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DCED Business Environment Working Group – Using BER to Build Back Better

Lessons Learned on the Role of Business Regulation in Economic Recovery from the COVID-19 Pandemic

The economic and employment crises created by the coronavirus (COVID-19) pandemic have far-reaching effects on private sector development around the world. Efforts to contain the spread of the virus have disrupted production flows, reduced demand for non-essential goods and services, and forced businesses to suspend or scale down operations. The challenges of recovering from this crisis are quickly emerging.

The Business Environment Working Group of the Donor Committee for Enterprise Development (DCED) is working with its members to identify ways that business environment reform can support the recovery process, and help developing and emerging economies to 'build back better'. It has commissioned a series of policy briefs on how donor and development agencies can work with governments, business representative organisations and other development partners to this end.

This is the second policy brief in this series. It looks at lessons learned from research on previous crises on the importance of a sound business regulatory environment for economic recovery and building resilience.

Key messages

1. A favourable regulatory environment for business is associated with stronger economic recovery after crises, and with long-term economic resilience. Crises can motivate systematic regulatory reforms.
2. The pandemic has disrupted economies in many ways, including reductions in both foreign investment and the integration of local firms into global value chains. The quality of the business environment plays a critical role in mitigating these effects, enabling firms to start, adapt, and reorient their activities.
3. The Covid pandemic is likely to require social distancing in the provision of government services for the foreseeable future; however, those most impacted by Covid are also the hardest to reach with such services.

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Introduction

Up to 195 million jobs globally could be lost due to the economic fallout from COVID-19.[i] Developing countries are expected to be the hardest hit; exports in Asia are falling, growth in Africa could be halved, and an extra 30 million people in Latin America could fall into poverty.[ii] Since small and medium enterprises (SMEs) account for over half of all jobs in developing countries[iii], ensuring their survival during the ongoing recession will be crucial.[iv]

Countries are facing a number of demand, supply, and financial shocks as a result of the pandemic. According to preliminary results from global WBG surveys, firms are expecting a significant decline in sales.[v] It is estimated that 2021 will see a global decline in FDI of 40%.[vi] This trend will adversely affect countries to various degrees, based on the dependence of an economy on FDI, the host countries' exposure to COVID-19, the source countries' exposure to COVID-19, and the concentration of FDI in highly impacted sectors.

This note presents some of the key findings from the economic literature on the role of the business regulatory environment for growth and recovery from past downturns and concludes with potential reform priorities to support economic recovery from COVID-19.

Findings from literature on the role of the business environment for economic recovery from crises

The business environment can influence macroeconomic performance during and after periods of crisis. Sound labour and product markets, framework conditions that support firm entry and operations, and strong institutions increase resilience towards adverse shocks.[vii] In assessing the influence of many possible factors on resilience post-crisis in the European Union, Alessi et al. (2019) find that a favorable business regulatory environment matters, particularly for long-term resilience, and is associated with stronger economic bounce-backs.[viii]

In times of crisis, lower entry restrictions can potentially mitigate the decrease in business density.[ix] Transparent regulations and rational legal institutions empower entrepreneurs to pursue productive activities, and firms to reallocate scarce resources, facilitating a swift return to potential output in times of crisis.[x] Sanchez et al. (2016) find that this increased efficiency does not come at the cost of higher financial fragility.

In several countries, economic crises have motivated systematic regulatory reforms. The OECD studied five countries (Sweden, the Republic of Korea, Japan, Mexico, and the United Kingdom) and found that the benefits of regulatory reform following crises were significant, in both the short and the long term.[xi] In Mexico, for example, reform momentum picked up formally in the 1990s, following the debt and peso crises. These reforms increased productivity, job creation, lowered prices and increased output and wealth creation (Box 1).[xii] Similarly, after the Asian financial crisis, the Republic of Korea undertook several regulatory reforms, which likely contributed to the country's successful recovery (see Box 2).

