

The Impact of the Business Environment on the Business Creation Process

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Abstract

New data from the 2008 *World Bank Group Entrepreneurship Survey* indicates a very strong and statistically significant relationship between entrepreneurship and a better business environment. Data for 100 countries on the number of total and newly registered corporations over an eight-year period (2000–2007) were collected directly from registrars of companies around the world. Data were also collected on the functioning and structure of business registries. Empirical evidence suggests that greater ease in starting a business and better governance are associated with increased entrepreneurial activity. After controlling for economic development (gross domestic product per capita), higher entrepreneurial activity is significantly associated with cheaper, more efficient business registration procedures

and better governance. Although the degree of progress in the modernization of business registries varies greatly, countries usually have a common goal to evolve from a paper-based business registry to a one-stop, automated, web-enabled registry capable of delivering products and services online via transactions involving authenticated users and documents. Tests show that business registry modernization (often a component of broader private sector reforms) has a positive impact not only on the ease of creating a business, but also on new business registration. Overall, the data show that a quick, efficient, and cost-effective business registration process is critical for fostering formal sector entrepreneurship.

This paper—a product of the Finance and Private Sector Team, Development Research Group, and Investment Climate Advisory Services Group—is part of a larger effort in the departments to study entrepreneurship. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at lklapper@worldbank.org.

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The Impact of the Business Environment on the Business Creation Process

by

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1. Introduction

Following the G20 summit on November 15, 2008, the leaders of the world's largest economies issued a statement explaining how they intended to restructure the world's economic architecture. On the very first page of this statement, they stated:

“Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.”

This statement highlights the relevance of entrepreneurship as a force behind economic development. It is therefore critical that governments be able to measure and understand the entrepreneurial activity of their countries. However, the mere concept of entrepreneurship, and how to measure it, still lacks a common language among scholars and academia.

The World Bank Entrepreneurship Survey (WBGES) was conceived to answer the demand of scholars and government for a reliable and internationally comparable indicator to measure entrepreneurial activity. In its third year, data for 100 countries were collected directly from the registrars of companies around the world on the number of total and newly registered corporations over an eight-year period (2000-2007).

The WBGES data continue to show that a good regulatory environment can boost entrepreneurial activity in developing countries. After controlling for economic development (GDP per capita), higher entrepreneurial activity is significantly associated with cheaper, more efficient business registration procedures (Doing Business, 2009) and better governance (Kaufmann and others, 2008).

The 2008 WBGES includes new data on the impact of modernization of business registries on business creation. It gathers extensive data on the functioning and structure of business registries in 71 countries from the registrar of companies. The data show that registry modernization is associated with shorter incorporation time and markedly lower cost of entry, thus reducing barriers to formal business formation and entrepreneurial activity, and relatively higher business entry rates. While the degree of progress in the modernization of business registries varies greatly, countries usually have a common goal

to evolve from a paper-based business registry to a one-stop, automated, web-enabled registry capable of delivering products and services online via transactions involving authenticated users and documents. Our tests show that business registry modernization (often a component of broader private sector reforms) has a positive impact not only on the ease of creating a business, but also on new business registration. Overall, the data show that a quick, efficient and cost-effective business registration process is critical to fostering formal sector entrepreneurship.

2. Methodology overview

The WBGES aims to understand the dynamics of private enterprises around the world through the collection of data on business creation at the international level that can be compared across heterogeneous legal, economic, and political systems. In order to make data comparable, the WBGES strives to define a unit of measurement, source of information, and concept of entrepreneurship applicable and available among the diverse countries surveyed. The definition of entrepreneurship used in the survey limits findings to the *formal sector*. This is because of the difficulties of quantifying the number of firms that compose the informal sector, and is no reflection on its relevance for developing economies. Moreover, previous literature highlights the potential advantages of formal sector participation, including police and judicial protection (and less vulnerability to corruption and the demand for bribes), access to formal credit institutions, the ability to use formal labor contracts, and greater access to foreign markets. Additionally, some firms that choose to stay informal might be unable to realize their full growth potential.

The WBGES data on formal business creation permit the study of regulatory, political, and macroeconomic institutional changes on entrepreneurship. The data also facilitate the analysis of the growth of the formal private sector, relative to the informal sector, and the identification of factors that encourage firms to begin operations in or transition to the formal sector.

While there are numerous established definitions for entrepreneurship, the concept still lacks a common language. Furthermore, many of the current definitions focus disproportionately on industrialized countries, highlighting the assumption of risks, innovation, and high growth as necessary characteristics of entrepreneurial activity. These characteristics are typical of entrepreneurship in industrialized countries, but might be difficult to measure in developing countries. Therefore, to make the data comparable across a large number of countries, the specific type of business measured is simply *the number of limited liability corporations*, or its equivalent in other legal systems.

