REFORMING THE BUSINESS ENVIRONMENT TO COPE WITH OVER-INDEBTEDNESS: THE CASE OF THE EU

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ABSTRACT

The problem of business over-indebtedness is growing; this is reflected in the rising value of unsettled liabilities and, consequently, in the rising number of business insolvencies. The role of legal business environment in treating this problem has proven to be crucial. Within the legal framework, the greatest attention in research has been given to the efficiency of the judicial system and the surrounding and supporting institutions dealing with contract enforcement and insolvency regime. In line with such research background, the World Bank (WB) project aimed at measurement of legal framework efficiency was launched in 2004. The goal of this paper is to evaluate the reformative efforts on the sample of EU national economies based on WB indicators of legal framework efficiency and WB data on actual implemented reforms regarding enforcing contracts and resolving insolvency. Methodology applied is dynamic panel-data estimation, which, besides the data on the existence of legal framework reforms, also includes additional variables that have an impact on judicial efficiency: level of GDP, government expenditures, and level of corruption. The results indicate that reformative efforts taken by the governments in this period have not had the desired effect on the indicators measuring the efficiency of the enforcing contracts and resolving insolvency procedures. Government efforts in the future should be devoted to better design of the reforms, since the resources for the reforms had not been allocated efficiently.

Keywords: *Business Environment Reforms, Enforcing Contracts, Resolving Insolvency, Business Over-Indebtedness*

1. INTRODUCTION

A sound business sector is a prerequisite of a well-functioning society. This means that every government's priority should be to design and implement policies that facilitate smooth business operation. Regulation is an essential part of the legal business environment and it should support easy resolution of business disputes and problems. Swift and inexpensive contract enforcement procedures as well as early signal system to detect potential insolvencies coupled with easy and quick resolution processes are in the core of such government arrangements. The paper is structured in the following way: the first section provides a review of literature dealing with the importance of business regulation and expected positive outcomes in the performance of national economies. Special attention is devoted to the government support in the field of business exit and settlement of disputable obligations where judicial system has the crucial role. Thereafter, the argumentation is developed that leads to the formulation of hypothesis. The selected variables for model testing are founded in the previous research and explained in line with the hypothesis.

The next section provides an overview of data collection procedures and dynamic panel methodology applied in this research. In the fourth section, the results of the research are presented and discussed, limitations explained, and recommendations for further research provided. The conclusions and policy implications are drawn in the final part of the paper.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The importance of business environment institutional improvement for macroeconomic performance has been proven in many studies (e.g. Djankov et al., 2006, Messaoud and El Ghak Teheni, 2014, Aguiar et al., 2017, Haidar, 2012). In this paper, the focus is on a segment of the business environment, i.e. institutional improvements that are considered most important when trying to cope with business over-indebtedness, specifically enforcing contracts and insolvency frameworks. Previous research show many significant links in this area. When dealing with insolvencies and contracts, a well-functioning judicial system has many beneficial effects on firms, such as easier access to long-term financing, lower cost of capital and fewer financial restrictions (Jappelli et al., 2005, Bae and Goyal, 2009, Laeven and Majnoni, 2005). It is also significantly related to higher business survival rates (Stam et al., 2008), higher business entry rates, higher self-employment rates (Garcia-Posada and Mora-Sanguinetti, 2014), quicker implementation of new technologies, enhancement of exports (Cooley et al., 2004, Nunn, 2007, Berkowitz et al., 2006) and a positive effect on FDI (Ahlquist and Prakash, 2010). It is important to mention another effect of efficient institutional framework for enforcing contracts and resolving insolvencies: its mitigating role in downsizing the informal economic activity (Domac and Bejaković, 2002, Bejaković, 2004, Dabla-Norris et al., 2008). In order to quantitatively assess the volume of governmental reformative actions in terms of insolvency and enforcing contracts, the data on the number of such reforms in the EU countries from 2005 to 2016 are presented in the following table:

Table 1: Number of reforms by EU country 2005 – 2016 (WB, 2006 – 2017)