Box 1. Regulatory reforms in Mexico in response to the Debt and Peso crises

In 1982, Mexico was the first of many Latin American countries to default on its sovereign debt due to – among other factors – sluggish GDP growth, falling commodity prices, and dwindling foreign reserves. Then, in 1995, currency devaluations resulted in capital flight, sparking a new recession. In response, Mexico began a program of deregulation and privatization.

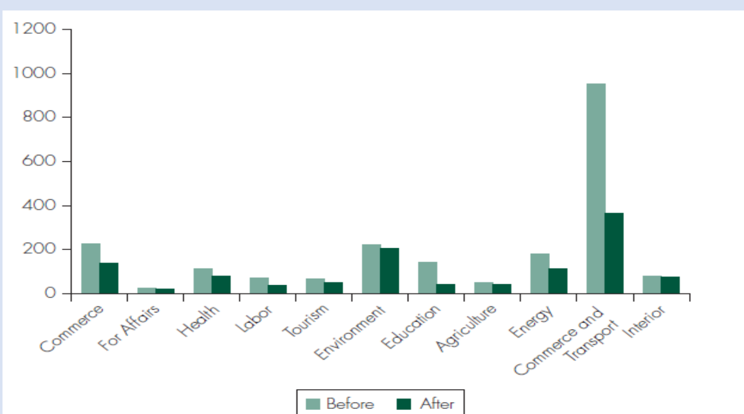

Figure 1: Reduction in licenses, permits and other information requirements by Mexican Ministries, 1995-2000. *Source: World Bank Group, 2008.*

As markets opened, there was a need for lower regulatory costs and enhanced predictability. To achieve this, Mexico created the Economic Deregulation Unit (UDE), passed the Federal Competition Law, and amended the Federal Administrative Procedures Law. Mexico also created a registry of regulations for firms to learn what requirements they are subject to - an initiative that was credited with nearly halving the number of procedures required of firms.[xiii] Finally, Mexico streamlined formalities related to business entry and many licenses were changed to notifications (figure 1), reducing the discretionary power of government agents.[xiv]

The regulatory reforms that were implemented likely contributed to Mexico's economic rebound at the turn of the millennium; the private sector share of GDP rose by 30% from 1980 to the end of the 1990s.[xv] Also, the reform effort solidified the role of the reform coordination body, which was transformed into the Federal Regulatory Improvement Commission (now known as the *Comisión Nacional de Mejora Regulatoria - CONAMER*) and given an expanded mandate, legislative backing, and new enforcement powers. Among the expanded role of CONAMER is to ensure the transparency of the regulatory process and promote regulations offering the greatest net benefit to society.

Box 2. The Asian financial crisis in the Republic of Korea added regulatory reform urgency

South Korea's economic success is well documented. And yet, the country was among the hardest hit by the Asian financial crisis (1997), as high-profile corporate insolvencies had a ripple macroeconomic effect. With the South Korean economy plunging into its deepest recession in history, a growing consensus emerged that large firms should no longer rely on the favours of government. Against this backdrop, the catchphrase among the political class became "[…] *turn the crisis into opportunity"*[xvi]. Using this momentum, the administration of Kim Dae-Jung (1998 – 2003) pushed a slew of reforms aimed at strengthening the ability of businesses to adapt to market fluctuations.[xvii] Many such reforms focused on simplifying regulatory compliance and easing business entry.

To drive its agenda forward, the reform program was institutionalized through the *Basic Act on Administrative Regulations* of February 1998, and the Regulatory Reform Committee (RRC) was created to identify and monitor reforms. Several actions were subsequently taken, using different approaches. For example, ministries were tasked to carry-out a stockholding exercise of all regulations. A Presidential Directive then halved the total number of regulations, with a focus on eliminating overlapping regulations, regulations contrary to global standards, regulations with low compliance rates, and regulations without a legal basis. The transparency of regulation was enhanced through information disclosure acts and the overall regulatory approach shifted from a negative system (where actions are prohibited) to a positive system (where actions are permitted with a simple registration or notice).[xviii]

The regulatory reforms implemented were key to the strong recovery of South Korea in the years following the crisis. As the percentage of sectors with barriers to entry decreased from 45% to 36% (figure 2), FDI rose significantly at the end of the decade.[xix]

