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# IFC SmartLessons

*real experiences, real development*

## Art or Science? Measuring the Impact of Business Environment Reforms at the Subnational Level

As the Western Balkan economies look toward integration into the European Union, each is striving to increase its competitiveness and improve its economic growth. Considerable momentum has been developing on business enabling environment (BEE) reform. Since 2005, four countries—Albania, Croatia, Macedonia, and Serbia—have been recognized as Top-10 reformers by the global Doing Business report. However, there is still much work to be done. The overall Doing Business rankings for the countries in this region are in the third and fourth quartiles for 2009, showing plenty of room for improvement. Investors identified improvements in regulations affecting businesses as a key priority for upgrading the business enabling environment in the region (Figure 1).

In this SmartLesson, we share our experience of adapting the Standard Cost Model to review regulations and measure impact in supporting BEE reforms at the sub-national level in Bosnia and Herzegovina, Montenegro, and Serbia. We have adapted a relatively sophisticated tool, and applied it to support BEE reforms to: (1) measure the impact of the reforms in terms of cost savings for businesses; (2) help drive the reform agenda by enabling

policymakers to build stakeholder support and target reforms recognizing that “what gets measured, gets done”; and, (3) support our regional monitoring and evaluation framework.

### *New Approach for BEE Reform in the Western Balkans*

Since 1995, IFC has been providing investment climate advice in this region, assisting our clients by, among other things, introducing new tools to systematically address the impediments to doing business, reduce the cost of doing business, and improve the quality of regulations affecting business activities. We developed a series of national and subnational projects that introduced systemic reforms to: 1) clean up the stock of regulations affecting business start-up and operation, using primarily the guillotine review of regulations; and 2) improve the flow of regulations by implementing processes to maintain the quality and consistency of those affecting businesses, by using the regulatory impact assessment tool. This approach is particularly important in the Balkans, where the stock of regulations and business formalities (administrative procedures, licenses, permits,

and so on) consists of layers of regulations, some predating the Yugoslav Republic. Information on these regulations and administrative requirements is often not readily accessible. This situation increases business risk and the cost of compliance due to limited access to information, lack of transparency, uneven interpretation and application of the regulations, and discretionary authority.

In particular, we adapted and applied the international

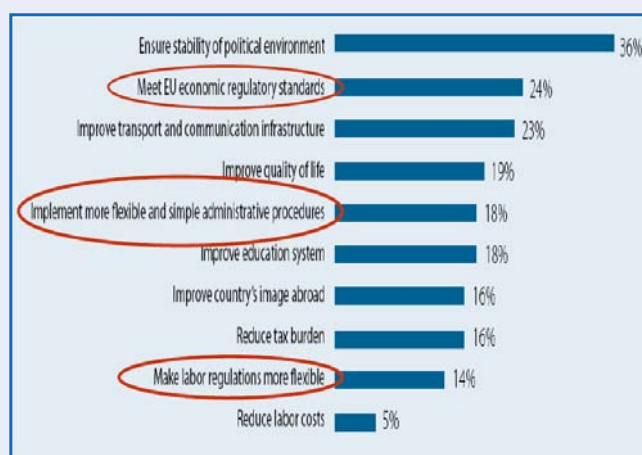


Figure 1: Business constraints as reported by investors in Southeast Europe.

Standard Cost Model, an integral pillar of the guillotine review of regulations, to the subnational level in several countries, including Bosnia and Herzegovina, Montenegro, and Serbia<sup>1</sup>. This adaptation of the SCM, referred to as the Balkan SCM, is part of an integrated monitoring and evaluation (M&E) framework.<sup>2</sup> Moreover, rather than apply this measurement simply as an internal or donor monitoring tool, we integrated it into the reform process and technology, providing for our clients an important metric for setting targets, establishing accountability, and engaging with the business community and other stakeholders to implement and sustain this important reform agenda. We engaged international experts and clients during the process of adapting this model and held a regional SCM workshop in Podgorica in October 2008.<sup>3</sup>

### What is the Standard Cost Model?

First developed in the Netherlands, and currently applied in most developed countries, the SCM is a method for determining the administrative burdens imposed on businesses by regulation. This activity-based measurement breaks down regulation into a range of manageable components that can be measured. The SCM does not focus on the policy objectives of each regulation, but rather measures only the administrative costs incurred by businesses in complying with regulations (highlighted in Figure 2). In adapting this tool, we simplified and minimized the detailed data requirements and categories of activities for the model, tailoring them to local administrative regulations and procedures.

