

# Administrative Barriers to Foreign Investment in Developing Countries

*Jacques Morisset*  
*Olivier Lumenga Neso*

The World Bank  
and  
International Finance Corporation  
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## Abstract

Recent international experience has shown that excessively complex administrative procedures required to establish and operate a business discourage inflows of foreign direct investment. Morisset and Lumenga Neso present a new database on the administrative costs faced by private investors in 32 developing countries. The database is much more comprehensive than the existing sources, as it contains not only information on general entry procedures, such as business and tax registration, but also captures regulation on land access, site development, import procedures, and inspections. The data include measures on the number of procedures, direct monetary costs, and time.

The cost of administrative procedures vary significantly across countries. The most important barriers appear to be the delays associated with securing

land access and obtaining building permits, which in several countries take more than two years. Countries that impose excessive administrative costs on entry tend to be equally intrusive in firm operations, thereby weakening the argument that barriers to entry are a substitute for the government's unwillingness or inability to regulate enterprise operations. The level of administrative costs is positively correlated with corruption incidence and exhibits a negative correlation with the quality of governance, degree of openness, and public wages. These correlations suggest that administrative reforms need to be incorporated into the broader agenda for reforms such as trade and financial liberalization, the fight against corruption, and public sector administration.

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This paper—a product of the Foreign Investment Advisory Service—is part of a larger effort to study the role of administrative barriers in the investment decision of private firms. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Monte Feghali, room I9-110, telephone 202-473-6177, fax 202-522-3262, email address [mfeghali@ifc.org](mailto:mfeghali@ifc.org). Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The authors may be contacted at [jmorisset@ifc.org](mailto:jmorisset@ifc.org) or [lumenganeso@hec.unige.ch](mailto:lumenganeso@hec.unige.ch). May 2002. (21 pages)

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# **ADMINISTRATIVE BARRIERS TO FOREIGN INVESTMENT IN DEVELOPING COUNTRIES\***

**Jacques Morisset<sup>§</sup>**  
**Olivier Lumenga Neso<sup>§§</sup>**

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<sup>§</sup> Foreign Investment Advisory Service (IFC and the World Bank), 1818 H street, Washington, DC 20433, USA; email: <jmorisset@ifc.org>.

<sup>§§</sup> University of Geneva, School of Business (HEC), 40, boulevard Pont d'arve, 1211 Geneva 4, Switzerland; email: <lumenhaneso@hec.unige.ch>.



## **I. Introduction**

Foreign direct investment (FDI) flows increased fivefold during the 1990s, reaching almost US\$250 billion by 2000. These flows, however, have been concentrated in a few countries with the world's top 30 host countries accounting for 95% and 90% of total FDI inflows and stocks (UNCTAD, 2001). The reasons for this concentration are multiple. Countries with large consumer markets and abundant natural endowments attract more multinational enterprises. The recent literature, e.g., Morisset (2000) has also demonstrated that the quality of the investment climate plays an important role in the location decision of many investors. There has been an increasing recognition that administrative procedures –and the costs and delays associated with them – can significantly influence the location of multinational firms and their resulting productivity (Dollar et al., 2001).

The role of administrative barriers has been investigated by Hernando de Soto in his seminal work on the negative impact of “red tape” on business activities. Time matters for investors – both foreign and local. A country where it takes excessive time and costs to accomplish all the procedures necessary to establish and operate a business will see its potential investors lose money and decide to locate elsewhere or cancel their investment projects. In spite of the relevance of this issue, there have been only a few attempts to quantify barriers in developing countries. The main reason for the lack of quantitative analysis is that information is difficult to compile since its collection requires first-hand experience and extensive interaction with government's officials.

The objective of this paper is to study the importance of administrative barriers in a set of 32 developing countries. The important contribution of this paper is that it provides a new database on the number of procedures, the delays and costs that investors have to face when they want to establish and operate a business. The database covers entry procedures such as business and tax registration and procedures required to access land, develop a site, connect to main utility services as well as a few operational procedures such as import or export. These last procedures have not been included in previous studies (e.g. Djankov et al., 2002 and World Competitiveness Report, 2001), even though they play a decisive role in the location decision of many foreign investors. Furthermore, the inclusion of operational procedures

allows us to examine the extent to which governments are intrusive after a company has been established.

This paper also attempts to explain cross-country variations in administrative costs faced by investors. By focusing on the bureaucratic, technological, and institutional aspects of the procedures, traditional policy recommendations have suggested eliminating duplicative documents or forms, establishing virtual networks or on-line registration as well as implement so-called “one-stop shops”. These recommendations, albeit useful, have generally failed to generate the expected results in most developing countries, suggesting that the origin of excessive administrative barriers lies in more fundamental factors. The role of governance, trade and financial openness, the political regime, public wages, and the legal system will be explored using simple correlations across countries. Our results suggest that administrative procedures should be viewed in a broader context than usually adopted by policymakers and advisors.