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Moreover, regulatory compliance costs for firms drastically declined; from 1999 to 2003, compliance cost savings amounted to KOR 18.69 trillion.[xx]

Year and Type of Industry	Total Industries	Industries with Barriers			Industries with Barriers as Percentage of Total
		Strong Barriers	Weak Barriers	Total	
1992					
Manufacturing	585	103	85	188	32.1
Nonmanufacturing	610	249	104	353	57.9
Total	1,195	352	189	541	45.3
2001					
Manufacturing	585	42	73	115	19.7
Nonmanufacturing	610	147	165	312	51.1
Total	1,195	189	238	427	35.7

Figure 2: Reduction in entry barriers across industries in South Korea. *Source: Kim, 2002.*[xxi]

As highlighted in these empirical examples, an enabling business environment is important in recovering from crises. A high-quality business regulatory framework facilitates adjustments and reallocates resources to the most productive firms and sectors within an economy. According to a 2019 Global Investment Competitiveness (GIC) survey (see Figure 3), a country's business environment ranks in the top three factors driving foreign investment decisions[xxii]; improvements in the quality of a country's legal and regulatory environment are therefore associated with higher FDI inflows[xxiii]. Also, the quality of institutions governing the business environment—measured in terms of bureaucratic efficiency, corruption levels, and property rights protections— has a statistically significant positive effect on FDI[xxiv].

Business Environment Reform and the specific case of recovery from the Covid pandemic

The current crisis is posing unique challenges for businesses and policymakers. Linkages constitute the main channel for productivity spill-overs from foreign-owned firms to local suppliers, yet disruptions in global supply chains are undermining those linkages.[xxv] Backward linkages are particularly important, economically [xxvi]. High growth potential, exporter status, R&D expenditure, availability of inputs and geographic proximity to MNC affiliates are among the important indicators that increase the likelihood of a local firm becoming a supplier to MNC affiliates[xxvii]. By impacting all these conditions, the current crisis impedes the ability of domestic firms to benefit from linkages. The WBG estimates that as many as 150 million people will fall into poverty by 2021 (depending on the severity of the economic contraction).[xxviii]