The main sources of information for this study are the national business registries.¹ In a limited number of cases where the business registry was unable to provide the data—usually because they do not keep business registrations digitalized—the WBGES used alternative sources, such as statistical agencies, tax and labor agencies, chambers of commerce, and private vendors (such as Dun & Bradstreet). Given that business registration is the first step to entering the formal sector, the WBGES also gathered information on the registries' functioning and structure to better understand their role in the business creation process.

The collection process involved telephone interviews and email/fax correspondence with business registries in over 120 countries; 112 countries responded to the survey in 2008 and data from 101 countries was considered accurate and comparable according to the WBGES methodology.

The WBGES aims to provide an indicator of entrepreneurship based on an objective measure of business creation. Its nature makes the WBGES an appropriate indicator to measure the impact of regulatory, political, and macroeconomic institutional changes on the private sector, therefore becoming a valuable tool for policy making.

The data itself only provide a snapshot of the countries' business demographics, and cannot by itself explain the factors that affect the business creation circle. However, when the WBGES is combined with other data such as the *Doing Business Report*, Investment Climate Assessments, OECD Entrepreneurship Indicators, or the Global

¹ The complete database and list of sources is available at: <http://econ.worldbank.org/research/entrepreneurship>.

Entrepreneurship Monitor, researchers and policymakers can better understand the variables that affect the business creation process.

Despite effort to minimize disparities and make the data comparable across countries, certain limitations preclude a completely systematic analysis of entrepreneurial development. The following represent the most frequently faced problems in the process of gathering and processing the data:

- *Data availability.* Several countries were only able to provide data on newly registered companies—and not able to provide data on total registered companies—since recent registration information is stored electronically, but historical data was not digitalized. Some countries were excluded from this survey because they lacked tools or resources to measure business registration. For instance, some countries have decentralized business registries that make aggregation at the national level extremely difficult. In other cases, the data are archived only in paper format.
- *Limitations regarding data on firm closures.* Although approximately 80 percent of surveyed countries require businesses to report closures, only a few were actually able to report the number of business closures. The reasons differ from country to country, but are mainly due to the fact that the registrars generally have no enforcement mechanisms to compel businesses to report closures. In other cases, the number of closed businesses was reported may be imprecise because only a low percentage of reporting businesses. Although the number of closed companies is essential to paint a clear picture of the economic and entrepreneurial activities of a country, it is not yet feasible to obtain comparable data.

In this regard, while information on “active” companies—excluding closed or inoperative businesses—is sometimes available from national tax agencies and labor ministries, the research shows that only a low number of countries can actually provide this data. Therefore, it was decided to focus on the business registries. Yet, this is an important indicator of private sector activity for business registrars to measure.

- *Shell corporations.* Shell companies are defined as companies that are registered for tax purposes, but are not active businesses. These corporations do not fit into

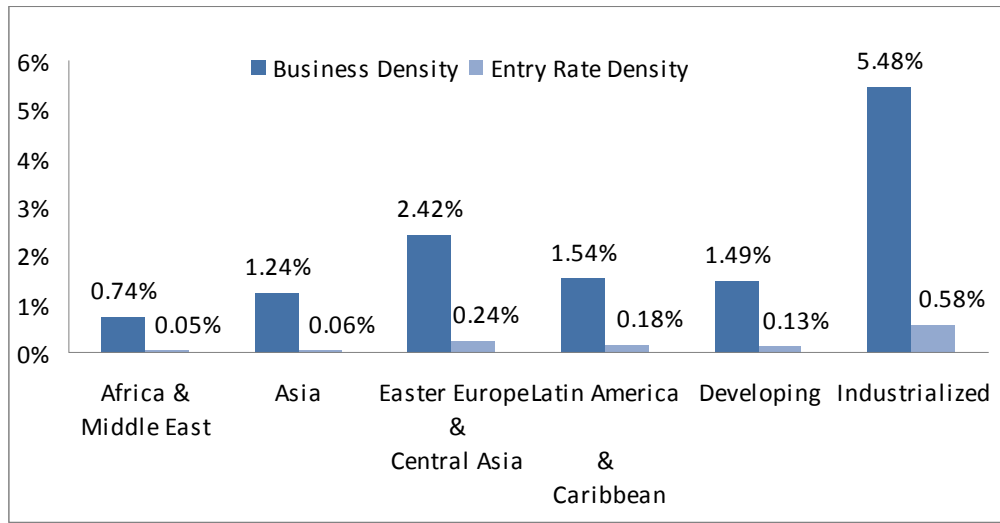
- *Diverse methodologies.* Some of the data collected by the WBGES 2008 might differ from official data published by individual countries. The reason for this is that local statistical agencies might use a different methodology. For instance, the European Statistical Agency (Eurostat) methodology is based on the minimum number of employees to measure entrepreneurship. As a result, in some cases the data published by Eurostat and the WBGES, while accurate in all cases, differs.