The paper is organized as follows. Section 1 discusses the definition and role of administrative barriers. Section 2 provides information on the database including sources of information and assumptions used in constructing the series as well as its limitations. Section 3 describes the basic results and compares them across countries and regions. Section 4 studies the reasons why countries have different set of administrative barriers. Lastly, section 5 concludes by a brief summary and four directions for future research.

## **II. What Are Administrative Procedures?**

Administrative procedures exist in all countries. Indeed, it is legitimate for governments to control or even screen for some activities and investors who are going to install on their territory. Many reasons explain the presence of these procedures. Authorities have generally advanced arguments such as security, protection of the environment, health protection, and quality control. The economic literature has justified government’s intervention in the public interest theory of regulation developed by Pigou (1939). In short, government regulation reduces or eliminates market failures, therefore raising global public utility.<sup>1</sup>

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<sup>1</sup> For fuller details, see Djankov et al. (2002).

Still, countries significantly differ in the ways in which they regulate business entry and operations. Excessive regulation, can lead to substantial delays and costs to firms that may decide to locate elsewhere or operate in the informal sector. The lost revenues can lead to a sub-optimal equilibrium and lower public utility. Along these lines, the public choice theory has argued that regulations can be captured by bureaucrats and politicians or by existing industries, which are able to keep out their competitors (Stigler, 1969; Shleifer and Vishny, 1993). In both ways, the overall social utility is reduced at the benefit of a few privileged groups.

It is difficult to identify when regulation is excessive. The approach followed in this paper is to compare current practices in a set of 32 developing countries by identifying 26 core administrative procedures that are generally required to set up and operate a business. These key procedures allow comparisons across countries. For simplicity, we grouped them into three principal categories, which are briefly described below (while each procedure is presented in Table 1).

*Entry Approvals.* For a foreign investor, entry starts with legal, statistical, labor, pension, and fiscal registration. Often, the investor also applies for fiscal incentives. The requirements and background documentation for these procedures vary significantly across countries depending on their institutional and legal frameworks. Some countries have been able to simplify these steps by using one application form, one identification number, or one agency (the so called “one-stop-shop”),<sup>2</sup> while others have retained a more diffuse process.

*Access to land, site development, and utility connections.* Subsequent to entry registration, or sometimes in parallel to it, the investor has to secure land access as well as develop his business site and connection to main utilities. Land ownership is a sensitive issue, especially in Africa (local communities) and in Eastern and Central Europe. For this reason, the investor will often lease land from the government rather purchase it. Both alternatives are considered in our paper. The process of buying or leasing land can be lengthy and expensive, since it involves multiple state agencies and sometimes the approval of local communities. Once an investor has secured land, his next regulatory challenge is to obtain permits, generally from the local authorities, for site and building developments. Those

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<sup>2</sup> For fuller details, see L. Wells (1992).

generally require pre-approvals, multiple site inspections, (health, security, labor, etc.) and final approvals. Lastly, the investor has to secure connections to key utilities, such as electricity and telephones.

**Table 1a: Summary of administrative procedures**

	<b>Categories</b>
<b>A</b>	<b>ENTRY APPROVALS</b>
1	Company registration
2	Investment Code Registration
3	Initial Bank Deposit
4	Residence and Working Permit
5	Tax Office Registration
6	Foreign Investment Licensing
7	Business and Trading Permit
8	Statistical Office Registration
9	Existence, Conformity, Opening Reporting
10	Health Care & Pension Plans
11	Social Security Registration
<b>B</b>	<b>LAND, SITE DEVELOPMENT, UTILITY</b>
12	Access to Land (State Land)
13	Town Planning Certificate
14	Site Inspections and General Approvals
15	Building Permits
16	Electricity and power connection
17	Telephone and Telex
18	Water and Sewerage
19	Post, Box and Private Bag
<b>C</b>	<b>OPERATIONAL REQUIREMENTS</b>
20	Import-Export Intention and Permits
21	Import-Export Clearance Process
22	Foreign Exchange Controls
23	Fiscal Situation Certificate (Quitus)
24	Health and Safety Inspections
25	Labor Inspections
26	Social Welfare Plan Payments

*Operational requirements.* The last set of procedures consists of operational requirements that the investor has to fulfill when operating his business. The main requirements included in this paper consist of import-export procedures, foreign exchange controls, tax and social security payments, as well as labor and health inspections. These



operational requirements, especially for import-export, are fundamental for enterprises that interact with foreign markets.

