productivity to higher productivity firms. Finally, while this issue is still debated in the literature, an increase in competition may act as a stimulus for firms to foster product and process innovation aiming at reducing production costs or at producing more sophisticated products, thus allowing firms for escaping from competition. This 'dynamic efficiency' effect of competition is considered as playing an important role in total factor productivity growth.

Investments are also likely to be affected by an increase in competition since incumbents firms may increase investments aimed at boosting productivity. Moreover, if deregulation translates into an expansion of the market size (removal of barriers to trade) firms are incited to invest in order to increase their production capacities and to gain market shares.

¹ OECD, « Businesses' views on red tape, administrative burdens and regulatory burdens on small and medium-sized enterprises », 2001. See also "How businesses see government responses from private sector surveys in 69 countries", World Bank paper, 1997, A. Brunetti, G. Kisunko and B. Weder.

² DG Enterprise. "Benchmarking Enterprise Policy: Results from the 2003 Scoreboard".

A large amount of empirical research, including work by the OECD and the European Commission, show a positive relationship between product market deregulation facilitating entry, productivity, investment and growth. In particular, four recent studies from the OECD and the European Commission are interesting in this respect. The first study from the OECD³ concludes that various measures of regulation, concerning more specifically entry barriers, are negatively related to investment, thus implying that regulatory reforms, especially those liberalising entry, are very likely to spur investment. The results of the second study from the OECD⁴ support the thesis according to which productivity growth is boosted by reforms promoting competition and indicate that entry-limiting regulation may hinder the adoption of existing technologies, possibly by reducing competitive pressures, technology spillovers or the entry of new high-tech firms. The third study, made by academics for the Commission⁵, finds evidence that reforms that ease entry, reduce tariff rates and regulatory barriers to trade and remove price controls affect negatively the average level of economic rents in the economy and also that greater competition (as measure by lower level of economic rents) is associated with higher levels of employment and investment. Finally, the fourth study⁶ finds strong support for the thesis according to which the regulatory framework has a significant negative impact on investment. However, the study finds that the regulatory environment does not play a significant role in stimulating total factor productivity, other factors such as the education level, R&D expenditure and the degree of openness to trade being more important in this respect. This study also concludes that even a relatively rapid deregulation towards US levels would not lead to sufficient productivity gains to close the efficiency gap of roughly 10 percent with the USA.

There is thus growing evidence that economic regulation imposing restriction to the well functioning of product market, and especially regulation imposing barriers to entries, has a negative impact on economic performance.

Issue for discussions

Do the Members agree with the description of the effects of regulation presented above? Can they report on their own experience in this respect?

2. EU policies to reduce administrative and economic regulations on businesses

Aware of the implications of over-regulation on businesses and macro-economic performances, the EU recently adopted a set of measures aiming at reducing administrative burdens and more generally at creating a business-friendlier environment. In this respect, the Lisbon strategy and the Broad Economy Policy Guidelines constitute the general framework of the EU policy, while concrete actions have been undertaken through the definition and the implementation of several more targeted measures.

³ “Regulation and investment », March 2003, OECD Working Paper n° 352, A. Alesina, S. Ardagna, G. Nicoletti and F. Schiantarelli

⁴ « Regulation, productivity and growth: OECD evidence », January 2003, OECD Working Paper n° 347, G. Nicoletti and S. Scarpetta.

⁵ “The link between product market reform and macro-economic performance”, 2003, CEPR/IFS report for the European Commission.

⁶ “Drivers of productivity growth: an economy-wide and industry level perspective”. The EU Economy: 2003 Review.