3. Data on new firm creation

The WBGES 2008 gathered data on the number of new and total businesses for 101 countries for the time period 2000 to 2008. In order to make this data comparable across countries, three different indicators were used, each displaying a different dimension of entrepreneurship (Figure 1):

- **Entry density rate:** This is the indicator used to measure new firms (those that were registered in the current year) as a percentage of working age population (ages 18-65). The data collected for 101 countries shows significant disparities across regions, ranging from 0.05% in Africa & the Middle East to 0.58% in industrialized countries.
- **Business density:** This is the indicator used to measure the number of businesses per capita. It is calculated as the number of total businesses (those that existed at the beginning of the given year) as a percentage of working age population (age 18-65). Similar to the entry rate density, this indicator shows a remarkable gap between industrialized countries, with an average of 5.48%, and developing countries, with an average of 1.39%.
- **Entry rate:** This is the indicator used to measure the number of new businesses as a proportion of existing businesses. It is calculated as newly registered firms as a percentage of total registered firms. The data collected for 100 countries shows that this indicator presents fewer disparities across regions, ranging from 6.6% to 10%.

Figure 1: Entrepreneurship around the world

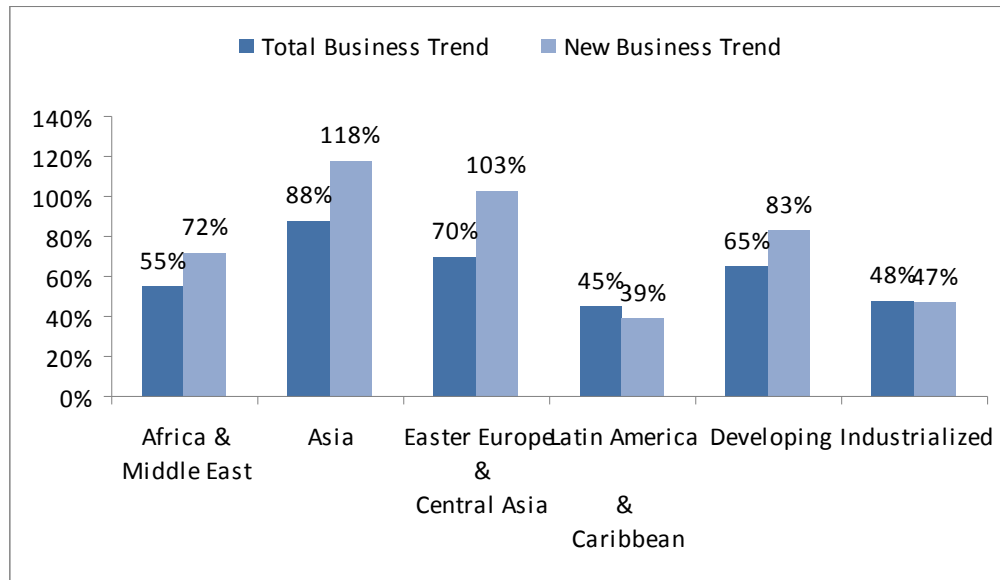


Source: 2008 World Bank Group Entrepreneurship Survey.

In addition to these indicators, the 2008 *WBGES* provides enough historical data to establish the trends in the number of new and total businesses in 100 countries during the eight year-period 2000 to 2008. In this regard, it is interesting to note that developing countries have a higher trend in both the number of total and new businesses, with some of the countries doubling their numbers during the period, whereas industrialized countries show little variation during the same period (Figure 2). Interestingly, the majority of the surveyed countries with a negative business growth were those that suffered a war, civil unrest or remarkable political instability during the eight-year period.²

² Such as Lebanon, Bosnia and Herzegovina and Haiti.

Figure 2: Entrepreneurship trends



Source: 2008 World Bank Group Entrepreneurship Survey.