We believe that these three categories, which include 26 separate core administrative procedures, provide a sufficiently broad basis for a cross-country comparison. We chose to avoid sector-specific procedures and other procedures such as environment assessment that differ significantly in their concept across countries. Nevertheless, it is worth noting that we cover more procedures than previous studies, which have focused on the general entry approvals (see for example Djankov et al., 2002) or building permits (Bertrand and Kramaz (2001)). By including land access and utility connection, we extend the analysis to procedures that are sources of important delays in most countries and, thus, are likely to influence significantly the investment decision of private enterprises. Furthermore, the data on operational procedures allow us to examine to what extent governments are intrusive on both entry and operations. This distinction is interesting since it can be argued that some governments choose to impose a higher burden on entry because they are unable or unwilling to regulate operating enterprises.

### **III. Sources and Methodology**

Our database covers 32 developing countries, including 20 African and 7 Eastern and Central Europe countries with by alphabetical order (the year of the data collection is in parenthesis): Argentina (1999), Armenia (2000), Bulgaria (2000), Burkina Faso (2000), Chile (1999), Czech Republic (1999), Egypt (1999), Ghana (1995), India (1999), Jordan (1998), Kenya (1999), Latvia (1999), Lesotho (1997), Lithuania (1999), Madagascar (1998), Malawi (2000), Mali (1998), Mauritania (1999), Morocco (1999), Mozambique (1996), Nigeria (2001), Romania (2000), Slovenia (2000), Senegal (1999), South Africa (1999), Swaziland (1997), Tanzania (1997), Tunisia (1999), Turkey (2001), Uganda (1997), Zambia (1999), Zimbabwe (1999). Focusing on developing countries ensures a degree of homogeneity in terms of institutional and legal development as well technological and administrative capacity. A comparison with industrial countries, while useful, would capture significant differences between countries not necessarily related to administrative procedures but rather to their level of economic development.<sup>3</sup>

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<sup>3</sup> For example, business registration is only a mouse click away from investors in most industrial countries thanks to the development of on-line registration. Such instrument is not readily available in the majority of

The two main sources are reports from the Foreign Investment Advisory Service (FIAS) and the United States Agency for International Development (USAID). These two agencies have collected the necessary information through official documents and interviews with focused groups such as private investors, government agencies, as well as private accounting and legal firms. These interviews should not be viewed as systematic surveys since they do not cover a large sample of users and regulators. Moreover, it has to be recognized that the quality of information varies across reports and countries. In most reports, the main objective was not to quantify administrative procedures but rather to identify issues and develop recommendations for the relevant authorities. Moreover, some procedures have not been systematically reviewed in every country, as the focus of each report depended on the interest expressed by the authorities. Whenever possible, the data on entry approvals were complemented by those collected in Djankov et al (2002).

For each country of our sample, the data were collected at one point in time, between 1997 and 2001 (with the exception of Ghana and Mozambique). The collection dates are sufficiently close to permit a comparison across countries. We report the number of official steps for each of the identified procedures as well as their time and costs. The number of steps indicates the number of documents and institutions for each procedure. For example, business registration may involve successively the Register of Commerce, the Ministry of Finance, and the Ministry of Trade and Industry (without accounting for notary services). The time or delay associated to each procedure provides a proxy for the investor's opportunity costs. When possible, time is defined as the real time spent by the investors, rather than official requirements. We ignore the time spent to gather information, and assume that all investors know all procedures from the very beginning. Lastly, the monetary expenses reveal the direct official fees to obtain forms, fiscal stamps, and so on. We do not consider costs that are paid to support private services such as notary fees and legal services and do not account for bribes. These three reporting methods provide complementary information.

We also report the total administrative costs—defined as the sum of time and out of pocket monetary fees—faced by private investors in each country. When an enterprise invests in one

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developing countries because of limited human and financial resources as well as poor communication infrastructure.

country, both the aggregate time and direct monetary costs spent in the administrative process matter in the decision. To calculate total administrative costs, the main difficulty is to convert time into monetary costs. For simplicity, we distinguish between local and foreign investors but assume that all investors have the same utility function and that all projects have the same size.<sup>4</sup> We then convert time into monetary costs by considering that for each business day spent in the administrative process, the foreign investor has a daily opportunity cost equivalent to the average daily income per capita in OECD countries (which account for over 85% of FDI outflows worldwide). Alternatively, the local investor's opportunity cost is equivalent to the average income per capita in his country.<sup>5</sup> We further assume that the local investor follows simplified procedures since it does not need to obtain immigration and residence permits as well as the "foreign investment" approval, which is still in use in some sample countries.<sup>6</sup>