Country	RI*	EC**	Σ	Country	RI	EC	Σ
Portugal	3	6	9	Hungary	2	2	4
Lithuania	5	3	8	Slovenia	4	0	4
Poland	6	2	8	Austria	1	2	3
Romania	5	3	8	Denmark	2	1	3
Italy	4	3	7	Germany	3	0	3
Spain	5	2	7	United Kingdom	2	1	3
Slovakia	2	4	6	Belgium	1	1	2
Bulgaria	3	2	5	Cyprus	1	1	2
Croatia	2	3	5	Finland	1	1	2
Czech Republic	2	3	5	Ireland	0	2	2
Estonia	2	3	5	Luxembourg	0	0	0
Greece	2	3	5	Malta	0	0	0
Latvia	4	1	5	Netherlands	0	0	0
France	3	1	4	Sweden	0	0	0
EU					65	50	115

**RI – resolving insolvency reforms; **EC – enforcing contracts reforms*

The total number of reforms that were implemented by 24 of 28 Member States can be assessed as a significant policy effort by vast majority of the EU countries.

This also implies that governments do accept previously presented research implications, and do intend to redesign the business environment in order to enable its better functionality. There has been a slightly larger number (57%) of insolvency framework reforms than the reforms directed towards strengthening the enforcing contracts procedures (43%). The cumulative qualitative outcomes of reforms are represented in the following table. The numbers express the total percentage change in the indicators that measure the efficiency of resolving insolvency and enforcing contracts. The percentage changes in the indicators in the year following the reform were added (see Appendix 1 and Appendix 2 for reference). Three indicators (time, cost and recovery rate) are taken into account for resolving insolvency and two (time and cost of the procedures) for enforcing contracts.

Table 2: Cumulative effect of reforms by EU country 2005 – 2016 (%) (WB, 2006 – 2017)

Country	RI (1)	EC (2)	Total (1+2)
Czech Republic	67	0	67
Poland	76	-12	64
Romania	56	2	58
Spain	-19	66	47
Slovenia	44		44
Lithuania	11	18	29
Slovakia	14	9	23
Italy	4	18	22
Germany	14		14
Finland	0	7	7
Cyprus	2	0	2
United Kingdom	2	0	2
Belgium	1	0	1
Ireland		0	0
Portugal	0	-5	-5
Greece	2	-11	-9
Hungary	-1	-15	-16
Croatia	1	-18	-17
Austria	0	-21	-21
Denmark	31	-76	-45
Estonia	-2	-45	-47
Bulgaria	-5	-47	-52
Latvia	-129	0	-129
France	0	-171	-171
EU average	7	-14	-6

The descriptive analysis shows a very inconsistent pattern of the effects of reforms across EU countries. Contrary to the expectations, the overall effect of all reforms is negative. Outcomes are better for resolving insolvency; however, only slightly considering the long period in question. The negative trend in enforcing contracts is especially troublesome. About half of the sample has improved the indicators following the reforms, but the other half has worsened the values of indicators.

It is noteworthy that Portugal, the country with the largest number of reforms, has worsened its outcomes. Appendix 1 and Appendix 2 provide a detailed presentation of data related to all 115 reforms: when and where each of the reforms took place and percentage change of resolving insolvency and enforcing contracts it induced in the year following the reform. All of the above strongly supports the need to test the hypothesis whether the implementation or non-implementation of the reform has significantly altered efficiency indicators of resolving insolvency and enforcing contracts. Since there is an undisputable link between overall economic performance and institutions' quality, GDP per capita is included to test the power of the level of economic development on the outcomes of reforms, i.e. whether more developed Member States also have more efficient outcomes of the reforms. Another measure of a country's intent to improve institutions in question is the level of government expenditures, i.e. whether the Member States that spend more resources also have more efficient outcomes of the reforms. Bearing in mind the above-mentioned importance of the quality of institutions for informal economy, the last variable included to be tested in this research is the level of corruption, i.e. whether countries with a lower level of corruption also have more efficient outcomes of the reforms. The main hypothesis can thus be formulated as follows: Countries that implemented reforms, that are more developed, that have greater government spending and a lower level of corruption, are expected to have significantly better frameworks for enforcing contracts and resolving insolvency.