3.1 The Impact of the Regulatory and Legal Environment

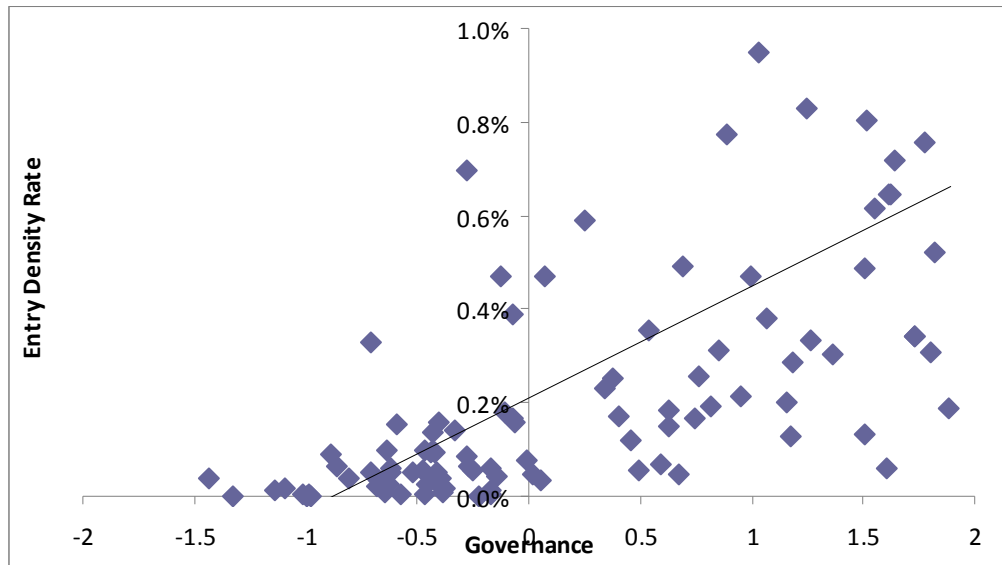
The WBGES data were merged with other variables measuring governance, political stability, the business environment, and the ease of registering a business. The data reveal interesting correlations, providing further evidence of the relevance of the regulatory and political environment in fostering entrepreneurship.

3.1.1 Governance

The WBGES 2008 data suggest that good governance and political stability are the first prerequisite to setting up a favorable business environment. The information collected reveals an inverse relationship between political risk and business creation, with countries with lower political risk having significant higher business entry rates.

For instance, using the average of the six Kaufmann Governance Indicators (Voice and accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption) to measure good governance, the data also shows a strong and significant relationship between higher business entry rates and better governance (Figure 3).

Figure 3: Relationship between governance and entrepreneurship



Source: 2008 World Bank Group Entrepreneurship Survey and Kauffman and others (2008).

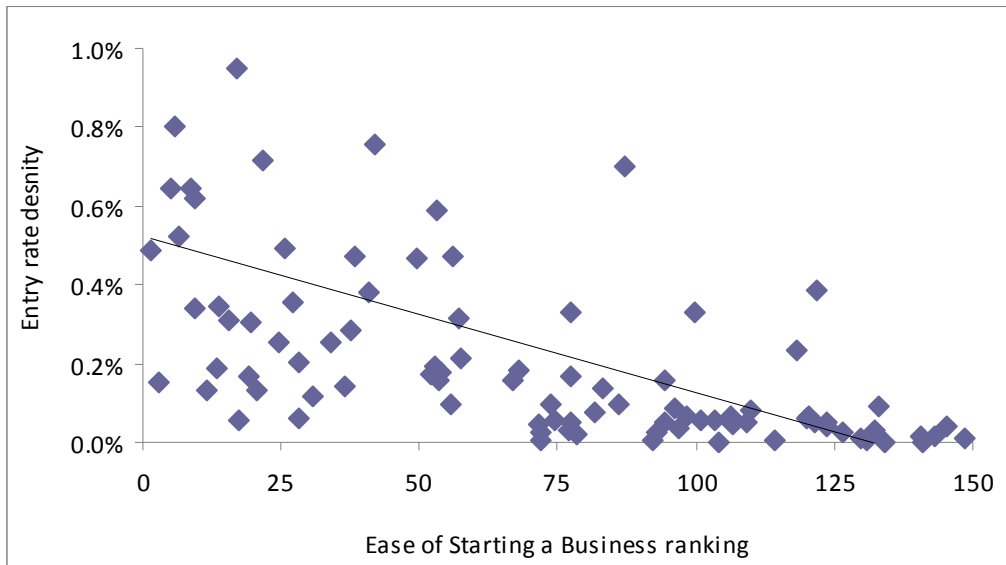
What is more, the majority of the surveyed countries with a negative business growth were those that suffered a war, civil unrest or remarkable political instability during the eight-year period (e.g. Lebanon, Bosnia Herzegovina and Haiti).

3.1.2 'Red-tape' reduction

The indicator used to measure the bureaucratic and legal hurdles an entrepreneur must overcome to incorporate and register a new firm is the "Ease of Starting a Business" indicator from the Doing Business Report. Unsurprisingly, the data shows a strong relation between a cheap and fast incorporation process as measured by the Ease of Starting a Business ranking, and the number of new businesses per capita (Figure 4).³

³ For additional discussion, see Klapper, Amit, and Guillem, 2008.