### What do we measure in the Balkan SCM?

The Balkan SCM goes beyond the international SCM practice of measuring the cost of information obligations<sup>4</sup> in the following ways:

- *To reflect the realities investors face in the field, it captures the **actual direct costs** borne by businesses in complying with the regulations, requirements, and administrative procedures imposed by public authorities. Therefore, we apply the concept of the business formality (see box) as a basis for quantifying and monetizing the costs incurred by business. The cost of compliance with a formality includes not only administrative costs but also fees and waiting time.*
- *The Balkan SCM quantifies and monetizes the **indirect costs** incurred by businesses in complying with business formalities. In developing and transition economies, the burden of waiting for authorities' responses and other "red tape" is one of the most significant compliance costs of regulations. It opens huge opportunities for corruption and "speed money," and immobilizes capital that could have been invested elsewhere. Moreover, this cost is often disproportionately borne by small and medium enterprises—the majority of businesses operating*

1 This model is also being applied in BEE reform projects in several other regions including Central Asia and Africa.

2 This M&E framework is developed in collaboration with the IFC Advisory Services Results Measurement Unit.

3 The second annual Regional BEE Reform Network Conference, Podgorica 2008. <http://www.fias.net/ifcext/fias.nsf/Content/RegionalConferenceinSouthEastEuropeOctober2008>.

4 These are obligations arising from regulations to provide information and data to the public sector and third parties.



Andre Nijsen: reputedly the "Father" of the SCM, explains the model to regional clients and staff, April 2009.

*at the local level and an important generator of growth for these economies. Since this is a significant burden on business, we adapted the SCM by monetizing<sup>5</sup>—albeit roughly and indirectly—an "opportunity cost" of investment income forgone while waiting for authorizations.*

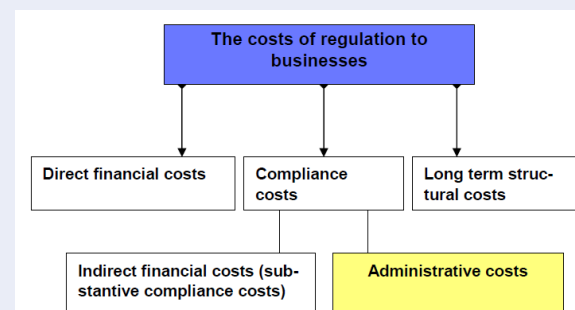
The Balkan SCM measures four key cost components:

- **Submission time:** monetization of the time invested in gathering information and preparing forms for submission
- **Fees and stamp:** duties required for each formality
- **Documentation:** amount of expenditures required to acquire and prepare supporting documents (data requirements)
- **Waiting time:** This includes: 1) time to receive or obtain supporting documents from the issuing authorities (submission time), and 2) time to receive a response from the relevant authorities after submitting the required paperwork

It is important to note two key assumptions of the model:

- 1) All registered businesses comply fully with all formalities;
- and 2) costs related to corruption, including unofficial

Figure 2. The International SCM Methodology



5 The basic formula used to estimate the waiting time savings is:  $OS = DS \cdot GPI \cdot I$ , where OS is the opportunity saving, DS is the aggregate number of days saved in the regulatory reform process, GPI is the average gross investment (by small and medium enterprises) in the country in the past five years, and I is the daily interest rate.

speed payments, cannot be reliably estimated or tracked for this model. Separate tools exist (outside of the SCM approach) for measuring the impact of corruption on compliance costs.