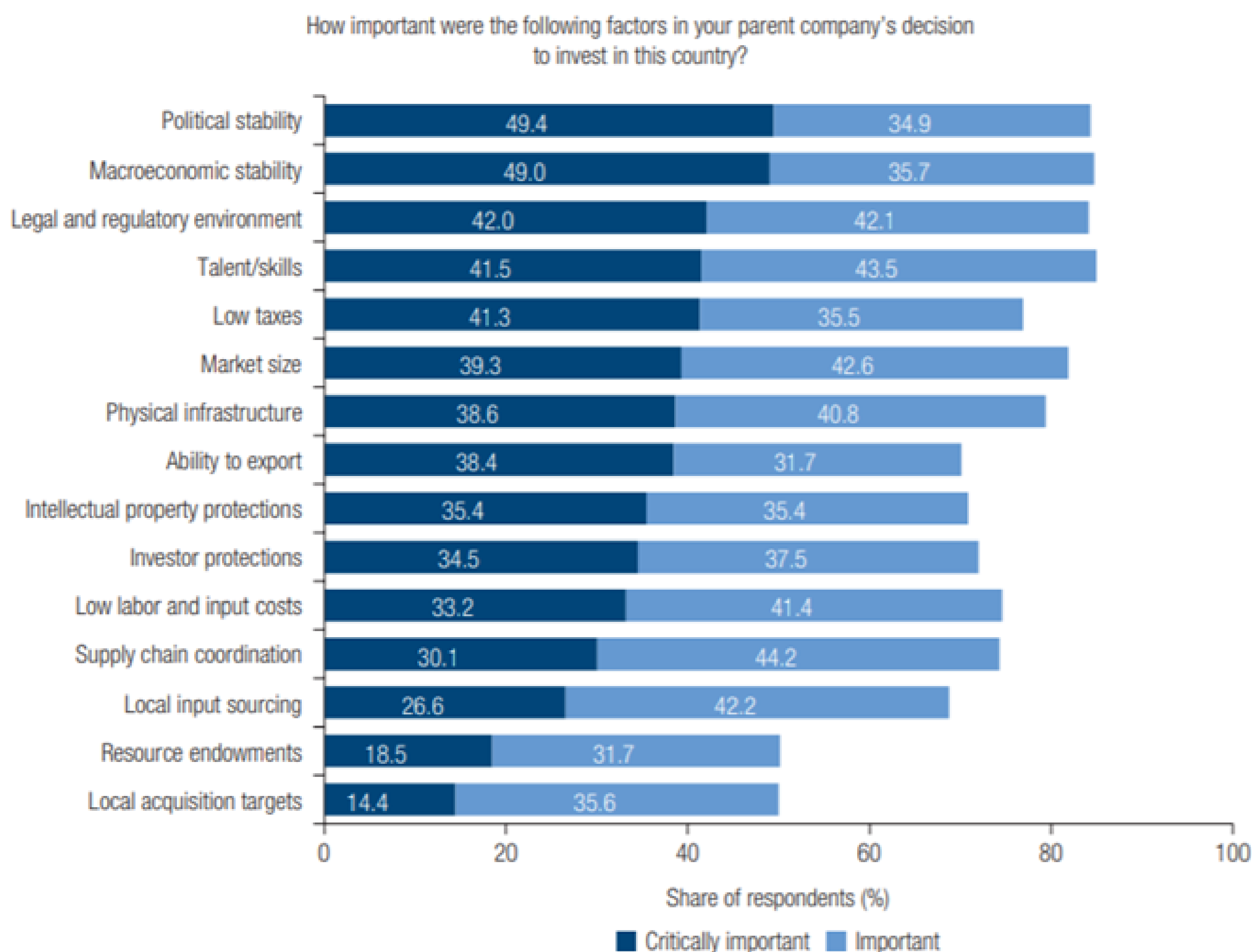

Figure 3: The importance of the legal and regulatory environment for foreign direct investors. Source: Computation based on 2019 GIC Survey

Challenges include length and depth of the crisis, low levels of policy reach in low and lower-middle income countries and lagging technology adoption. According to preliminary results from WBG surveys conducted in over fifty countries since the beginning of the crisis, firms are expecting a significant decline in sales, even 15 months into the crisis. The same surveys find that access to government support programs in response to the crisis is limited, especially in poorer countries and among smaller firms.[xxix]

While technology can be used to adjust to public health measures, and to access new market opportunities, technology adoption by firms has been limited so far. In fact, only 40% of businesses reported an increase in the use of digital platforms, and only 17% invested in digital solutions.[xxx] The digital divide not only impacts the private sector, but also governments, and the contrast is particularly stark across regions. Compared to OECD high-income economies,

countries in Sub-Saharan Africa are on average half as advanced regarding e-government services and practices (Figure 4).