Figure 4: Relationship between the business environment and entrepreneurship



Source: 2008 World Bank Group Entrepreneurship Survey and Doing Business 2009.

Empirical tests show that the Doing Business and governance indicators significantly predict new business creation (Table 1). Our dependent variable is entry density rates, averaged over 2004-2007. Ordinary least square (OLS) regressions show a significantly positive relationship between economic development (as measured by GDP per capita) and new business creation. Even after controlling for economic development, we find a significantly positive negative relationship between the Doing Business (2009) 'Ease of Starting a Business' indicator (where 1 is the highest ranking), the number of procedures and cost of doing business, and average density rates. Furthermore, we find a significantly positive relationship between better governance (as measured by Kauffman, et al., 2008) and entry density rates. These results provide strong evidence of the relationship between better governance and business regulations and private sector development.

Table 1: The relationship between the business environment and entrepreneurship

The dependent variable in all regressions is average new density for 2004 to 2007. p-values are shown in parentheses. GDP per capita and one-year GDP growth rates are from WB-WDI statistics (2009). The ‘Starting a Business’ index (a lower number is a higher ranking), and the cost and number of procedures to start a business are from Doing Business (2009). The Governance Index is from Kauffman, et al. (2008). Asterisks *, **, and ***, indicate significance at the 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)
Log GDP per capita	0.0017*** [0.000]	0.0010*** [0.000]	0.0014*** [0.000]	0.0009*** [0.000]	0.0005 [0.186]
Log ‘Starting a Business’ Ranking		-0.0013*** [0.000]			
Cost of starting a business			-0.0008* [0.093]		
Log number of procedures to start a business				-0.0029*** [0.009]	
Governance Index					0.0018*** [0.004]
Constant	-0.0122*** [0.000]	-0.0013 [0.633]	-0.0100*** [0.000]	0.0003 [0.933]	-0.0019 [0.525]
Observations	99	97	97	97	99
R-squared	0.308	0.473	0.332	0.453	0.368

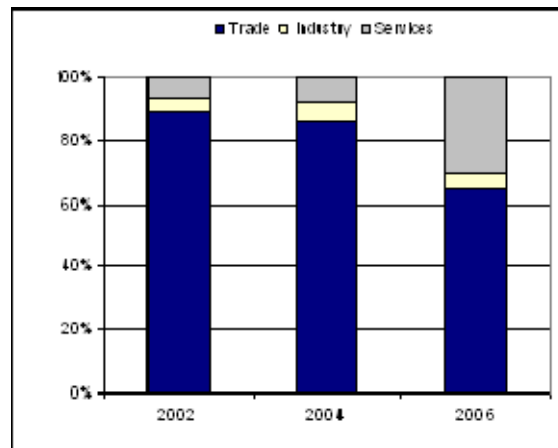
Georgia: The Impact of Reforms

The impact of regulatory reforms can be further assessed by studying Georgia, a top Doing Business reformer in 2007. For instance, beginning in 2004, Georgia undertook a series of dramatic regulatory reforms aimed to alleviate the excessive financial and administrative burden placed on entrepreneurs. The most important reforms included an unparalleled gradual elimination by 2006 of the minimum capital required to start a new business, as well as a reduction in the number of registration procedures from 9 in 2004 to 5 in 2006 and a reduction in the number of days required to register a business from 25 days in 2004 to 11 days in 2006. In addition, Georgia created ‘one-stop registration’ by delegating certain formalities such as tax and statistical registration to the company registrar. The impact of these progressive reforms – in combination with the significant simplification of the licensing regime and strengthening of investor protection

laws – led to an increase in business activity, as evidenced by the growth in the number of new businesses per capita.

Furthermore, as shown in Figure 5, a sectoral analysis of the dynamics of business registration indicates that this reform encouraged greater registration of companies working in the service sector. The large increase in the number of service-oriented firms, relative to trade and manufacturing firms, might indicate that this reform led not only to a larger absolute number of newly registered service-sector firms (from 103 in 2002 to 1,432 in 2006), but also encouraged informally operating service firms to transition to the formal sector.

Figure 5: Sectoral distribution, Georgia



Source: 2008 World Bank Group Entrepreneurship Survey.

3.1.3 Legal reform

In an effort to better understand the legal forms favored by entrepreneurs and its impact on the creation of new businesses, the WBGES collected data on the main characteristics of the three prevalent legal forms per country. However, given that legal forms cannot be accurately translated across different legal systems, each legal form was dissected according to the following characteristics: registration requirements, legal entity, minimum and maximum number of shareholders, liability, transferability of shares, possibility of “going public”, taxation and minimum capital requirements.