3 DATA AND METHODOLOGY

The main source of data analyzed in this research is WB Doing Business database. WB started this project in 2004 and some of the indicators have changed in the period covered in this paper. The dependent variables are two enforcing contracts indicators(time needed to enforce unsettled liabilities measured in days, and cost of the enforcement procedure measured as percentage of the value in dispute), and three resolving insolvency efficiency indicators (time required to recover debt measured in years, cost required to recover debt measured as percentage of debtor's estate value, and recovery rate for creditors measured as percentage of their claims recovered through reorganization, liquidation or foreclosure proceedings). The first explanatory variable is the presence of the reform in a certain point of time: whether or not (dummy) a country had a reform in place that dealt with resolving insolvency or enforcing contracts. The assessment of the presence of the reform was done by WB and is taken from the Doing Business database. The Eurostat database (European Commission, 2018) was used as a source for data on GDP per capita, and World Development Indicators (WB, 2018) as a source of government expenditures expressed as percentage of GDP. Data on corruption were taken from Transparency International (2018) (and expressed as the value of the Corruption Perceptions Index (CPI). The CPI methodology changed within the analyzed period and the data were normalized in order to accommodate the change. The time frame covered is 2005 to 2016, for which period data on all selected variables were available. The final sample excludes three EU countries (Cyprus, Luxembourg, and Malta), because these countries were included in the Doing Business project at a later point in time. Due to their relative size, their exclusion should have no significant effect on the conclusions drawn from this research. Dynamic panel-data estimation is performed by using the two-step system Generalized Method of Moments (GMM). GDP per capita and government expenditure variables are both expressed in natural logarithm. Statistical procedures are performed in Stata statistical software package.

4. RESULTS, DISCUSSION AND FUTURE RESEARCH

The results of five dynamic panel data estimations are presented in this section – one for each of the dependent variables – three for the indicators that measure the efficiency of resolving insolvency, and two for the indicators that measure the efficiency of enforcing contracts. The next table summarizes the results of all the conducted procedures:

Table 3: Dynamic panel data estimation for resolving insolvency and enforcing contracts indicators (Authors' calculations)

Sample: 25 (EU ex Cyprus, Luxembourg and Malta)
Number of obs. = 275

Independent variables	Dependent variables				
	RI cost	RI time	RI recovery	EC cost	EC time
Reforms - dummy	-0.157	-0.034	-1.164	-0.029	18.437
	[0.171]	[0.035]	[0.727]	[0.472]	[16.803]
	(0.360)	(0.334)	(0.109)	(0.952)	(0.273)
Lgdp	0.056	**-0.250*** **	**6.654*** **	0.495	12.044
	[0.147]	**[0.066]**	**[2.315]**	[0.678]	[10.033]
	(0.705)	**(0.000)**	**(0.004)**	(0.465)	(0.230)
Lgexp	**-1.076***	0.144	-2.581	-1.560	-27.255
	[0.579]	[0.181]	[4.017]	[1.895]	[31.836]
	(0.063)	(0.426)	(0.520)	(0.410)	(0.392)
CPI	-0.005	-0.001	0.068	-0.002	0.117
	[0.007]	[0.002]	[0.051]	[0.016]	[0.308]
	(0.487)	(0.393)	(0.183)	(0.914)	(0.705)
Constant	3.703	2.531***	-45.409**	3.013	-28.080
	[2.888]	[0.499]	[17.759]	[7.954]	[125.181]
	(0.200)	(0.000)	(0.011)	(0.705)	(0.823)
Wald test – chi-square (p-value)	4662.30 (0.000)	5025.54 (0.000)	2365.67 (0.000)	950.48 (0.000)	1204.61 (0.000)

Robust standard errors in brackets, p-values in parentheses
***p<0.01, **p<0.05, *p<0.1,

The hypothesis was derived from background literature and previous research results, and as such, it was expected to find further evidence of the beneficial role of reforms and other measures of institutional action in increasing the quality and efficiency of business environment. Still, the results that are to be discussed are by no means a surprise. The descriptive analysis from previous sections already indicated troublesome notions about the reforms that most governments conduct on a large scale and fulfillment of the goals they were designed for. These results strongly confirm the non-existence of any link between the reforms and the expected and intended outcomes of reforms. Namely, the reforms' dummy variable is insignificant in case of all measured indicators of resolving insolvency and efficiency of enforcing contracts. When specifically discussing the enforcing contracts framework, the results of all of the analyzed explanatory variables are insignificant. This provides strong evidence that the field of enforcing contracts research should be extended to some completely new phenomena or brand new ways of measuring the existing variables of interest. This is particularly important since contract enforcement is crucial for every single business entity in the national economy, not only for those in distress (that are the primary object of resolving insolvency procedures).