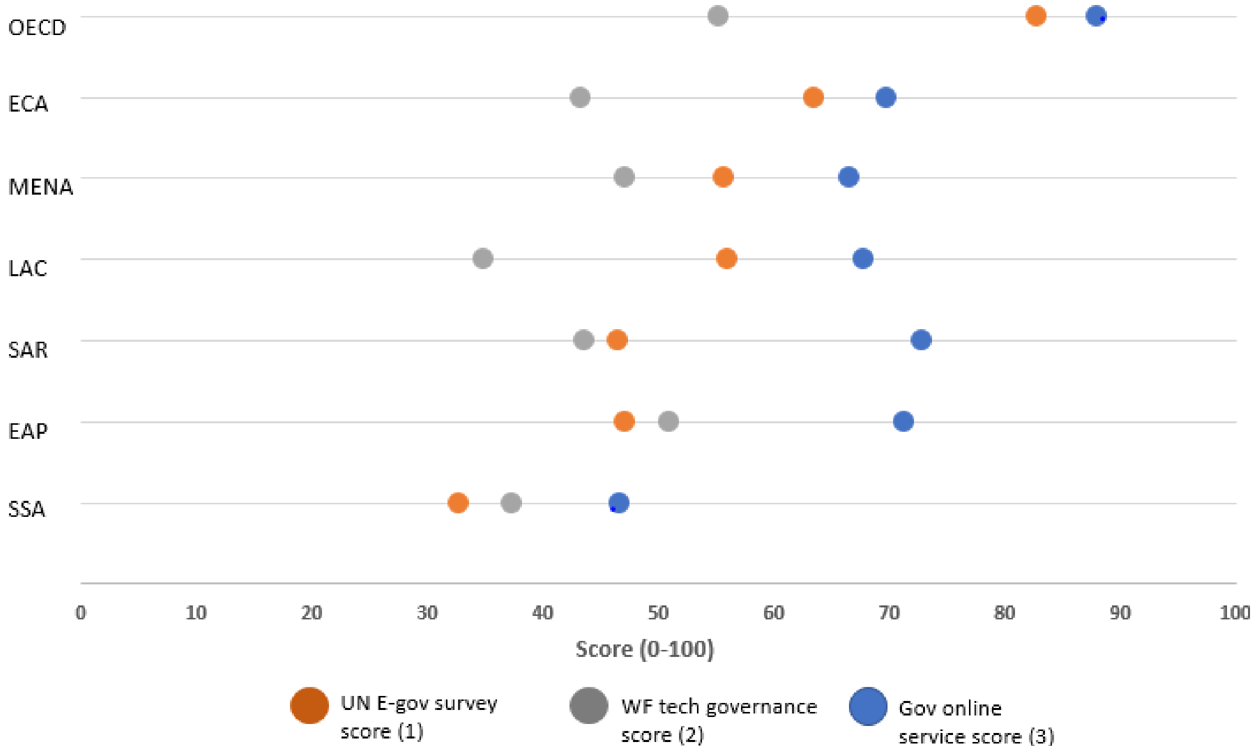

Figure 4. Measures of e-government services across regions. *Source: (1) The e-government survey (UN) measures countries' use of information and communications technologies to deliver public services. It captures the scope and quality of online services, the status of telecommunication infrastructure, and existing human capacity. (2) The tech governance score (WEF) measures how countries are adapting to digital business models (e.g. e-commerce, sharing economy, fintech, etc.) (3) The government online service score (Global Innovation Index) assesses the national central portal, e-services portal, and e-participation portal as well as the websites of* ***leading ministries (e.g. education, labour, social services, health, finance, etc.).***

For policymakers, being able to provide government services in a context of social distancing is likely to remain necessary for the foreseeable future, so developing digital government services, and boosting demand for existing services, will remain important[xxxi]. Therein lies a major challenge; the populations most impacted by COVID-19, including women and informal workers, are the hardest to reach. This is particularly the case, for example, in South Asia and the Middle East, and North Africa (Figure 5). In these regions, women's economic participation also continues to be hindered by laws and regulations lessening their decision-making power within the household, difficulty in obtaining formal employment, and lack of protection at the workplace, among others (Figure 6).[xxxii]

