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viewpoint

Entrepreneurship

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How Much Does the Business Environment Matter?

Entrepreneurship is important for the continued dynamism of modern economies and for job creation. Policymakers need to know how new firms get started and what financial and institutional factors promote entrepreneurial activity. A new cross-country, time-series data set shows a strong correlation between entrepreneurship and the quality of the legal and regulatory environment, ease of access to finance, and prevalence of informality. This finding tells policymakers what they can do to promote entrepreneurship.

Efforts to measure entrepreneurship at the global level have focused mostly on the industrial world or on specific regions. To address this gap, a new World Bank Group study collected annual data on the total number of firms in each of 95 countries and on the number of new firms in 63 countries (box 1).[1] These data, by establishing an international comparison of entrepreneurship, can help answer these questions:

- Is entrepreneurship an indicator of economic development?
- What is the relationship between entrepreneurship and economic growth?
- Can the business environment foster entrepreneurship? If yes, which of its dimensions are important?

The study defines entrepreneurship as the effort an individual or group of individuals makes to initiate an economic activity under a legal form of business within the formal sector. This working definition helped in developing a methodology applicable in all countries and in making the data comparable across diverse legal and economic systems.

Business density and new entry

The first step in the analysis is to calculate business density, defined as the number of registered firms as a percentage of the active population (those ages 15–64), and the entry rate, defined as new firms (those that were registered in the current year) as a percentage of total registered firms. The entry rate is the key indicator of entrepreneurship. All data in this analysis are for year-end 2003.

On average, the analysis finds about 50 businesses for every 1,000 active individuals. Business density ranges from less than 1 percent in many low-income African countries to 23 percent in Australia. Entry rates range from less

Box 1 What the study and the data set cover

The entrepreneurship study is limited to enterprises registered in the formal sector. To preserve consistency, it used as its primary data source business registries in the countries surveyed. Alternative sources such as tax authorities, finance ministries, and national statistical offices also occasionally provided information. The data were collected for as many years as available between 1990 and 2003.

Despite the large number of countries participating in the survey, some issues preclude a complete analysis of entrepreneurial development. For example, some countries were excluded from the survey even though they collect data on enterprise creation—simply because they lack the tools or resources to process the data or because the data are archived in decentralized facilities or paper format.

In addition, not all registered firms are economically active, requiring the study to cope with a systematic measurement error in the data set. Low-income countries tend to have the least accurate data on closed firms and as a result may overreport total firms (including more registered but inactive firms) relative to higher-income countries. And many high-income countries might overreport total registrations (including shell and other inactive companies established for tax purposes).

The study also collected information on the disclosure requirements for registered firms. About 65 percent of countries require corporations to submit annual financial statements. Almost 90 percent require all firms to report closures, though enforcement of this requirement is reportedly weak. A few countries, such as Denmark, maintain active registries that annually confirm that registered firms are still operating. This type of mechanism improves the integrity of the data and their usefulness for creditors and business partners.

than 5 percent in India and Pakistan to almost 20 percent in Germany, New Zealand, and the United Kingdom.

At a regional level, the highest business density is found in industrial countries and the transition economies of Europe and Central Asia (figure 1). The lowest is in the low- and middle-income countries of the Middle East, Africa, and Asia. Industrial countries also had the highest entry rates in 2003, averaging more than 10 percent. Interestingly, mean entry rates are consistently about 7–8 percent across developing countries.

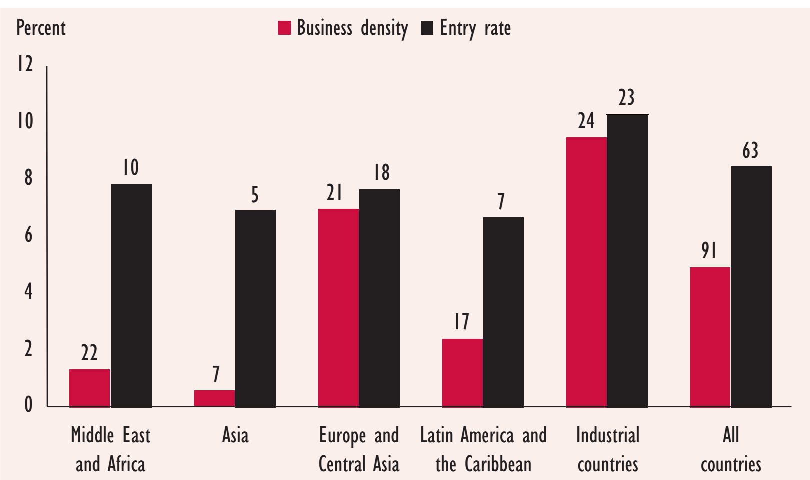
Business density varies widely across country income groups, ranging from less than 1 percent on average in low-income countries to almost 10 percent in high-income countries (figure 2). Entry rates show less variation by income level. Still, greater entrepreneurship appears to be associated with higher income levels.