### **How is the Balkan SCM used?**

The Balkan SCM is used as part of a guillotine review of regulations, which systematically reviews the stock of business formalities to determine which ones should be eliminated or amended to increase transparency and consistency, and ultimately reduce the cost and risk of doing business. First, it is applied after the inventory of formalities is completed to measure the baseline costs incurred by businesses. In subsequent phases of the stock review, it is integrated into the registry of formalities to: 1) provide estimates of the changes in costs as a result of recommendations for reforms; 2) calculate the cost of formalities after the implementation and validation of the reforms; and 3) calculate the cost savings generated by the reforms.

### **Lessons from the Balkan SCM**

Two sets of lessons are emerging from our use of the Balkan SCM to measure the impact of regulatory reforms at the local level: 1) the “art” of adapting sophisticated tools to make them scaleable and replicable in challenging situations; and 2) the importance of measurement tools in building support and momentum for reforms and in targeting reforms.

#### **1) Using focus groups for data collection and validation improves flexibility and saves money.**

The baseline costs are compiled on the basis of information provided by regulators and public authorities as well as the private sector. In addition, primary and secondary data are collected regarding:

- *Official information on the costs, frequency, and coverage of formalities from national, city, and municipal governments*
- *Economic and labor statistics from national and subnational official statistics departments; and quantitative and qualitative information on formalities, compliance costs, and time (from focus groups with selected businesses, business associations, citizens who are required to comply with the inventoried formalities, and intermediaries such as third-party service providers of professional and technical services to businesses).*

The data are validated through a rigorous process of review, analysis, and confirmation by stakeholders and experts. Gathering reliable and accurate data is therefore critical for the successful application of the Balkan SCM. We have effectively used focus groups (with business owners, business associations, and intermediaries) to collect and validate data inputs for the Balkan SCM. Focus groups provide a cheaper and more flexible instrument for collecting and validating data, as compared to firm-level surveys, for example. This is particularly important at the

subnational level, where firm-level surveys are expensive—in both cost and time—and where it is difficult to draw robust samples for municipalities through national-level surveys.

In addition to the cost of large firm-level surveys, there is the issue of survey fatigue and low response rates when surveys are conducted too frequently. As noted by the OECD<sup>6</sup>, “Opinion surveys of businesses are, in particular, susceptible to the business cycle. Poor company performance may induce managers to respond to opinion surveys in a negative fashion.” However, putting together and facilitating focus groups constitute both a science and an art. Our initial efforts to conduct focus groups met with mixed results. We learned that extensive local networking and partnering with the local business associations were essential for building trust, increasing the number of participants, and improving the quality of the participation. Firms and entrepreneurs have to be assured that they will not be penalized for frank feedback, and they need to know what’s in it for them. In addition to data collection and validation, focus groups have been useful for “taking the temperature” of the business climate and proactively identifying emerging issues of concern for businesses, in a cost effective way.

#### **2) Build support for reforms: “What gets measured, gets done.”**

By incorporating into the reform process the measurement of the costs associated with implementing or complying with business formalities, we provide our clients with a language and metric for articulating the importance and scope of the reforms. This enables our champions and mayors to explain more concretely—not only to stakeholders but also to their public administration—how the burdens imposed on businesses by regulations limit investors’ productive capacities and resources for investment. This is an intuitive but powerful argument in localities where industries died off during the transition and there are significant levels of unemployment and excess capacity. The mayor of Vranje, Serbia, explained this best during a recent conference in Belgrade when he said that by going through the process of reviewing the formalities and measuring the time and cost of compliance, city officials now understand in concrete monetary terms how reforms to formalities and business procedures can impact business and, ultimately, their decisions on where to invest. Mr. Azdejkovic, Mayor of the City of Krusevac, added that one of the most important benefits of this work is the changing mindset of officials, improving governance and accountability, and the shifting to a more service orient culture as officials recognize the “costs” imposed by poor regulations and excessive requirements.