2.1 *The Lisbon strategy and the Broad Economy Policy Guidelines*

The Lisbon European Council in March 2000⁷ identified the creation of a friendly environment for starting up and developing innovative businesses, especially SMEs, as part of the strategy for the EU to become by 2010 “*the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*”. The strategy adopted in Lisbon notably called for further efforts to lower the cost of doing business and remove unnecessary red tape. To this end, European institutions, national governments and regional and local authorities were asked to pay particular attention to regulatory impacts and compliance costs to businesses. The 2003 Broad Economy Policy Guidelines⁸, which update this strategy in light of the orientations defined in the Barcelona European Council (2002), also urge Member States to generate a supportive environment for entrepreneurship and for SMEs to start-up and grow in particular by reducing the administrative burden on business and by improving the regulatory environment, notably entry and exit mechanisms.

2.2 *EU targeted measures to reduce administrative burdens and improving the business environment*

The European charter for small enterprises⁹ endorsed at the Feira European Council in June 2000 also called upon Member States and the Commission to take action in a number of areas to support and encourage small enterprises. Recognising the crucial role these types of enterprises play in the growth of the European economy, the Charter identified better legislation and regulation as well as cheaper and faster start-up as being amongst the key factors of small businesses’ promotion and development. In particular, the Charter calls on the countries having the longest delays and most burdensome procedures for approving new companies to take measures to catch up with the fastest. In the field of regulation, the Charter urges Member States to assess the impact of new regulations on small enterprises, to simplify national rules and to adopt user-friendly administrative documents. To incite Member States to make progress towards the goals defined in the Charter, the European Commission undertakes benchmarking projects. These projects encourage them to improve their performance not only through concrete guidance and examples of good practice, but also through peer pressure.

At the EU level, a number of processes have been put in place to ensure that regulation is used only when necessary and that the burden it imposes is proportionate to its aim (‘Better Regulation’ processes). For instance, the regulatory impact assessment (RIA) is an instrument that was developed by the Commission to systematically identify likely effects of a legislative proposal, including possible disproportionate compliance costs for business and new burdensome administrative procedures. This tool is now put in practice in the EU institutions as well as in most of the Member States. Moreover, in June 2002 the Commission launched the action plan “Simplifying and improving the regulatory environment”. The action plan, while not specifically targeted to small businesses, defines measures for the Commission, the European Parliament, the Council and the Member States in the areas such as the quality of legislation or the reduction of Community legislation, which are likely to reduce administrative burdens on enterprises.

⁷ http://europa.eu.int/comm/lisbon_strategy/index_en.html

⁸ http://europa.eu.int/comm/economy_finance/publications/broadeconomypolicyguidelines_en.htm

⁹ http://europa.eu.int/comm/enterprise/enterprise_policy/charter/index.htm

3. Measures in the field of business regulations in the EU Member States

The situation prevailing in the EU Member States as regards business regulations may be assessed through two different sets of indicators. The first set of indicators provides a direct measure of the restrictiveness of regulation. The second set gives indirect information on the impact of business regulations by measuring the time and costs necessary to set up a new company and the number of entries and exits of companies. However, these indicators are not always up-to-date and are therefore supplemented by other information taken from the national reports on the implementation of the European Charter for small enterprises.

