

Less red tape, more local entrepreneurship and foreign direct investment: the path to recovery



Fiscal crises such as the one spurred by the COVID-19 pandemic [motivate regulatory reform](#), which in turn can speed up the economic recovery. Past evidence suggests that this acceleration takes place through two main channels: new local entrepreneurship and increased foreign direct investment (FDI).

Entrepreneurship is critical for the continued dynamism of the modern economy, as forcefully argued by Austrian economist Joseph Schumpeter in deriving his theory of [creative destruction](#). Startups make economies grow faster – as a source of innovation and new jobs. The business environment needs to be conducive to growth for new businesses to be born in the first place, to get a “birth certificate” (formal registration with the authorities) and subsequently expand.

When faced with costly regulations, startups lose the freedom to innovate and grow their business efficiently, often opting to stay informal. Friedrich Hayek, one of [LSE's many Nobel Prize winners](#) in economics, is best-known for promoting such freedom. Informal firms are less productive and can [erode formal firms' market share](#) and societal resources available to boost productivity, which slows down economic growth.

The global analysis illustrates that countries with easier business regulatory processes tend to inspire more new business creation (figure 1). This finding mirrors a [recent study](#) using panel data for 10 years across more than 180 economies which finds that an improvement of 10 points in the overall measure for business regulations is linked to an increase of 50 new businesses per 100,000 adults. To put this estimate in perspective, hypothetically it would mean an additional 26 thousand new businesses in the United Kingdom each year.

A hypothetical improvement in business regulations from lowest quartile to highest quartile of countries globally is associated with a 0.8 percentage point increase in annual per capita growth. Again, to put this estimate into perspective, it hypothetically implies an additional 18 billion pounds of GDP growth in the United Kingdom in 2019, a sizable effect. Conversely, costly regulations hamper the creation of new firms, [especially in industries that should have high entry](#).

Figure 1. Economies with more conducive business environment have more startups



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