The data collected in 59 countries revealed that entrepreneurs tend to choose the simplest legal form available, usually one that requires only one shareholder and has low capital requirements. Yet, while these simplified legal forms might be adequate for single-employee establishments, they may not be suitable for the future growth of the business as they generally impose restrictions in the transferability of shares and cannot be publicly traded. Moreover, the data suggest that those countries that have more flexible legal business forms enjoy a higher entry rate density, with an average of 0.36%, than those that impose more requirements, such as limitations in the number of shareholders, with an average entry density of 0.15%.

It is also notable that the equivalents of Joint Stock Companies (more rigid and usually associated with bigger businesses) prevail in developing countries, while limited-liability corporations (LLCs) and sole proprietorships (more flexible and generally used by SMEs) dominate in industrialized countries. This fact does not entail that the average size of the businesses in developing countries is bigger, but rather that only the bigger business of these countries transition to the formal economy, while the equivalents of the LLCs and sole proprietorships (small and micro enterprises) in these countries tend to remain, unregistered and in the informal sector.

An analysis of the variety of legal business forms across countries suggests that industrialized countries have a rather homogeneous business regulation that share equivalent legal forms, as opposed to developing countries, where endemic business legal forms that do not have equivalents in other countries abound. Although we cannot rule out reverse causality – that greater private sector activity and higher levels of new firm creation lead to legal reform – the evidence suggests that more flexible legal regime encourage greater formal sector participation.

4. Data on business registry modernization

The first step for entrepreneurs joining or transitioning to the formal sector is to register their business at the registrar of companies. A modernized, quick, efficient, and cost-effective business registry is therefore critical to enabling

entrepreneurial activity and its business environment. Creating such a modernized business registry entails reforming inefficient or ineffective processes and automating the reformed registry.

The 2008 WBGES includes new data on the impact of modernization of business registries on business creation. The WBGES gathers extensive data on the functioning and structure of business registries in 71 countries directly from the registrars of companies. First, data were collected on the types of information firms are required to report to the registry, such as annual financial filings. Second, in order to assess the different degrees of automation of business registries, the survey collected information on the availability of electronic registration, which broadly includes the computerization of local registrars, the ability to register over the Internet, and electronic distribution of data via the Internet.

The findings show that while almost 80 percent of high- and upper-middle income countries require firms to file annual financial statements, only about half of lower-middle and low-income countries require their firms to do so. Moreover, while most countries have regulations compelling business to notify the business registry if the business ceases operations, few countries have mechanisms to enforce such an obligation. As a result, most developing countries do not have accurate records on businesses that have ceased to exist. Correcting such ineffective functions and automating a reformed business registry remain important tasks of business registry modernization in many developing countries.

The benefits are multi-fold. Both businesses and governments can see reduced transaction time and costs through proper streamlining of registry processes and removal of the hurdles of in-person visits. These efficiencies include the extension of service availability to 24 hours, 7 days a week through online transactions rather than traveling to a physical location and waiting in line; improving data quality and accuracy through reduction of human error, providing real-time access to registry updates; automatic verification of identities and roles; as well as facilitating anti-corruption efforts where needed by removing middle persons and providing full transparency of information. In Latvia, for example, reforming and automating the business registry reduced processing time of typical transactions from weeks to (with a rush-charge) four hours. In Bologna

(Italy), the electronic business registry reduced the average time for correcting errors (“suspended registrations”) from 10 days to a half day. The benefits of business registry reforms implemented during the last decade have led to web-based overtaking paper-based transactions in developed countries such as Italy (2003) and Denmark (2004). Advanced electronic business registries can also aggregate and analyze data, which can provide an important tool for market surveillance and business monitoring, such as for attracting foreign direct investment.

While the degree of progress in the modernization of business registries varies greatly, countries usually have a common goal to evolve from a paper-based business registry to a one-stop, automated, web-enabled registry capable of delivering products and services online via transactions involving authenticated users and documents. The implementation of such an electronic business registry has a positive impact not only in the ease of creating a business, but also in other aspects of the business cycle (Table 2).