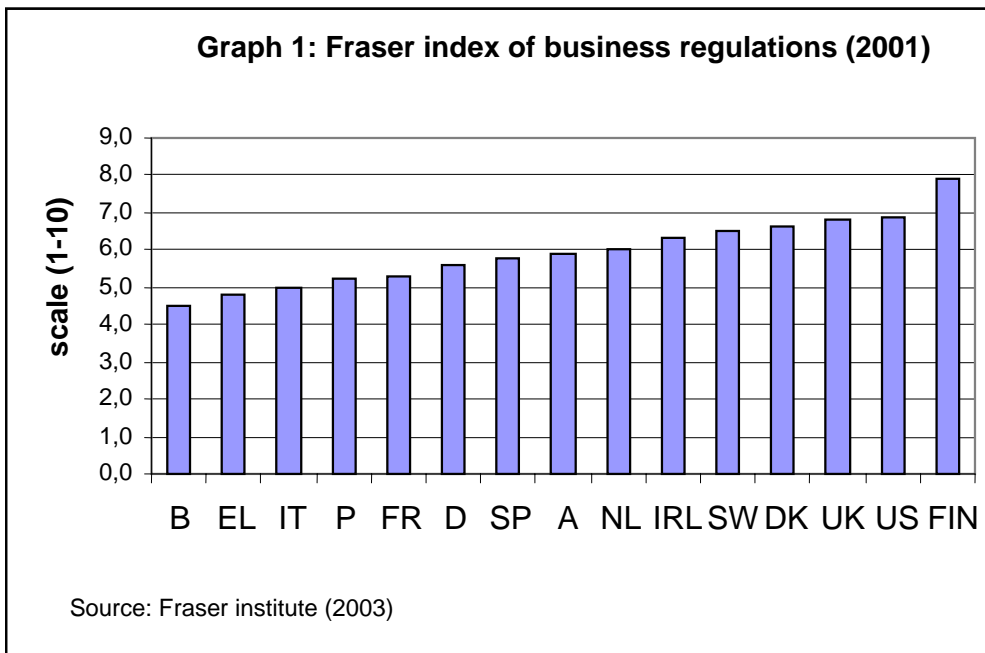
3.1 *Business regulations are more cumbersome in the EU than in the US*

Data availability in the field of business regulations

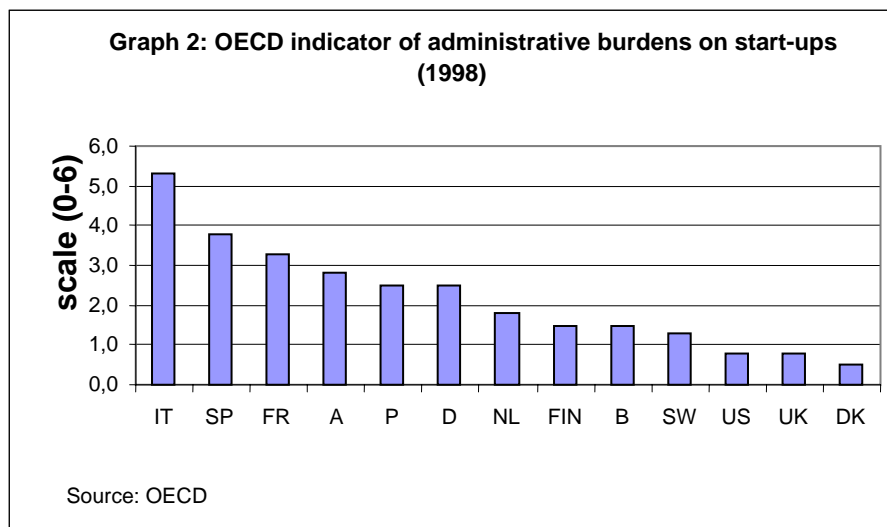
Developments and cross-countries comparisons in the field of economic regulation and administrative burdens on businesses are difficult to establish because data on these topics are relatively scarce. Three main sources of information are available, all three being based –at least partly- on survey data.

- . First, the OECD database on regulatory reforms. It contains indicators providing detailed information on regulatory and administrative policies as well as on administrative requirements for business start-ups. As these indicators are dating from 1998, the OECD launched a project aimed at updating them. However, the new data will not be available before October 2004.
- . Second, composite indicators are also available from the Fraser Institute. Among 38 indicators based both on survey data and on data provided by different national and international sources, 5 refer to business regulations: price controls; administrative conditions (procedures) to start a new business; time spent with government bureaucracy; ease to start a new business; and irregular payments connected with, among others, import/export permits, with business licences or with exchange controls. These indicators are designed to identify the extent to which regulatory restraints and bureaucratic procedures limit competition and the operation of markets.
- . Third, the ENSR surveys, which are carried out by the Observatory of European SMEs, have for several years included questions on the appreciation by SMEs of administrative burdens.

