New Firm Creation

What Has Been the Effect of the Financial Crisis?

New data from the World Bank Group Entrepreneurship Snapshots show that new businesses are created at a faster rate in countries with good governance, a strong legal and regulatory environment, low corporate taxes, and less red tape. The data also show that nearly all countries experienced a sharp drop in business entry during the financial crisis. The decline in new firm creation was faster and more severe in countries hit harder by the crisis.

Entrepreneurial activity can help economic growth. For evidence of the economic power of entrepreneurship, we need look no further than the United States, where young firms have been shown to be a more important source of net job creation than incumbent firms (Haltiwanger, Jarmin, and Miranda 2009). As millions around the world feel the impact of the financial crisis through slower economic growth and job losses, understanding regulatory and policy constraints on entrepreneurs wanting to start a formal business has never been more important.

To measure entrepreneurial activity, a 2010 survey, the World Bank Group Entrepreneurship Snapshots (WBGES), has collected annual data directly from company registrars on the number of newly registered firms over the period 2004–09. The 2010 WBGES builds on earlier editions of the data and incorporates improvements in methodology and data from more low-income countries, notably in Sub-Saharan Africa. This year 112 countries participated in the survey—the highest number yet—including 20 for the first time. The data can help answer such questions as these:

- What is the relationship between entrepreneurship and the business environment and financial development?
- How much did the financial crisis affect entrepreneurial activity in the formal sector?
- What factors determine how severely the crisis affected new firm creation?

The main variable of interest is entry density, defined as the number of newly registered corporations per 1,000 working-age people (those ages 15–64). As in the World Bank’s annual Doing Business report, the units of measurement are private, formal sector companies with limited liability.

Entry density

As expected, there is large variation in entry density, across both regions and income levels (figure 1). On average, in high-income countries about...
four new limited liability firms register annually per 1,000 working-age people; in low- and middle-income countries, less than one. Among developing regions, Europe and Central Asia has the highest average entry density (2.26), and Sub-Saharan African and the Middle East and North Africa the lowest (0.58 and 0.63). The entry densities translate roughly into national averages of 55,000 newly registered limited liability firms a year among high-income countries and about 35,000 in Latin America, 14,000 in South Asia, and 9,000 in Sub-Saharan Africa.

Consistent with earlier studies, the data show that countries that have higher GDP per capita and greater financial development also have higher entry density (figure 2).

The business environment and entrepreneurship

Two Doing Business indicators on starting a business show the impact of the business environment and barriers to entry on new firm registration. The first indicator, cost to start a business, captures all official fees and fees for legal and professional services involved in incorporating a company and is measured as a percentage of the economy’s gross national income (GNI) per capita. The second measures the procedures necessary to start a business. There is a strong negative correlation between both these measures and entry density (figure 3).

A formal econometric analysis extends these simple correlations. To ensure that a better business environment is related to subsequent business registration, the cross-country regressions average new registrations over 2005–09 and use the business environment variables from 2004 as controls. The results show that the initial business environment is important for subsequent new business registrations, which suggests a causal relationship. In addition, to ensure that the results are driven by the business environment rather than the overall level of development in a country, the analysis controls for GDP per capita—which is also significantly and positively related to entry density (see figure 2). The Doing Business indicators remain significant predictors of entry density.

To consider the overall economic, political, and financial conditions of the surveyed countries over time, the analysis compares
entry density with measures of country-level governance. Results show a positive correlation between entry density and the governance composite index from Kaufmann, Kraay, and Mastruzzi (2008). Breaking this index down into its subcomponents reveals that the most significant factors affecting new business creation are regulatory quality and government effectiveness. Using data from KPMG, the analysis also compares entry density with the corporate tax rate for 77 countries. This shows a negative correlation between new firm creation and the tax rate. The relationships between entry density and both governance and the tax rate are statistically significant even after controlling for the income level of the country in a multivariate econometric analysis (Klapper and Love forthcoming).

The crisis and entrepreneurship
Data for 95 countries show that nearly all experienced a sharp drop in business entry during the crisis (figure 4). Only 20 percent experienced growth in business entry between 2008 and 2009, while 74 percent did between 2006 and 2007. In general, the speed and intensity with which the crisis affected new firm creation varied by income level and crisis intensity. Richer countries, which were more exposed to the global financial system, experienced economically meaningful drops in business entry in both 2008 and 2009. Low-income countries, which were less affected by the crisis and introduced many reforms modernizing registration, experienced no changes in new firm creation. In Spain, for example, the number of new firms registering dropped by 45 percent, from 145,593 in 2007 to 79,759 in 2009. In Burkina Faso, which introduced a one-stop shop for registration as part of a larger reform package, new firm registrations increased from 581 in 2007 to 610 in 2009. A similar pattern holds for the annual percentage change in new firm registrations over time.

An important question is whether the crisis affected business entry in some countries more severely than others. An econometric analysis confirms that countries with higher GDP per capita experienced sharper declines in new registrations during the crisis. This is expected, since the crisis originated primarily in high-income countries. Countries in which financial markets play a larger part in the domestic economy (as measured by the
ratio of domestic credit to GDP) also experienced sharper contractions in new firm creation. One plausible channel for this is through firms‘ access to external finance, which is more important in countries with higher levels of financial development. This channel suggests that countries where start-ups rely more on the banking sector were more likely to experience larger contractions in new firm creation as a result of the credit crunch and withdrawal of finance that characterized the crisis. The analysis also reveals that the ratio of domestic credit to GDP is a more powerful predictor of the impact of the crisis on new firm creation than GDP per capita—a notable result, given the high correlation between the two measures of development (Klapper and Love forthcoming).

The degree to which the crisis affected new firm creation is highly correlated with measures of the severity of the crisis. Using an index from Calderon and Didier (2009) that measures the crisis-related turbulence in 65 countries (with lower numbers indicating greater effects from the crisis), the analysis shows that countries that were hit harder by the crisis also had larger shocks to new firm creation (figure 5). For example, Brazil and Morocco, which were less affected by the crisis, experienced no decline in new firm creation. But Bulgaria and Lithuania, among those most affected because of the near collapse of their financial markets, saw a drastic drop in new firm creation.

**Conclusion**

The 2010 WBGES data show that dynamic business creation occurs in countries that provide entrepreneurs with good governance, a strong legal and regulatory environment, and less red tape. The data also show that nearly all countries experienced a sharp drop in business entry during the financial crisis. But high-income countries experienced faster and more severe effects than other income groups. The degree to which the crisis affected new firm creation is correlated with measures of the severity of the crisis. And countries in which financial markets play a larger part in the domestic economy experienced sharper declines in new business registrations. These results can help guide effective policy making and deliver new capabilities for identifying the impact of reforms.

**Notes**

1. Countries classified by the International Monetary Fund as offshore financial centers are excluded from the analysis. For a complete list, go to http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm.
2. The analysis shows that three other Doing Business indicators—time to start a business, cost to close a business, and an employment rigidity index—are also significant predictors of entry density.

**References**