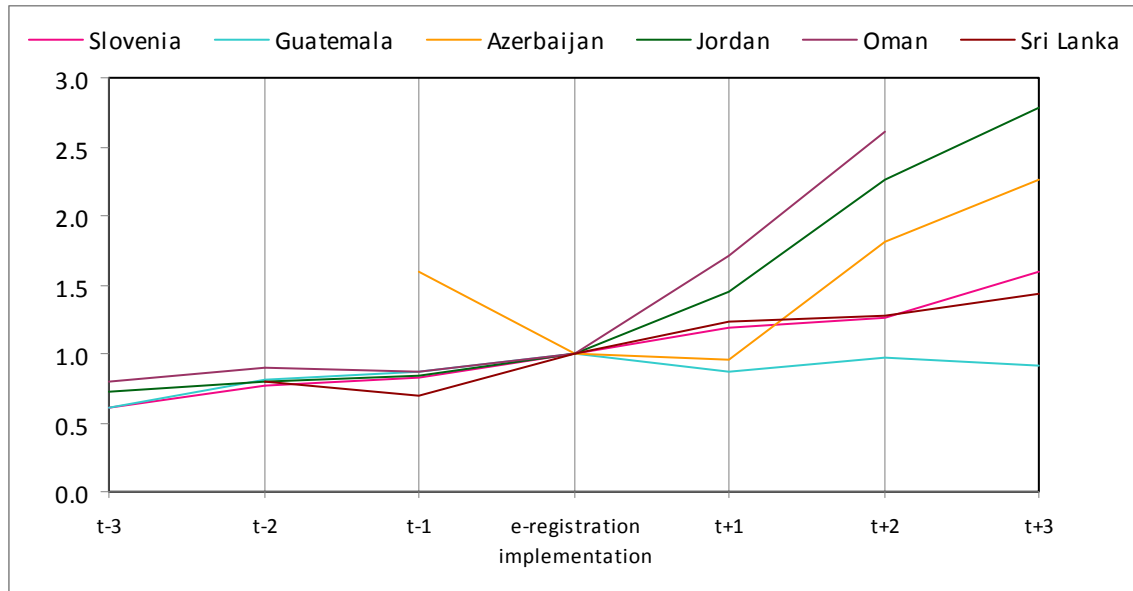
Table 2: Potential Uses of an Electronic Business Registry

Potential Users of an e-BR	Potential use of e-BR services:
A business owner registers a new business, lists the board of directors of his/her firm, makes changes to the business’s contact details, or files annual financial statements.
A loan approval officer at a financial institution confirms the financial health and history of a potential borrowing firm and owners.
A potential customer confirms information on the operations and management of the firm.
A potential supplier confirms the financial health of a potential buyer in making trade credit decisions.
A lawyer or notary signs in to validate information.
A government official (e.g. a tax, customs, pension, VAT or social security authority official)	... verifies a firm’s active business status.

Source: Lewin and others (2007)

The data collected by the WBGES 2008 suggest a relation between the implementation of electronic registration and an increase in the number of new businesses registered. Countries like Slovenia, Guatemala, Azerbaijan, Jordan, Oman, and Sri Lanka had increases of more than 30 percent in new density rates after the full implementation of electronic registries (Figure 6). These increases cannot be attributed solely to the improvements in the countries' business registries, but it can be stated that the modernization of their business registries was the culmination of a successful implementation of regulatory reforms when taken together, produced a significant and positive impact in the ease of doing business in these countries.

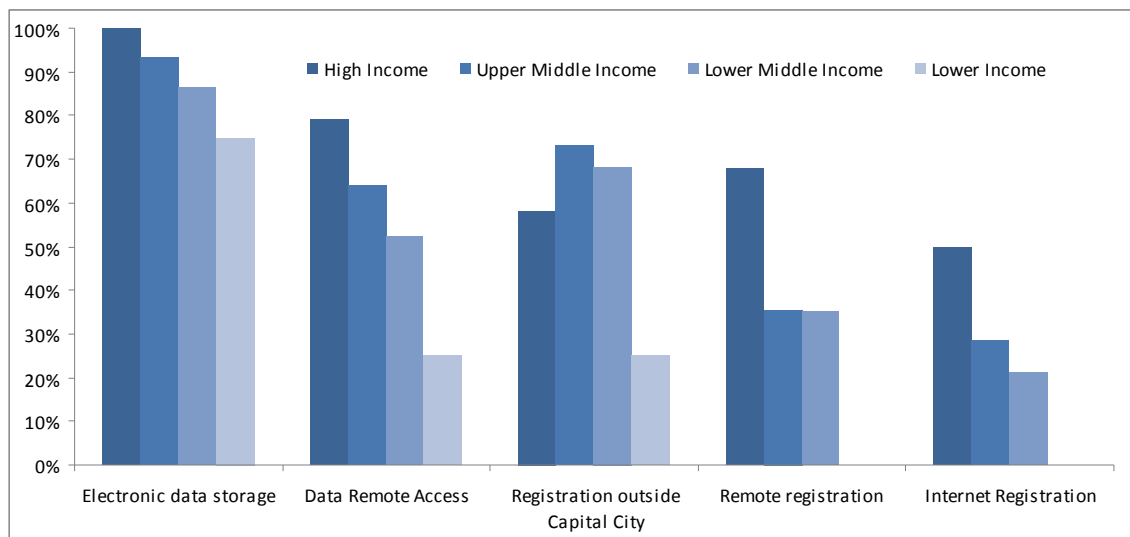
Figure 6: Impact of e-registration implementation



Source: 2008 World Bank Group Entrepreneurship Survey.