The first graph compares EU countries and US performances as regard the Fraser Institute index of business regulations. This index is ranged from 1 to 10, with 1 indicating the lowest level of economic freedom (or the highest level of regulation) and 10 indicating the highest level of economic freedom (or the lowest level of regulation).

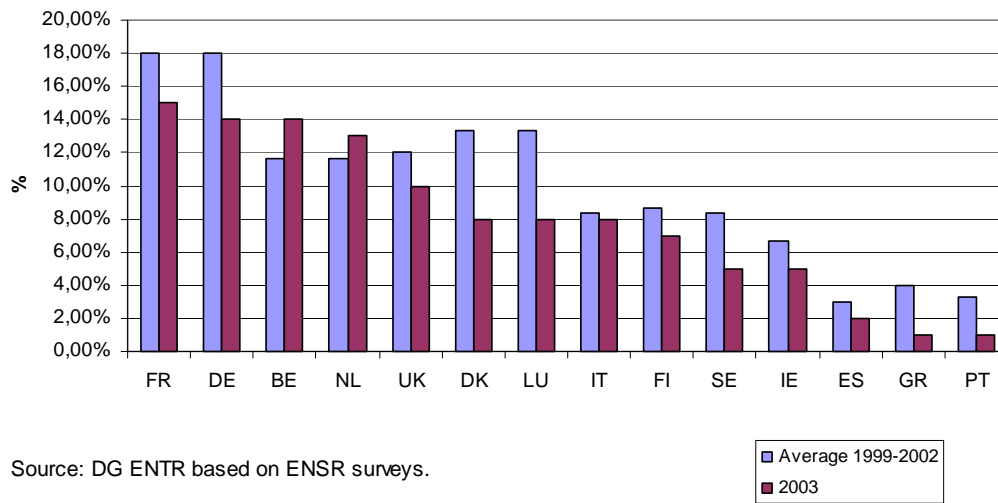


The second graph compares EU countries and US performances as regard the OECD indicator of administrative burdens on start-ups. This indicator varies between 0 and 6 and is increasing in the restrictiveness of regulation.



The main conclusion that can be drawn from these two graphs is that business regulations in the US are generally lower than in the EU, excepted for some countries such as the Nordic countries or the UK. The graphs also show that performances in this field are uneven amongst the EU countries and that there is clear scope for improvements in a majority of EU countries, including in particular large countries such as France, Germany, Italy and Spain. However, data from the Fraser Institute and especially from the OECD are relatively outdated and progress in reducing the administrative burdens on business has already been made in all EU countries. This latter point is highlighted by the results of the ENSR surveys on the percentage of SMEs identifying administrative burden as a major constraint for their business.

Graph 3: Share of SMEs picking "Administrative burdens" from a list of major constraints for business performance (%)



These data confirm that in countries such as France and Germany, administrative burdens are heavier than in the Nordic countries or even in the UK and Ireland. The low levels of SMEs in the Mediterranean countries picking administrative burdens as a major constraint for their performance appears to be inconsistent with the previous data from the Fraser Institute and the OECD which show that business regulations are high in these countries and could be explained by the fact that other factors such as the lack of external financing and of skilled labour are of higher importance in these countries. Moreover, while the data for the year 2003 is not directly comparable with the ones of the previous period, because the survey question was slightly altered, they tend to indicate that administrative burdens affecting small businesses have decreased somewhat over the recent period.

3.2 *Large differences persist between Member States regarding the time and cost necessary to set up a new business*

