How Excessive Regulation Hobbles Development

In Chapter 16 we discuss the motivation for government intervention in otherwise unfettered markets. Due to externalities, market power, public goods, or imperfect information, markets left to their own devices often fail to produce an allocatively efficient outcome—these situations are called *market failures*. In these cases, there is a justification for government intervention designed to increase efficiency. In addition, even in the absence of such market failures, there are other reasons for government intervention involving income distribution, the protection of individuals, paternalism, and the encouragement of social responsibility.

Government Intervention Is Not Costless

But government intervention is not costless. The direct costs of government intervention include the salaries of the civil servants involved in the design and implementation of the government programs, the goods and services that governments purchase in the course of regular functioning, and the direct funds that many government programs transfer to individuals, firms, or other organizations. These direct costs are the ones that are readily observable in the government's financial records—the *public accounts*.

Government intervention also involves indirect costs—costs that do not show up directly on the government's books but nonetheless involve the expenditure of real resources by the private sector. These include the costs imposed on individuals and firms from complying with government legislation or regulations. For example, if governments mandate that industrial firms must clean their emissions of air and water into the environment, firms will have to spend real resources in ensuring that these standards are met.

A common name for such indirect costs of government intervention is "red tape"—a term to describe the collection of tasks that must be undertaken, or forms that must be completed, or time that must be spent waiting, or lengthy conversations that must be endured in order to get through the normal activities of life. Everyone experiences red tape in various forms. We all must spend time waiting in line and filling out forms to get passports, drivers licences, and public health-insurance cards. Individuals must fill out income-tax forms every year; firms must compute and remit income-tax and GST payments every quarter. Homeowners spend a considerable amount of time appealing changes in the assessed value of their homes for the purposes of computing property taxes.

Despite the prevalence of red tape in our lives, we tend to accept it as a simple fact of life. Few people in Canada probably think that it is very important—it is certainly a hassle, but surely it is no more important than that. Or is it?

Red tape *does* matter. Recent studies suggest that the collection of government regulations that we broadly refer to as red tape matters for the economic development of nations. This may be less obvious in developed economies like Canada, the United States, or Sweden, but it is much clearer in the developing world. Let's consider developed and developing countries separately.

Red Tape in Developed Countries

Every year the World Economic Forum, a group of business and government leaders that meet every year in Davos, Switzerland, publishes the *Global Competitiveness Report*. Based on publicly available data from a large number of countries, combined with survey data from leading international business executives, the *Report* constructs a Growth Competitiveness Index that ranks countries according to their attractiveness as a location for doing business and for promoting long-term economic growth. In the 2003–04 report, Canada fell from its 9th-place spot a year earlier to 16th overall, out of a total of approximately 100 countries. (See the World Economic Forum's website at www.weforum.org and look for the *Global Competitivess Report*.)

How is this ranking constructed, and what sorts of things does it consider? The Growth Competitiveness Index is based on three broad sets of variables. First, it considers the general macroeconomic environment within each country, including the rate of inflation, the level of government fiscal imbalances, interest rates, and labour-market flexibility. In this category, Canada ranked 11th overall in the 2003–04 ranking (Singapore and Finland took the top two spots, while Japan and China ranked 24th and 25th, respectively).

The second category of variables considered by the index is technological progress, the logic being that such progress lies at the heart of long-term economic growth. By examining a country's ability to either create new patents or apply domestically patents created in other countries, the authors of the *Report* can rank the countries. In 2003–04, Canada ranked 11th overall, with the United States and Finland in the top two spots and Slovenia and Spain at the 24th and 25th spots.

It is in the third category that Canada does much poorer in relative terms—public institutions. Of course, Canada has a well-developed judicial system that is based on the rule of law and the protection of property rights. But according to the authors of the *Report*, many of Canada's public institutions still stand in the way of economic growth by diverting public funds to inefficient uses and regulating firms and individuals excessively. In 2003–04, Canada ranked 24th overall in this category, whereas Denmark and Finland ranked at the top and the United Kingdom and Luxembourg ranked 12th and 13th, respectively.