In every country, the number of procedures, time and monetary costs vary significantly not only across industries, but also with firms' characteristics such as size, ownership and legal status. For this reason, our approach has been to consider a "standardized" firm with the following main characteristics: it performs general industrial or commercial activities, it operates in the largest city by population (mainly countries capitals), it is exempt from industry-specific requirements, it does participate in foreign trade, it employs expatriates and a total of 20-50 employees, it purchases or leases State land<sup>7</sup>, it is connected to 10 phone lines and uses on average 100 kWh of electricity during peak hours (and half otherwise), and it is a limited liability company with a initial capital of US\$10,000.<sup>8</sup> Furthermore, if a range of delays or costs were reported, we used the median. If costs were reported in US dollars, we register them directly. When, however, they were in local currency, we converted them to U.S. dollars using that year's end exchange rate. By using a standardized company, we

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<sup>4</sup> As explained below, we assume that one standardized firm makes all investments.

<sup>5</sup> For local investors, we have followed the same approach than Djankov et al. (2002). It has to be noted that the opportunity costs is likely to be underestimated because the revenue from local investors is certainly higher than the average in each country.

<sup>6</sup> In reality, additional differences are likely to exist because local investors are more familiar with the system and with the government's officials that are foreign foreigners. In a recent paper, Smarzynska and Wei (2000) have shown that foreign investment under the form of joint ventures is more likely to occur with complex and long administrative procedures. In other words, they have shown that administrative barriers influence FDI ownership composition as foreign investors look for local partners in a complex and lengthy administrative system.

<sup>7</sup> The value of land is equal to 50 % of the initial capital, the renting price of land 10 % of the capital. We set the superficies of the land at 1'000 square meters with 60 % of them being used or covered.

<sup>8</sup> The amount of US\$10,000 has been retained for two reasons. First, it is close to the average minimum required capital in most African countries and, second, it is not far from the figures chosen by Djankov et al (2002) and, thus, facilitates the comparison.

exclude potential information about the variability of the procedures, which also influences the location decision of investors.

A word of caution might be necessary, especially when trying to interpret cumulative figures. First, the database does not report the cumulative time that the investor will spend in dealing with all procedures. Some of them can be realized simultaneously, while others can only be initiated after others have been achieved. A second limitation is that the database does not report how often a business has to face operational procedures, like for example for import-export activity. By contrast, entry registration procedures have to be realized only once – when the company attempts to establish in the country. Lastly, it is important to note that missing data do not necessarily mean that the procedure does not exist in the country. Rather, it may indicate that we did not find any information in the sources used for this study.

#### **IV. Cross Country Comparison: Basic Results**

The data reveal considerable variations in the number of administrative procedures as well as the time and monetary costs associated to them across countries. Still, in almost all countries, the aggregate costs appear sufficient to explain why investors are influenced in their decision and may decide to circumvent administrative procedures by locating elsewhere or remaining in the non-official economy. The overall results for every country are summarized in Table 2, while data for each individual procedure are available upon request. Below is a review of the basic results in terms of number of steps, time and monetary costs, followed by a comparison of the total administrative costs faced by local and foreign investors, respectively, in each country of our sample.

A closer look at the number of procedures emphasizes that the second category (access to land) requires the largest number of steps, up to 125 in Turkey (when the land is purchased from the State).<sup>9</sup> Among this category, the site inspections and approvals by local authorities are the main barriers, followed by building permits. Operational requirements consist on average of more procedures than entry registration (11.3 versus 10.6), especially in Africa where import-export permits and processes as well as health and safety inspections generate many administrative steps (up to 15 in Nigeria for only import-export). The number of

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<sup>9</sup> Contrary to most countries included in our sample, Turkey has an extensive and active market for private land. In that case, the delays associated to administrative procedures would have been much shorter than those reported for purchasing State land.

procedures also varies significantly across countries, even for simple procedures such as company registration ranging from 1 (in Ghana, Senegal, or Uganda) to 7 or 8 in Burkina Faso and Bulgaria.