Data on time and costs to set up a new company and on business dynamism

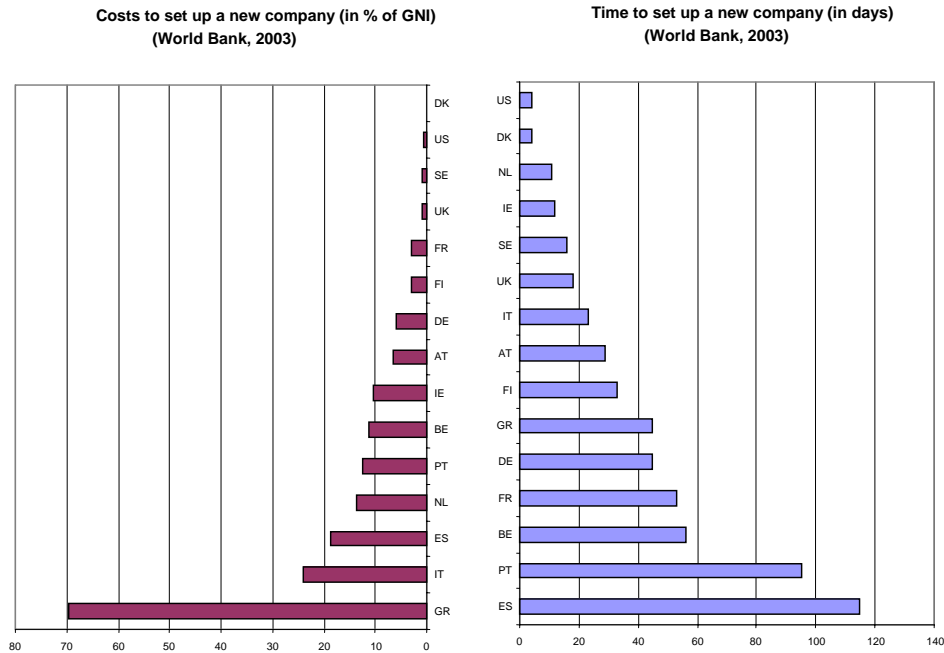
Data on time and costs

The World Bank measure of time and costs to start a business is computed on the basis of a questionnaire fulfilled by local professionals such as incorporation lawyers and consultants. The OECD also provides a synthetic indicator in this field.

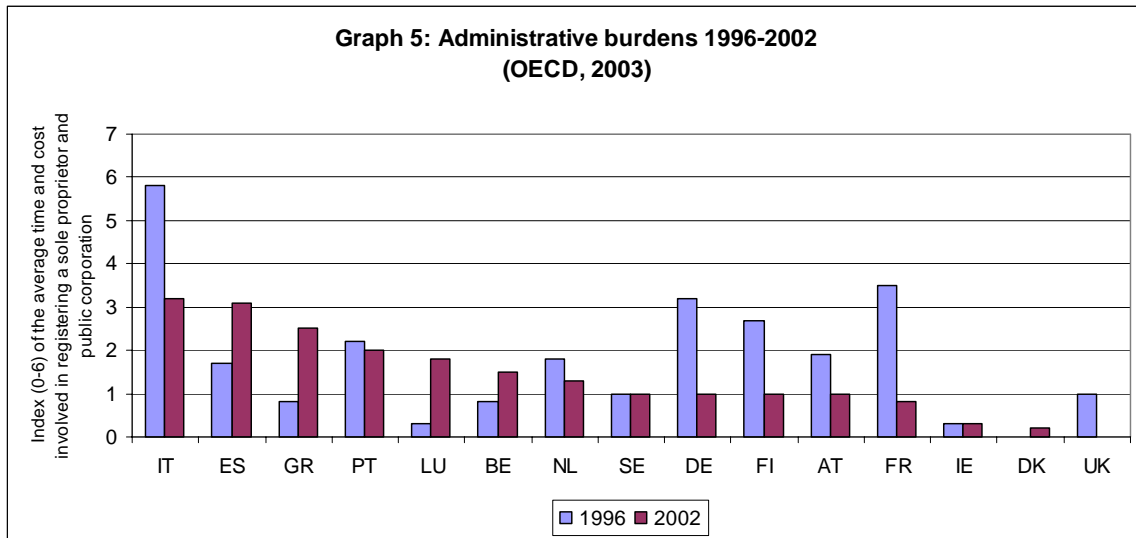
Data on business dynamism (business demography)