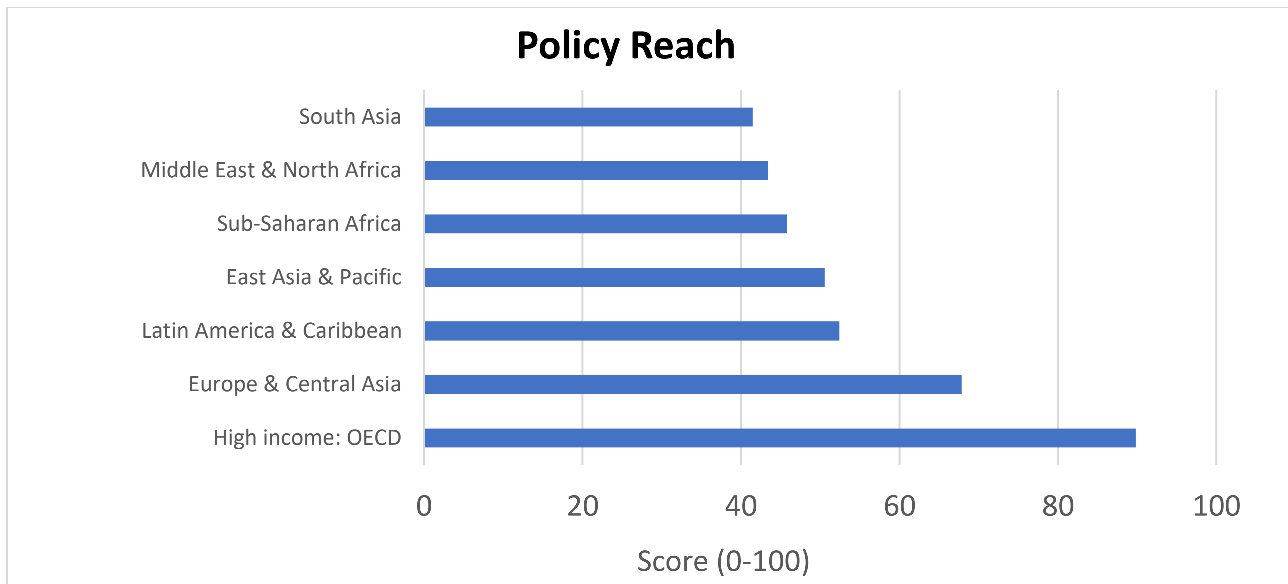

Figure 5: Policy reach across regions. Source: Authors' calculations. The Policy reach Index is a composite index of 4 sub-indicators: credit reporting coverage (Doing Business), ICT adoption (WEF), informal employment (ILO), and Women's participation in the labor force (ILO).