Dealing with business over-indebtedness would most certainly benefit more from streamlined contract enforcement, and this would not only positively affect the existing business, but also enhance new entries. The results for resolving insolvency also confirm that reforms must be redesigned in order to make a difference. One can observe that, in this case, level of development and level of government expenditure are significant, GDP per capita is significant for two indicators (RI time and RI recovery), and government expenditure for the third (RI cost). More developed economies (as measured by GDP pc) have higher recovery rates. They also spent less time resolving insolvencies. Governments' interest in businesses in distress is reflected in these results as well as in larger number of RI reforms (65 vs. 50). The companies facing insolvency render grater public and policy makers' attention (recent high-profile Croatian cases: Agrokor and Uljanik); it is therefore not surprising that resolving insolvency framework changes can be labeled as more successful ones, yet not due to reforms, as detected and measured by the WB. Considering all of the above-mentioned facts, the main hypothesis is rejected. General implications for further research can be given: firstly, an in-depth analysis of institutional arrangements for dealing with contract enforcement and insolvency procedures should be carried out and result in new research subject areas compared to the ones elaborated so far, and secondly, the measurement of the institutional efficiency including methodology of data collection should be reconsidered. At the policy level, the decision-makers should devote much more attention to the design phase of the reformative efforts, thus ensuring that reforms intended for improving the business environment would render the results they had been designed for.

5. CONCLUDING REMARKS

The study presented in this paper and its results confirm previous general conclusions of descriptive analyses that were part of the papers within the same research project in the past four years (Škalamera-Alilović, Dimitrić, 2016, Dimitrić, Škalamera-Alilović, 2016, Škalamera-Alilović, Dimitrić, 2015) conducted by the same authors. Unfortunately, we witness the era of inefficient governments, unable to support smooth functioning of the business, and reformative efforts remain nominal, whereas the content of public services to business continues to decline in quality (not quantity). The problem of over-indebtedness has been getting worse and current measures are inadequate for fostering better development results in the European Union. Comprehensive reformatting of institutions that are the essential part of the business environment are more than necessary if we want to see competitive EU business taking pivotal part in increasingly unstable, global-level economic activity.

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APPENDIX

Resolving insolvency reforms and outcomes in the EU countries 2005-2016 (Authors' calculations)

Reform year	Country	Cost change	Time change	Recovery change	Average
2011	Austria	0%	0%	-1%	0%
2010	Belgium	0%	0%	2%	1%
2005	Bulgaria	-13%	0%	-2%	-5%
2008	Bulgaria	0%	0%	-1%	0%
2011	Bulgaria	0%	0%	1%	0%
2007	Croatia	0%	0%	4%	1%
2013	Croatia	0%	0%	1%	0%
2016	Cyprus	3%	0%	2%	2%
2008	Czech Republic	0%	0%	-2%	-1%
2010	Czech Republic	-13%	51%	167%	68%
2007	Denmark	0%	63%	23%	29%
2011	Denmark	0%	9%	-2%	2%
2009	Estonia	0%	0%	0%	0%
2010	Estonia	0%	0%	-5%	-2%
2008	Finland	0%	0%	-1%	0%
2006	France	0%	0%	1%	0%
2009	France	0%	0%	0%	0%
2011	France	0%	0%	1%	0%
2008	Germany	0%	0%	-2%	-1%
2009	Germany	0%	0%	0%	0%
2012	Germany	0%	0%	45%	15%
2008	Greece	0%	0%	-1%	0%
2012	Greece	0%	0%	6%	2%
2007	Hungary	0%	0%	-3%	-1%
2010	Hungary	0%	0%	-1%	0%
2006	Italy	0%	0%	-1%	0%
2007	Italy	0%	-50%	56%	2%
2011	Italy	0%	0%	5%	2%
2013	Italy	0%	0%	-1%	0%
2006	Latvia	-225%	-173%	-58%	-152%
2008	Latvia	0%	0%	-16%	-5%
2010	Latvia	0%	0%	10%	3%
2011	Latvia	0%	0%	76%	25%
2005	Lithuania	13%	0%	2%	5%
2009	Lithuania	0%	12%	3%	5%
2010	Lithuania	0%	0%	0%	0%
2011	Lithuania	0%	0%	3%	1%
2012	Lithuania	0%	0%	0%	0%