- . The New Cronos database managed by Eurostat contains data on a harmonised definition of entry and birth of enterprises broken down by sectors according to the NACE rev 1.1 (two digit level) for 10 EU Member State and from 1998 to 2000. The data should be updated every year. The database will serve as a basis for computing a new structural indicator on business demography. However, information on France and Germany are lacking.
- . A DG ENTR database contains information on market entries and exits for all Member States from 1995 to 2000. However, owing to the fact that the definitions of entry and exit are not harmonised, data are not comparable across countries.
- . An OECD database is also available. It contains information on the number of exiting, entering and continuing firms by year at the two digit industry level for 8 EU countries from the mid 80s to 1997 or 1998. The EU countries are the following: France, Germany, UK, Italy, The Netherlands, Denmark, Portugal and Finland. However, the time series available vary from a country to another: for Germany, data are available from 1978 to 1998 (largest sample) while for Italy data are available from 1987 to 1993 (smallest sample). Moreover, for UK there is a break in the series due to a change in the enterprise definition in 1994. Consequently, data for the period 1994-1997 can not be compared to data for the period 1986-1993. For Italy and Denmark, no data is available after 1993 or 1994.

The data provided by the World Bank on the time and costs necessary to set up a new company are consistent with the ones provided by the Fraser Institute and by the OECD on business regulations. They show that generally it is easier to start a new business in the US than in the EU and that some European countries (the UK, the Nordic countries) perform better in this field than countries such as France, Germany, Spain and Italy. However, the OECD synthetic indicator on time and costs shows that for France, Italy and Germany, the situation has improved markedly over the recent period. In fact, the analysis of the World Bank and the OECD graphs reveals that in France and Germany the costs for setting up a new company have been reduced substantially, but that the time of this procedure remains relatively long. For Italy, the opposite is true: the time necessary to create a new company appears to be relatively short in 2003, while the costs are amongst the highest in the EU.



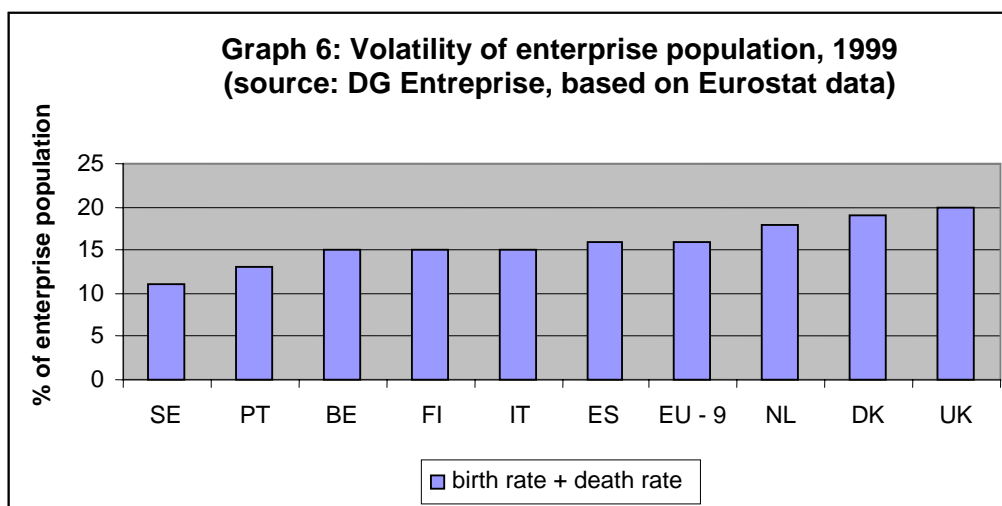
Graph 4: Time and costs to set up a new company