Importance of the business environment

Several results highlight the importance of the business environment for the growth and development of businesses. Barriers to starting a business are significantly and negatively correlated with business density and the entry rate. For example, the fewer the procedures required to start a business, the greater the number of registered firms—and the higher the entry rate (figures 3 and 4).

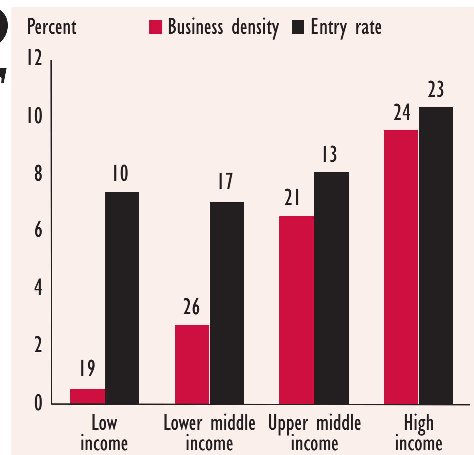
There is also a significant relationship between the cost of starting a business (as a percentage of gross national income, or GNI) and business density and the entry rate (not shown).[2] For example, for every 10 percentage point decrease in entry costs, density and the entry rate increase by about 1 percentage point.[3]

Figure 1 Business density and entry rate by region, 2003



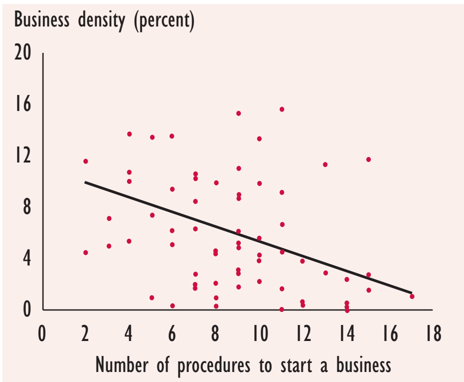
Note: The numbers above the bars are the countries in each region for which data are shown.
Source: World Bank Group Entrepreneurship Database.

Figure 2 Business density and entry rate by country income group, 2003



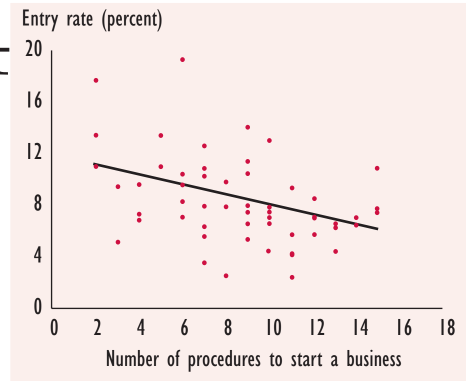
Note: The numbers above the bars are the countries in each income group for which data are shown.
Source: World Bank Group Entrepreneurship Database.

Figure 3 Density and number of procedures to start a business, 2003



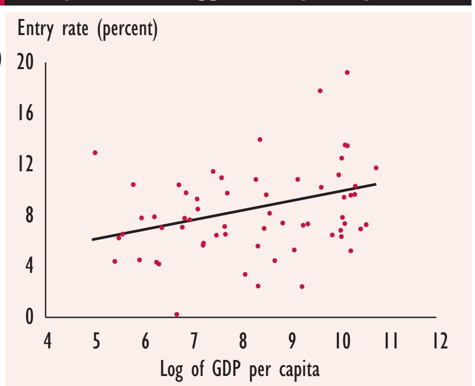
Note: Coefficient = −0.006, *p*-value = 0.000, *R* = 0.21, N = 88.
Source: World Bank Group Entrepreneurship Database; World Bank Group 2005.