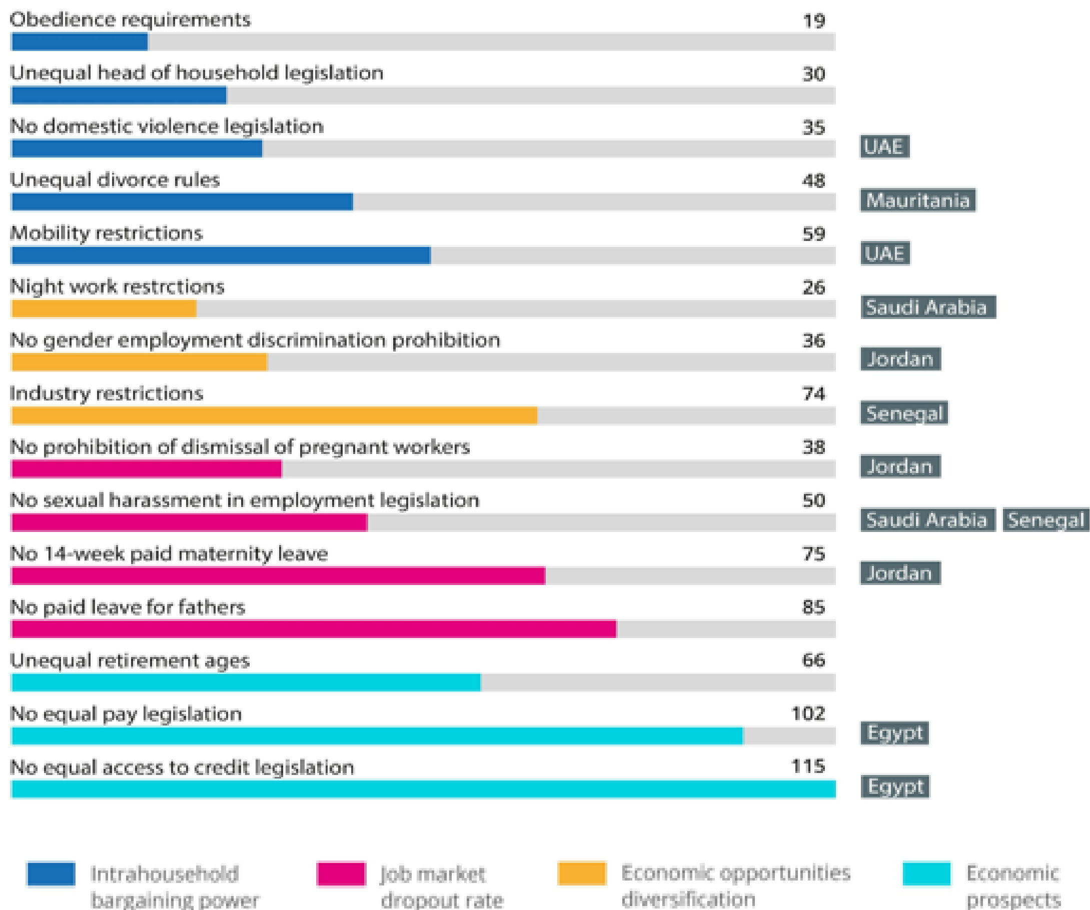

Figure 6: Laws and regulations on Women. Source: Women, Business and the Law, 2019 (WBG).

Conclusion and the way forward

In the current context of COVID-19, creating a sound business environment will be critical in ensuring recovery and reinstating investors' confidence.

In the medium to long term, the regulatory environment for businesses will influence how well firms cope in the COVID-19 crisis, and the extent to which they can seize opportunities when recovery begins. Where business regulations are predictable, efficient, and foster competition by creating a level playing field - and where institutions ensure the protection of property and contractual rights - it is easier for firms to start up, to adapt to new rules, and to reorient their economic activity to meet new market demands. The quality of the business environment also plays a critical role for foreign investment and local firms' integration into global value chains. Much of the empirical evidence suggests that improving efficiency of product market regulations, and the ease of doing business, both support economic recovery post-crisis. Many governments globally are already investing in such reforms to improve the business environment, in response to the COVID-19 crisis.

Economic crises can provide a political economy more favourable to systemic long-term regulatory reforms. The examples of Mexico and South Korea show that governments can use crises to implement structural regulatory reforms, to overhaul their approach to regulation, and to institutionalize the reform process. Governments may be able to similarly harness the COVID-19 crisis to implement such reforms.

Using a data-driven framework to assess areas of need and development gaps can help policymakers prioritize their actions. While the COVID-19 crisis has impacted almost all countries around the world, regional and country-specific challenges to respond vary. A data-driven framework, can provide initial insights by answering key questions, *e.g. How prepared are countries for the ongoing economic crisis and recovery? How much flexibility (e.g. fiscal, macroeconomic) do policymakers have to introduce short-term liquidity support measures? How great is the reach of support measures through formal channels, and to what extent are business regulations and institutions set up to support private sector recovery?* From there, opportunities for reform across regions can be identified.

There is an urgent need to close the digital divide. For policymakers, this will require both digitalising existing systems and simplifying processes. A regulatory overhaul is also necessary in some cases, as laws governing electronic documents and G2B and G2G transactions have to be introduced or updated. The good news for financially constrained governments is that the regulatory and legal reforms that lay the groundwork for RegTech solutions are comparatively inexpensive.

Another area for policymakers to consider when prioritizing their regulatory reform agenda is how to support the most vulnerable segments of the population, which also tend to be most impacted by COVID-19. For example, reforms can support greater women's participation in the

economy. If women have more bargaining power within the household, equality in access to finance, protection from violence, and equality in employment opportunities, they are better equipped to weather economic shocks, like the one from COVID-19, and participate in economic recovery.

Lastly, governments must ensure that contracts and property rights are enforced. Globally, debt resolution and insolvency cases are expected to rise. Already, SMEs (and particularly women-led firms), have been severely impacted by business closures due to COVID-19, so it is particularly important post-crisis that property rights and contracts are secure. Security of property rights and the contractual environment will also increase investor confidence.

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This material has been prepared for discussion purposes only. As such, the material should not be regarded as incorporating legal or investment advice, or providing any recommendation regarding its suitability for your purposes. Conclusions expressed in this report do not necessarily reflect the views of the DCED or its members.

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