**Table 2: Summary of Main Results per Country**

	Number of procedures			Time (number of business days)			Monetary Cost (US \$)		
	Entry	Land, Site	Operations	Entry	Land, Site	Operations	Entry	Land, Site	Operations
Argentina	13			47			763		
Armenia	13	45	10	59	131	15	84	4414	75
Bulgaria	29	40	19	157	545		291	233	
Burkina Faso	14			29			655		
Chile	9			26			620		
Czech	11			65			447		
Egypt	10			52			943		
Ghana	8	19	12	34	255	30	338	2940	202
India	9			39			261		
Jordan	15	36	12	60	89			11281	
Kenya	10	22	10	51	70	39	397	3975	2282
Latvia	17	19		114			367	5885	
Lesotho	2	19	8	61	341	122	120	154	
Lithuania	10	22	9	36	166		139	1550	
Madagascar	11	15		171	375	8	80	47	
Malawi	10	30	2	46	413	20	470	562	10
Mali	9	27	13	79	170		154	2696	250
Mauritania	11		10	54			328		3186
Morocco	12	16	5	91	278	63	255	1149	1981
Mozambique	8	34	13	106	625		143	11045	
Nigeria	8	23	26	18	210	30	176	13750	809
Romania	10	42		50	584		154	22523	
Senegal	11	25	10	96	228	40	801	1847	51
Slovenia	12	30	7	30	45		2895		
South Africa	6			23			158		
Swaziland	10	13	8	53	117	20	391	4006	200
Tanzania	19	25	18	187	795	45	3040	508	12
Tunisia	7			39			286		
Turkey	22	125	8	121	985		304		
Uganda	9	24	14	69	495	70	607	1520	
Zambia	6			29			124		
Zimbabwe	6	21	10	85	90	30	352	4379	13
Average	11	31	11	68	334	41	504	4723	756
Minimum	2	13	2	18	45	8	80	47	10
Maximum	29	125	26	187	985	122	3040	22523	3186

Note: Missing data means that the information was neither available nor applicable in the country.

The investors spend considerable time in administrative procedures with enormous variations across countries (Table 1). Data on individual countries indicate that the longest delay is found in Turkey (1106 business days), followed by Mozambique (731), Bulgaria (702 days), and Romania (634 days). The most important delays arise from land (purchase from the state) and site development procedures, especially permits and inspections from local authorities that appear relatively little efficient in processing the investors' requests. It is noteworthy that, in spite of recent trade liberalization efforts, import-export permits and clearance processes are still extremely time-consuming in Africa, averaging almost 47 business days (with a maximum delay of 63 days in Morocco) and exceed significantly the time spent in other regions. In most countries, general entry approvals appears less time consuming than other procedures, with the notable exception of residence and working permits that can generate delays above 2 months in Bulgaria or Tanzania.

The direct official monetary costs exceed US\$10,000 in 3 countries of our sample (Romania, Nigeria, and Mozambique), but remain relatively low in absolute values in the majority of the countries. They are however relatively high when they are compared to the average income per capita in most countries, especially in Africa where most investments are from micro-enterprises. By far, the procedures associated to land access are the most expensive in most countries, averaging over US\$1,500, followed by building permits (especially in Africa), and some utility connection (electricity in Romania). Among the operational procedures, import-export processes can require payments over US\$1,000 in Morocco, Nigeria, and Mauritania. Finally, general entry approvals can require payment over US\$1,000 in Senegal and Slovenia but are almost free in Malawi, Madagascar, and Argentina. Among these procedures, immigration and working permits are generally the most expensive.

The aggregate time and fees spent by local and foreign investors are presented in Table 3, where countries are ranked in ascending order. It has to be noted that we used the two series normalized by the number of procedures to minimize the bias introduced by difference in the information reported in each country. The ranking per country indicates that Zambia, Madagascar, and India are relatively inexpensive for their local investors, in contrast to Romania, Jordan, Slovenia, and Nigeria. The total administrative costs for foreign investors are relatively low in South Africa, Zambia, and Chile, but can exceed US\$5,000 per procedure in Turkey, Mozambique and Romania. The variations in the aggregate costs

between worst and best performers seem sufficient to explain FDI patterns across countries. These variations can also be interpreted as the maximum bribes for circumventing or accelerating the administrative approval process in every country. Although the investor can establish elsewhere or operate in the non-official economy, it would be equivalent for him to pay, *ceteris paribus*, these extra amounts (per procedure) for release from regulation. The positive correlation between administrative costs and bribes has been advanced by the “tollbooth” theory and will be explored further in the next section.

**Table 3: Total costs per procedure (in US\$) a/**

FOR LOCAL INVESTORS		FOR FOREIGN INVESTORS	
Madagascar	48	Zambia	417
India	83	Chile	470
Lesotho	85	Burkina Faso	517
Malawi	100	Tunisia	576
South Africa	101	Argentina	639
Tunisia	105	Egypt	727
Burkina Faso	135	Czech	869
Chile	168	India	974
Uganda	196	Mauritania	1221
Senegal	201	Latvia	1229
Egypt	214	Kenya	1318
Czech	243	Armenia	1366
Tanzania	246	Swaziland	1560
Mali	255	Senegal	1784
Ghana	257	Lithuania	1850
Argentina	319	Ghana	1884
Armenia	326	Zimbabwe	2098
Morocco	395	Mali	2172
Zimbabwe	402	Slovenia	2363
Bulgaria	405	Lesotho	2605
Swaziland	443	Morocco	2650
Kenya	444	Malawi	2703
Lithuania	449	Uganda	2733
Mauritania	512	Jordan	2941
Latvia	540	Nigeria	3343
Turkey	832	Madagascar	3452
Mozambique	1070	Tanzania	4756
Nigeria	1365	Bulgaria	6023
Slovenia	1535	Romania	6207
Jordan	1945	Turkey	6480
Romania	2530	Mozambique	6695