The data also show that the percentage of countries beginning the automation process (electronic data storage) is similar regardless of their stage of economic development (Figure 7). The differences begin to rise gradually in the next steps of the automatization process, resulting in a wide gap between industrialized and developing countries in the latter steps; for example, none of the low-income countries in the survey have implemented remote or internet registration, in comparison to 50 percent of high-income countries.

Figure 7: Business registration modernization



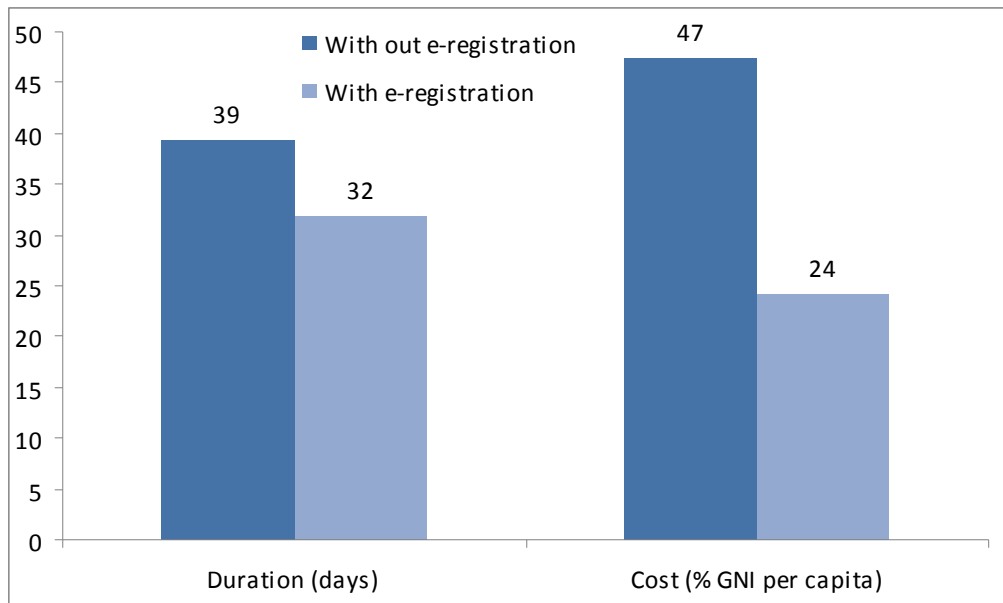
Source: 2008 World Bank Group Entrepreneurship Survey.

Multiple elements can achieve this goal. For example, registries in developing countries might start by offering entrepreneurs the ability to retrieve information on a web site (such as laws and regulations), download registration forms (but not necessarily to submit them on-line), and check available firm names. Governments may need to provide a centralized interface for a regional system, such as by merging local courts' business registries into a central registry database. Countries that already have a centralized registry but are still paper-based need to digitize historical and automate new data entries by using networked computers and online forms. Registries that are already automated need to implement secure, legal authentication methods, such as digital signatures, to remove the last vestiges of in-person or in-paper requirements. Registries that aim to benefit from further time and cost-savings would interlink the electronic business with other e-Government services, such as e-Tax, e-Customs or e-Procurement applications, for additional cost- and time-efficiencies for governments.

It is difficult to isolate the causality between the implementation of electronic registration, improvements in the business environment, and the creation of new businesses. Nevertheless, the data collected by the WBGES 2008 suggest that business registry modernization provides a more favorable business environment for starting a business and facilitates the business creation process. On average, countries with remote

registration (including internet, phone, and kiosks) require over 30 percent less time to start a business, and that costs are reduced by 50 percent, as measured by the Doing Business Report (Figure 8).

Figure 8: Impact of business registration modernization



Source: 2008 World Bank Group Entrepreneurship Survey and Doing Business 2009.

5. Conclusions

With new topics and broader coverage of developing countries, the 2008 World Bank Group Entrepreneurship Survey and future surveys will continue to support a deeper and more comprehensive understanding of conditions that can encourage entrepreneurship, as a policy tool to measure the impact of policy reforms to create new firms and stimulate economic growth.

The WBGES findings show that those countries with the highest business entry rates provide entrepreneurs with a stable political climate, good governance, modernized business registries, reduced red tape, and simplified business legal forms. Therefore, policy makers and governments should take these variables into account to better design, implement, monitor and evaluate policies and programs aimed to develop the private sector.

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