Figure 4 Entry rate and number of procedures to start a business, 2003



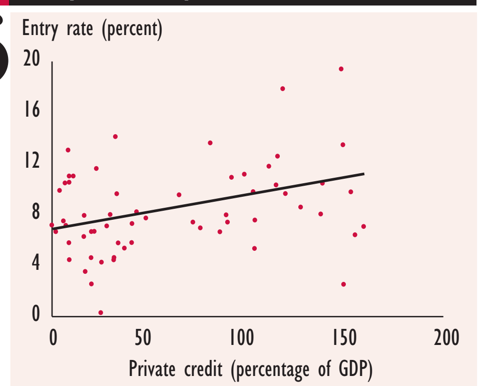
Note: Coefficient = −0.338, *p*-value = 0.009, *R* = 0.08, N = 62.
Source: World Bank Group Entrepreneurship Database; World Bank Group 2005.

Figure 5 Entry rate and logged GDP per capita, 2003



Note: Coefficient = 0.007, *p*-value = 0.014, *R* = 0.101, N = 63.
Source: World Bank Group Entrepreneurship Database; World Bank, World Development Indicators database.

Figure 6 Entry rate and private credit, 2003



Note: Coefficient = 0.026, *p*-value = 0.006, *R* = 0.117, N = 62.
Source: World Bank Group Entrepreneurship Database; World Bank, World Development Indicators database.

A boost from economic and financial growth

The data also show a positive and significant relationship between economic and financial development and entrepreneurship. The log of GDP per capita and domestic credit to the private sector (as a percentage of GDP) are both positively and significantly correlated with the entry rate (figures 5 and 6) and business density (not shown). This suggests that greater business opportunities and better access to finance are related to a more robust private sector.

Relationship with the informal sector

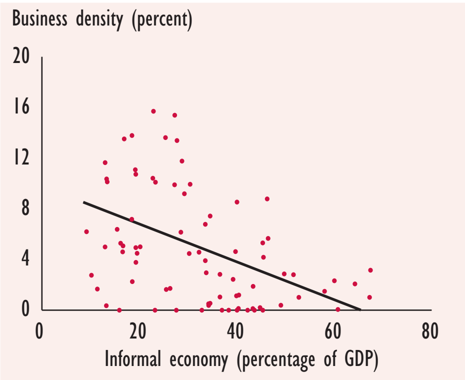
Total firm registrations are significantly higher in countries with a smaller informal sector (figure 7). This suggests a substitution effect and a larger informal sector in countries with higher entry barriers. The data also show a significant relationship between the entry rate and the informal sector (figure 8).

Together, these results suggest that an increase in total and new registered firms might indicate a decrease in the size of the informal sector. Indeed, the data show that a 30 percentage point increase in business density and a 10 percentage point increase in the entry rate are commensurate with a 10 percentage point decline in the informal sector (as a share of GDP).

Conclusion

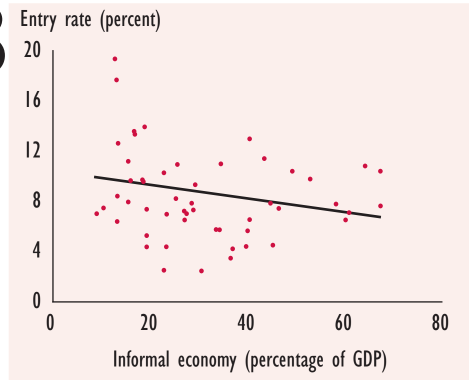
The new data set shows that the business environment matters for rates of entrepreneurship.

Figure 7 **Business density and the informal sector, 2003**



Note: Coefficient = −0.1515, *p*-value = 0.000, *R* = 0.19, N = 80.
Source: World Bank Group Entrepreneurship Database; World Bank Group 2006.

Figure 8 **Entry rate and the informal sector, 2003**



Note: Coefficient = −0.052, *p*-value = 0.102, *R* = 0.04, N = 54.
Source: World Bank Group Entrepreneurship Database; World Bank Group 2006.

If governments reduce barriers to starting a formal business and ease access to credit (such as through better collateral laws, contract enforcement, and credit information sharing systems), rates of entrepreneurship might grow, all else equal. The data set and indicators of entrepreneurship also provide tools for monitoring and evaluating such policy reform efforts, helping to maximize impact and communicate with stakeholders in reform. They make it possible, for example, to measure how reforms in the business environment affect the growth of the formal sector and how political, macroeconomic, and other shocks affect the entry and exit of private firms.

Notes

1. The World Bank Group Entrepreneurship Database is available on the Web at http://www.ifc.org/ifcext/sme.nsf/Content/Resources. The data were collected and the first annual database published through the collaboration of the World Bank's Development Economics Research Group and the International Finance Corporation's Small and Medium Enterprise Department.

2. Data on the cost of starting a business are from World Bank Group (2005).

3. Countries with entry costs greater than 40 percent of GNI per capita are excluded.

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