Note: a/ Total costs are defined as delays (converted into monetary costs) plus direct costs associated to administrative procedures in each country. Delays have been converted into monetary costs assuming that opportunity costs for local investors are equal to the number of days multiplied by the daily GDP per capita in the country. b/ For foreign investors, we used the daily average GDP per capital in OECD countries.

The ranking per country differs significantly for local and foreign investors. The explanation is that time is relatively more valuable for foreign investors, who have higher opportunity costs. Time or delays account for about 80 percent of their total costs, while they are only equivalent to 30 percent of total costs for local investors. This difference may reflect that foreigners are less likely to accept long delays as they are used to best practices in industrial countries.

We conclude this section by exploring a few patterns from the data. First, it appears that the countries with the highest number of procedures are not necessarily the ones with the longest delays or greatest monetary costs.<sup>10</sup> For example, Latvia has many more procedures than Nigeria but a greater capacity to deal efficiently with them.<sup>11</sup> It is therefore possible that the number of steps reflects the public interest theory through which the government protect its citizen, while delays and costs can be viewed as a rough indicator of the government's capacity or willingness to respond to investors' requests (the public choice theory).

Another insight from the data is that governments are likely to impose high barriers on entry and operations simultaneously, weakening the argument that entry procedures are a substitute for the government's inability or unwillingness to interfere with operating enterprises. Our data show relatively high positive correlation coefficients between entry and operational procedures, in terms of number of steps (0.21), time (0.58) and direct costs (0.60).

## **V. Administrative barriers: Why?**

There are many possible explanations to why the costs of administrative barriers vary so much across countries. If most advisers have focused on the bureaucratic, technological and institutional aspects of administrative procedures, this focus has failed to generate significant progress in most countries. We believe that the reasons for this lack of success are rooted in the fundamental features of each country. Therefore, we propose to explore to what extent the

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<sup>10</sup> For example, Nigeria does have a reasonable number of procedures compared to other African countries, and delays are relatively short, but costs exceed 3 to 4 times those identified in Senegal, Mali, and Ghana.

<sup>11</sup> The relatively low positive correlation coefficients between the number of steps and the associated time (equal to 0.49) and between the number of steps and monetary costs (0.16) suggest that that these variables may capture different motivations from governments. Note that Djankov et al, found higher correlation coefficients in their study, with a different sample of countries and by normalizing costs and delays with the average income per capita in each country.



variations in administrative costs are explained by structural factors such as the political regime, the corruption level, the degree of openness, the public sector wage policy, and the legal system in use in each country of our sample. Including these factors should allow us to better understand the success and failures of governments in their efforts to streamlining these administrative barriers.

In the absence of a precise analytical model underlying the factors determining administrative costs, the basic variables for our analysis were selected on the basis of the existing literature. At the outset, it is useful to note that we voluntarily focus on the public choice theory of regulation by retaining the aggregated administrative costs faced by investors, rather the number of procedures, as the variable that we want to explain across countries.<sup>12</sup> We alternatively use the aggregate costs faced by local and foreign investors as reported in Table 3. Controlling for the level of development is crucial and so we divided the costs by GDP per capita in each country. Not only is it expected that costs are strongly and positively correlated to economic development but also that, without income controls, our political and institutional variables may be no more than proxies for income levels.<sup>13</sup> In making this adjustment, we also follow Djankov et al. (2002).

The selection of the basic variables, which has been partly driven by the availability of data in our sample of countries, is provided below. The level of *corruption* or the lack of good *governance* is expected to influence the administrative costs as bureaucrats and politicians are more likely to capture the extra rents. Corruption can be both the cause and the consequence of high administrative barriers. While we recognize this double causality, we privilege the explanation that it is easier for government to reduce or remove administrative procedures than to alter the extent of corruption in the country.<sup>14</sup> Along the same lines, it can be argued the *degree of political freedom* affects the capacity of bureaucrats or incumbent enterprises to exploit rents derived from administrative procedures. In a despotic regime, rents are more likely to be captured by interest or political groups that have more opportunities to exploit market failures.