3.3 Differences also persist in terms of business dynamism

Volatility rates, as defined as the sum of enterprise birth and death rates, is an indicator of entrepreneurial dynamism in the sense that high volatility rates show a high turnover of business population thus indicating that entry and exit are easy and not restricted by regulatory barriers or by administrative or judiciary procedures. High volatility rates may also be interpreted as a sign of fast adapting and changing economies. As far as business dynamism is concerned, the data available from Eurostat show the same picture as the one for time and costs, namely that UK and Denmark are the best performers in the EU. However, as enterprise creation and failure are also influenced by the economic situation, this indicator –

like all indicators on business demography- must be interpreted cautiously. Moreover, this indicator –like the ones of the OECD and of the Fraser Institute on business regulations- is relatively outdated. However, an OECD study¹⁰ shows that the US does not outperform the EU in terms of start-up creations but that it does in terms of start-up growth, especially as regards employment expansion, thus indicating that employment legislation may play a key role in this respect. In addition, the OECD study also points out the fact that the employment protection legislation have a strong (negative) effect on market access of SMEs, but not on very small firms, which are often exempted from these regulations.



3.4 *Recent progress has been made by Member States in the field of business regulations and administrative burdens*

All Member States made progress in implementing the recommendations of the European Charter for Small Enterprises. Most of them took measures in 2002 and 2003 to reduce the time and costs required for setting up new enterprises, especially combined with e-Government initiatives, and to improve the regulatory and the legal environment for businesses, with the aim of simplifying the registration of companies and reduce ongoing compliance costs.

A few Member States have set *targets* for the creation of new enterprises (FR and BE), and further targets are announced by Member States in context of the enterprise Quantitative Target Project. The *transfer of business* has received increased attention in FR and NL, and measures to ease the tax burden of generational change of ownership are taken by EL, FI and SE.

Expanding *Business support services* is a priority in most Member States, but only a few takes measures to further address the quality of these services (ES, FI, DK, PT). Few Member States report on specific measures designed to ease the administrative burden to *the hiring of staff*, but systems for the registration of employment of new workers have developed (BE, ES, FR and EL). Several Member States have set up inter-ministerial working groups or task forces on the *simplification and improvement of regulation*. In the UK the revised guide on

¹⁰ “The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data”, OECD Working Paper n°329, 2002.

regulatory impact assessment specifically requires departments to carry out small business impact tests on new regulations, to be followed up by clear responsibility for regulatory reform in each Government Department. The simplification of existing regulation continues in the Member States, and efforts have increased regarding the impact assessment of new legislation and in tackling conflicting regulations.

A number of Member States are looking into *simplification of bankruptcy laws*, including DK, EL, PT FI, and BE. Several Member States have introduced new or strengthened existing measures for *access to funding for start-ups, new and existing SMEs*. In addition, some countries, such as Belgium, Denmark and the Netherlands have set up quantitative targets, committing themselves to reducing administrative burdens on enterprises by 25% by 2006 for the Netherlands and by 2010 for the two other countries.

Table 1: Recent measures adopted by the Member States for which the 2003 BEPGs recommended to “generate a supportive environment for entrepreneurship and for SMEs to start-up and grow”.

Country	Measures adopted in 2003
Belgium	Streamlining and acceleration of administrative procedures
Germany	Initiatives to reduce over-regulation and measures adopted to encourage enterprise creation
Greece	Measure to reduce bureaucratic and legal obstacles to start-ups
Spain	Simplification of the legal framework for SMES
France	Reductions of administrative burden and of time and costs required to set up a new company
Italy	Simplified administrative procedures for company start-ups
Luxemburg	Streamlining of data required to start up a business

Issues for discussions

While progress has been made by most of the EU Member States in reducing administrative burdens on enterprises, the level of business regulation appears to be still relatively high,

especially if one includes regulation other than time and cost of establishing a business. In light of their national experience, do the members share this point of view?

Do the Members have examples of good practices to speed up the move towards reduced administrative burdens and better and simpler regulations affecting businesses?

Do the members agree that regulations relative to health, employment and environment, have increased over the recent period and that they may have an important impact on business and economic performances? Do they agree that the employment protection legislation may have a negative impact on start-up growth?