#### **3) Target “high-value” formalities for reform.**

It is generally difficult to attribute changes in levels of employment or gross domestic product (GDP) directly to regulatory reforms. However, using the Balkan SCM, we can calculate the costs of the formalities and the savings generated by firms as a result of such reforms as reductions

<sup>6</sup> Organisation for Economic Co-operation and Development.

in fees or waiting time and streamlined procedures. Since the baseline provides a fairly rigorous estimate of the cost of complying with specific formalities, it is possible to target “high-value” formalities for reform. Despite the risk of bias, focusing on reforms with high opportunity costs (waiting time), and perhaps avoiding procedural reforms, is a potentially powerful tool for setting priorities and allocating resources to implement reforms in areas where there is potential for the greatest impact. We are using this more targeted approach based on an 80/20 rule—meaning that we focus the review and reforms on the 20 percent of the regulations that, according to international experience, account for roughly 80 percent of the administrative compliance costs. We are applying this approach in three municipalities in Montenegro as well as for the second round of municipalities in Bosnia and Herzegovina and Serbia. Our goal is to push for deeper reforms to improve governance and fiscal accountability by focusing the discussion and the importance of avoiding the use of regulations and fees as extra-budgetary mechanisms for financing the bureaucracy.

## Conclusion

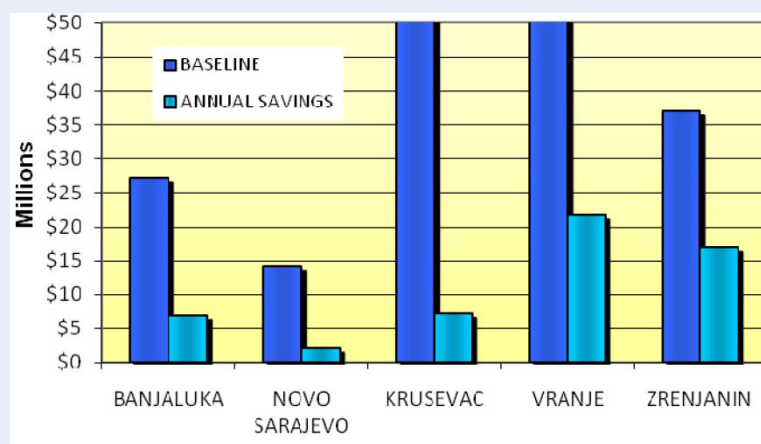
We successfully adapted for the subnational level a relatively sophisticated tool that has been applied to drive the national-level administrative simplification agenda in Western countries such as the Netherlands. To date, five municipalities in Bosnia and Herzegovina and Serbia have completed detailed inventories and reviews of more than 1,000 formalities, and have implemented legal and operational changes in 90 percent of those formalities. Many of the amendments relate to reductions in the time required to comply with formalities and resolve requests

for information and approvals or permits. Based on the reforms actually implemented and randomly verified, the estimated direct and indirect cost savings to firms is approximately \$50 million annually. The “bang for the buck” ratio (of cost savings generated to project costs) is almost 50 to 1.

We achieved this ratio by reducing the number and types of activities covered by the international SCM, applying the measurement to formalities (not just information obligations) with which firms are required to comply, and including the indirect costs of complying with the formalities, thereby focusing on the regulatory and compliance issues faced by the countries in the region. Where robust firm-level survey data were not available, we used alternative sources of data and focus groups. We successfully transferred to our clients the technology for the Balkan SCM, a relatively low-cost tool, and are building their capacity to continue applying this tool to review the impact of regulations affecting businesses.

Finally, it should be noted that the Balkan SCM is just one of a combination of measurement tools that are being applied in the region to assess the impact of reforms. A preliminary comparison of the results from a firm-level survey, the Balkan SCM, and the subnational Doing Business Study in Bosnia and Herzegovina is showing an encouraging trend in the convergence of the results produced by these tools. This analytical exercise is ongoing for Bosnia and Herzegovina and Serbia.

Figure 3. Baseline Cost of Formalities and Ex-Post Annual Savings Generated.



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