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<sup>12</sup> Our departure from the public interest theories of regulation is mainly justified by the difficulty to capture this argument with quantifiable explanatory variables. Nevertheless, for such an approach, see Djankov et al (2002). These authors conclude in favor of the public choice over the public interest theories of regulation.

<sup>13</sup> For example administrative capacity is lower in poor countries.

<sup>14</sup> See Bai and Wei (2001) for a similar approach with capital controls.

The inclusion of the degree of *trade or financial openness* can be justified on the grounds that administrative costs are lower in an open country. The process of liberalizing forces the policymakers to address a number of vested political interests, including those of bureaucrats, which may in turn lead to a decline in administrative costs (see Wei 2000 for a fuller explanation). We include the level of public wage following the argument that low paid bureaucrats are more likely to capture extra rent by raising administrative costs. To the extent that the government's objective in screening investors is partially the result of the existing *legal framework*, it is relevant to examine its impact on administrative costs. Finally, *regional patterns* may reflect differences in cultural factors or mentalities, which in turn affect the way through which governments regulate private companies entry and operations.

In order to test empirically the relationship between total administrative costs and the above variables, we decided to not proceed with cross-country regressions but rather with simple a correlation analysis for three main reasons.<sup>15</sup> First, we cannot solve easily the endogeneity problems between administrative costs and several explanatory variables because of the lack of observations and, consequently, degrees of freedom.<sup>16</sup> For example, as discussed earlier, corruption can be the cause or be the cause of high administrative costs. Second, it is also possible that both the political variables and administrative costs are simultaneously determined by some deeper historical or cultural factors. Finally, there exist some multicollinearity problems between variables (e.g., political freedom and corruption are highly correlated) which can biased the estimated results. Although the correlation analysis can only give us indications on the basic relationships between variables, it aims at motivating and providing directions for future research.

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<sup>15</sup> Upon request, the results of simple OLS regressions are available. They do not differ in their direction from the correlation coefficients presented in Table 4.

<sup>16</sup> Moreover, our sample of countries is relatively small and does not cover one single reference year.

**Table 4: Correlation Coefficients (all variables in logs)**

	Total Administrative Cost per Procedure over GDP	Total Administrative Cost per Procedure over GDP
	Local Investor	Foreign Investor
Corruption	-0.62	-0.61
Governance	-0.59	-0.60
Political Freedom	0.40	0.36
Trade/GDP	-0.04	-0.03
FDI/GDP	-0.18	-0.12
Openness Index	-0.59	-0.70
Average Wage	-0.36	-0.54
African countries	0.34	0.52
Anglo-Saxon Legal Origin	0.17	0.24

Sources::

The Transparency International Index measures corruption, while governance was captured by the scores compiled by Kauffman, Kray, and Zoido-Lobaton (2001). The degree of freedom in each country is defined by the Freedom House, which rates the levels of political rights and civil liberties worldwide (a low score indicates more political freedom). The degree of openness has been defined using the ratio of trade over GDP, the ratio of FDI over GDP, and the overall indicator developed by the Fraser Institute (which includes an evaluation of property rights, capital and exchange rate controls, price stability, and structure of commercial flows). Since we were unable to obtain consistent data on public wages, we used instead the average salary in each country reported in the ILO Yearbook and various World Bank's publications. We classify countries based on the origin of their commercial laws, distinguishing by a dummy variable between Continental and Anglo-Saxon systems. Finally, countries are separated between African and non-African countries, using a second dummy variable.

The most interesting aspect of the empirical findings is that they emphasize the difficulty to reduce administrative costs in corrupt and closed economies. Reformers will have to face the resistance of both the middle-level bureaucrats and incumbent enterprises. As expected, the negative correlation coefficient between administrative costs and corruption (as well as governance) indicates that high levels of corruption are associated with higher administrative costs and longer delays for investors. The estimated coefficient indicates that the better the country is ranked in the Transparency database, the lower are the administrative costs faced by investors. In a country with widespread bureaucratic corruption, the government loses the ability to collect fiscal revenues from formal tax channels and, as a consequence, it has to rely increasingly on the otherwise inefficient and distortionary administrative procedures to

finance the provision of public goods<sup>17</sup>. It is only when the level of corruption is significantly reduced, or tax collection improved, that administrative costs could be reduced significantly. It has to be noted that we found that the costs associated with administrative barriers are lower in a free political regime, confirming that politicians and bureaucrats have fewer opportunities to capture extra rents.<sup>18</sup>

The positive correlation coefficient between financial openness and administrative costs suggests why protected incumbent firms may resist lower entry barriers. In relatively closed economies, high administrative costs are likely to protect incumbent enterprises from new entrant that might compete with them.<sup>19</sup> The causality can of course operate in two ways since lower administrative barriers will in turn encourage FDI and, thus, create a virtuous circle. It has to be noted that the trade openness index (as measured by the ratio of trade over GDP) was not correlated significantly with the cross-country variations in administrative costs.