Why do such rankings matter? If Canada is indeed a less hospitable environment for doing business, then business will choose not to locate here. For a firm producing machine tools or computer software or legal services, it may be just as easy to locate in another country and service the Canadian market from there. In some industries this would be difficult because personal connections are important and it is more difficult to establish and maintain such relationships from abroad. But in other industries the price and the quality of the product being offered are relatively more important, and serving the Canadian market from a foreign home office is entirely feasible. If the Canadian business environment is sufficiently unattractive that existing firms decide to relocate elsewhere, or foreign firms decide *not* to establish a presence in Canada, then the demand for Canadian labour, capital, and intermediate goods will be reduced. This reduction in factor demand will have a negative effect on Canadian factor incomes.

Red Tape in Developing Countries

In developed countries, red tape is frustrating but not fatal—Canadians clearly have, on average, a standard of living that is envied by most people in the world. In developing countries, however, red tape can be a serious obstacle to economic development and thus a primary reason why living standards remain low for long periods of time.

A recent report from the World Bank captures the importance of government regulation and red tape in the developing world: *Doing Business in 2004—Understanding Regulation* (see the World Bank's website at www.worldbank.org). The authors of the report collected data from many developing countries on the number and types of procedures required to start businesses, hire employees, and purchase and register property. They then analyzed the relationship between economic performance and the extent of government regulation. The findings are very interesting and point in the direction of recommending that governments in developing countries think carefully about reforming their regulatory structures.

One finding is the negative relationship between the number of procedures required to start a business and overall labour productivity. The more procedures entrepreneurs must face in order to start a business, the lower is labour productivity. If starting a business and operating it on a day-to-day basis is cumbersome because of the number of regulatory hurdles that governments place in the way, the cost of doing business is higher. Firms may respond in one of two ways. First, they may choose not to start a business at all or to start one and keep it small, "under the radar" of the regulatory authorities. Since fewer or smaller firms typically means less physical capital, it is no wonder that workers (who have less capital with which to work) will be less productive.

Entrepreneurs facing high costs of starting a business legally may also choose to operate their business illegally. This may have no negative direct effect on labour productivity, but if the businesses are operating in the black market then they will generally not be taxed and government tax revenues will therefore suffer. And such public tax revenues are required for governments to spend on necessary public goods such as sanitation systems, electrical networks, schools, and hospitals.

The World Bank study finds that countries in which there is more red tape have larger "informal sectors" (untaxed, and often illegal) and also suffer from more corruption. Indeed, the way that corruption often thrives is by placing many regulatory hurdles in front of firms and individuals—with each form that gets filled out or each licence that gets approved, some official gets "paid off." Of course, such regulatory corruption not only slows the workings of the economy but directly increases the cost of establishing and running a business. As a result, average real incomes suffer.

Finally, the extent of red tape can have dramatic effects on the functioning of capital markets with important consequences for economic development. The Peruvian economist Hernando de Soto has written a fascinating book called *The Mystery of Capital* in which he argues that a central economic problem in developing countries comes from the inability of individuals to register their ownership of assets and, as a result, their inability to borrow using their assets as collateral. The argument is as follows. Faced with massive amounts of red tape when registering one's ownership of land, structures, or even capital equipment, many individuals decide not to register their ownership officially. They continue to spend real resources in acquiring such assets, and many people including their family and friends recognize their ownership. But in the eyes of the law there is no clearly defined ownership. As a result, an individual who "owns" a house and then wants to borrow in order to start a small business using the home as collateral is unable to do so. No bank or other financial institution will lend to her or him because there is no official record of her or his ownership of the asset. Hernando de Soto calls such assets "dead capital" because owners are unable to use them to finance new investment. De Soto argues that the prevalence of red tape in developing countries has contributed to the accumulation of huge amounts of dead capital. The problem in such countries, he argues, is not the absence of saving; instead, it is that the considerable saving that does take place takes the form of dead capital because of excessive regulations. An important part of the solution to promoting economic development in these countries is to drastically reduce red tape; the effect would be the resurrection of formerly dead capital and the creation of new businesses, economic activity, and wealth.

Summary

The finding that some government regulations provide obstacles to economic development and improvements in average living standards does not support the view that government regulations are *always* undesirable. Indeed, as we discuss in Chapter 16 of the textbook, in situations of market failure there is a clear justification for a careful design of government intervention to enhance allocative efficiency. In addition, even in the absence of market failures there are types of government intervention that garner broad public support and that, if carefully designed and implemented, can be very effective at achieving their objectives. But the important connection between red tape and economic development should make public officials wary of the effects of excessive regulation, and should cause them to think carefully about the genuine need for regulations and also about the appropriate design of regulations to ensure that they achieve their objectives while imposing the least possible cost on firms and individuals.