2005	Poland	-22%	0%	-6%	-9%
2008	Poland	9%	0%	7%	5%
2009	Poland	0%	0%	0%	0%
2011	Poland	25%	0%	1%	9%
2012	Poland	0%	0%	73%	24%
2017	Poland	0%	0%	4%	1%
2007	Portugal	0%	0%	-1%	0%
2008	Portugal	0%	0%	-6%	-2%
2012	Portugal	0%	0%	5%	2%
2005	Romania	-13%	0%	154%	47%
2006	Romania	0%	0%	14%	5%
2010	Romania	0%	0%	-10%	-3%
2011	Romania	0%	0%	11%	4%
2016	Romania	5%	0%	5%	3%
2006	Slovak Republic	0%	17%	25%	14%
2012	Slovak Republic	0%	0%	-1%	0%
2011	Slovenia	0%	0%	0%	0%
2012	Slovenia	0%	0%	-3%	-1%
2014	Slovenia	0%	0%	0%	0%
2015	Slovenia	0%	60%	76%	45%
2005	Spain	-81%	0%	-7%	-29%
2010	Spain	27%	0%	4%	10%
2012	Spain	0%	0%	1%	0%
2014	Spain	0%	0%	-1%	0%
2015	Spain	0%	0%	0%	0%
2005	United Kingdom	0%	0%	-1%	0%
2010	United Kingdom	0%	0%	5%	2%

% - percentage change of indicators in the year following the reform

Enforcing contracts reforms and outcomes in the EU countries 2005-2016 (Authors' calculations)

Reform year	Country	Cost change	Time change	Average
2005	Austria	0%	0%	0%
2008	Austria	-42%	0%	-21%
2008	Belgium	0%	0%	0%
2007	Bulgaria	-59%	-28%	-43%
2008	Bulgaria	-7%	0%	-4%
2006	Croatia	0%	-35%	-18%
2013	Croatia	0%	0%	0%
2016	Croatia	0%	0%	0%
2016	Cyprus	0%	0%	0%
2013	Czech Republic	0%	0%	0%
2014	Czech Republic	0%	0%	0%

2015	Czech Republic	0%	0%	0%
2006	Denmark	-23%	-129%	-76%
2005	Estonia	0%	0%	0%
2006	Estonia	-8%	-83%	-46%
2013	Estonia	2%	0%	1%
2005	Finland	10%	5%	7%
2006	France	-1%	-341%	-171%
2014	Greece	0%	-22%	-11%
2015	Greece	0%	0%	0%
2017	Greece	0%	0%	0%
2017	Hungary	0%	-53%	-27%
2018	Hungary	-41%	64%	12%
2014	Ireland	0%	0%	0%
2015	Ireland	0%	0%	0%
2006	Italy	0%	13%	6%
2013	Italy	23%	2%	12%
2016	Italy	0%	0%	0%
2016	Latvia	0%	0%	0%
2005	Lithuania	35%	0%	18%
2014	Lithuania	0%	0%	0%
2015	Lithuania	0%	0%	0%
2007	Poland	0%	15%	8%
2012	Poland	-58%	17%	-20%
2005	Portugal	0%	0%	0%
2007	Portugal	-22%	-17%	-19%
2008	Portugal	20%	0%	10%
2009	Portugal	8%	5%	7%
2014	Portugal	-6%	0%	-3%
2015	Portugal	0%	0%	0%
2008	Romania	0%	5%	2%
2013	Romania	0%	0%	0%
2016	Romania	0%	0%	0%
2005	Slovak Republic	0%	0%	0%
2006	Slovak Republic	-5%	0%	-2%
2012	Slovak Republic	0%	4%	2%
2018	Slovak Republic	47%	-29%	9%
2017	Spain	7%	0%	4%
2018	Spain	66%	59%	62%
2010	United Kingdom	0%	0%	0%

% - percentage change of indicators in the year following the reform