The other results can be briefly commented. Average salaries do influence administrative costs, thus supporting the argument that low paid bureaucrats are less assiduous in dealing with investors' requests. Note, however, that we used the average wage in each country (rather than the average public wage), so that our estimated coefficient may not capture properly this relationship. The origin of the legal system may influence the administrative costs since countries with a Anglo-Saxon legal system appear to have higher administrative costs..<sup>20</sup> Similarly, African countries seem to have higher administrative costs.

## **VI. Conclusion and What Next**

This paper uses administrative regulation data collected in 32 developing countries to show that governments impose significant administrative costs on firms that want to establish and operate in their country. While some procedures are necessary, others are not and their costs vary considerably across countries. The ranking has shown that administrative costs faced by

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<sup>17</sup> Or more precisely, the marginal costs of collecting tax revenues rises with the level of corruption (see Bai and Wei (2001)).

<sup>18</sup> Djankov et al. found a similar positive correlation with other proxy of political freedom such as political rights and efficiency of the judiciary system. In fact, most political variables are highly correlated and it does not matter so much which variable is used in the regressions.

<sup>19</sup> See Hoekman, Kee, and Olarreaga (2001) for some empirical evidence.

<sup>20</sup> It is possible that administrative costs and corruption are determined jointly by the origin of the legal system.

foreign investors are the lowest in South Africa, Zambia, and Chile, while they are highest in Mozambique, Turkey, and Romania. The variance between the best and worst performer is extremely high, as the average cost per procedure is more than 10 times higher in Mozambique than in South Africa.

The main conclusions of the paper are the access to land and site development are the sources of longest delays in most countries, followed by operational requirements for import-export, especially in Africa. Although business registration appears not so costly relative to land access and site development, there is a wide dispersion across countries. There are no systematic positive correlation between the number of procedures and their costs (both monetary and in time), suggesting that the number captures the governments' willingness to protect their citizen (the public interest theory of regulation), while costs may reflect the ability of a few privileged groups to capture those rents (the "public choice" theory). Finally, the high and positive correlation between administrative costs on entry and operations suggests that governments are equally intrusive before and after the enterprises is established, thus weaken the argument that entry regulation is a substitute for operational requirements.

When policy advisers attempt to reduce excessive red tape, they generally address administrative, technological, and institutional issues. Their emphasis on the administrative aspect is justified because complex and redundant procedures are often the result of unnecessary forms, signatures, and documents. Technology can also provide a useful tool by linking together agencies via virtual networks and, thus, facilitating the relations not only between investors and government's officials but also within the public administration. Finally, there has been a strong push towards institutional reforms –most notably in favor of the so-called one-stop-shop.

The traditional recommendations are important, but far from sufficient. Given our results, it is not surprising that recent efforts aimed at streamlining administrative barriers have failed to bring the expected results. This limited success has been explained by the lack of coordinated effort across the public sector and the resistance from middle-level bureaucrats, who may prefer to maintain the status quo. Last but not least, it often involves changing mentalities and behaviors, which takes time and prolonged actions as well as strong political commitment. Our analysis has shown that rationalizing administrative procedures is a difficult task. Administrative costs reflect more profound characteristics of each country. Countries with

higher corruption levels, lower quality of governance, lower degree of financial openness, and lower public wages are more likely to have higher administrative costs. It seems that administrative reforms must be incorporated in broader reforms, such as trade and financial liberalization, corruption and public sector reforms.

There are at least four directions for future research. The first direction consists of improving data and inputs. Not only the quality of the data needs to be improved for the countries included in this study, but it would also be especially useful to expand the number of countries by including Latin American and East Asian countries. The second direction would be to use the database for identifying best practices and helping governments in their efforts to set up targets and monitor progress over time. This effort would need to account for the legal and institutional framework in each country, beyond the quantitative approach followed in this paper. The third direction would be to go one step further in the understanding of the causes behind the variations in administrative costs by giving, for example, further attention to the eventual role of institutions such as “one-stop shops” or “enterprises networks” that have been implemented in various countries, sometimes with success. Finally, the fourth direction would be to examine the impact of administrative costs on investment decisions and on firms’ productivity. A first indication of this impact can be derived from the estimated elasticity reported in our correlation analysis: for every 10 percentage point decrease in the administrative costs (as perceived by foreign investors and in percentage of GDP), the ratio of FDI over GDP rises by about 1.2 percentage points. This empirical result should be interpreted with caution but is indicative of the significant positive impact that a reduction in administrative cost may produce on foreign direct investment. It should provide a motivation for future research.

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