

Why are minimum capital requirements a concern for entrepreneurs?



Minimum capital requirements significantly slow entrepreneurship.¹ Such requirements also fail to serve their intended purpose of protecting consumers and creditors from hastily established and potentially insolvent firms. In recent years many governments have stopped requiring new businesses to deposit minimum capital in banks or with notaries before they can begin operations.

What is a minimum capital requirement? It is the share capital that must be deposited by shareholders before starting business operations. For the *Doing Business* starting a business indicator the paid-in minimum capital is usually the amount that an entrepreneur needs to deposit in a commercial bank or with a notary when, or shortly after, incorporating a business, even if the deposited amount can be withdrawn soon after a company is created.² In most cases this required amount is specified in an economy's commercial code or company law.³ Research shows that the existence of a minimum capital requirement directly hinders business development and growth.⁴

Of the 189 economies studied in *Doing Business 2014*, 99 have no minimum capital requirements. Some economies never required firms to deposit money for incorporation, while 39 have eliminated minimum capital requirements in the past seven years. Armenia, Belarus, Bulgaria, Denmark, Kosovo, the Republic of Korea, the Kyrgyz Republic and the United Kingdom are among these economies that have cut or eliminated such requirements. For instance, Belarus halved its minimum capital requirement for private limited liability companies in 2008, then abolished it a year later. In 2009 Bulgaria reduced its minimum capital requirement by 99%, to less than \$2. That same year,

Denmark slashed its minimum capital requirement for limited liability companies from about \$22,000 to about \$14,000. All of these changes lower the costs to entrepreneurs to operate in the formal sector. The other 90 economies still require entrepreneurs to deposit capital before registering a business. This amount varies greatly—from €1 in Germany to more than \$58,000 in Myanmar.

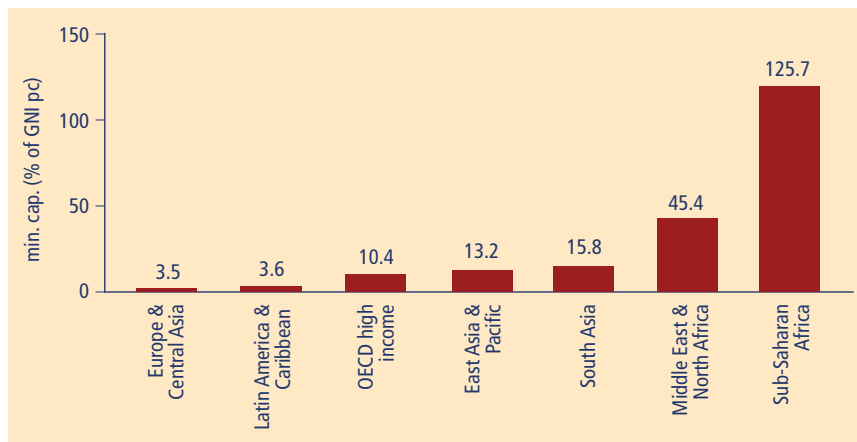
WHERE IS THE MINIMUM CAPITAL REQUIREMENT MORE PREVALENT?

Across regions, minimum capital requirements are lowest in Europe and Central Asia, Latin America and the Caribbean and OECD high-income economies (figure 4.1). In Latin America and the Caribbean only 10 of 32 economies require new businesses to deposit minimum capital, with the Dominican Republic imposing the most—almost half of income per capita, or about \$2,500. Still, most of the 10 economies that had enforced capital requirements keep them low. In Suriname it is about \$30—0.4 percent of income per capita—and in Bolivia it is \$40, equivalent to 1.8 percent of income per capita. And in the past 10 years other economies in the region, such as Mexico, St. Kitts and Nevis, and Uruguay, have eliminated minimum capital requirements altogether.

Among OECD high-income economies, Austria and Slovenia have the highest minimum capital requirements, asking entrepreneurs to commit more than 40% of gross national income per capita. In Sub-Saharan Africa 13 economies have minimum capital requirements exceeding 200% of income per capita. An extreme example is Niger, where the minimum

- Across regions, minimum capital requirements are lowest in Europe and Central Asia.
- Of the 189 economies studied in *Doing Business 2014*, 99 do not have minimum capital requirements for firms. Some economies have never had them, while 39 have eliminated them in the past seven years.
- Minimum capital requirements are comparatively higher in low-income economies.
- Paid-in minimum capital is often a fixed amount that does not take into account firms' economic activities, size or risk related to their activity.
- Higher minimum capital requirements are associated with less access to finance for small and medium-size firms.
- Higher minimum capital requirements are associated with weaker regulations on minority investor protections and tend to enable the informal economy.

FIGURE 4.1 Minimum capital requirements by region



Note: Myanmar is excluded from the sample as it is a significant outlier.

Source: *Doing Business* database.

capital requirement is equivalent to 528% of income per capita—about \$2,000.

Globally, except in South Asia, minimum capital requirements have been cut over the past seven years. The biggest changes have occurred in the Middle East and North Africa, where the share of economies with minimum capital requirements of less than 5% of income per capita fell from over 60% in 2006 to 6% in 2013 (figure 4.2). In 2011 Jordan reduced its minimum capital requirement from about

\$14,000 to less than \$2. Similarly, in 2013, Morocco eliminated its minimum capital requirement for limited liability companies. Many economies in Europe and Central Asia and the OECD high-income region have also sharply cut or eliminated minimum capital requirements.

In South Asia only India and Maldives still have minimum capital requirements. In India it is about \$1,900; in Maldives, \$135. In general, South Asia is lagging behind on business entry regulatory reforms

compared with other regions. For instance, in 2012/13, Sri Lanka was the only economy of 8 in those studied that simplified business registration—compared with 10 of 21 in Europe and Central Asia.⁵

Minimum capital requirements are relatively higher in low-income economies than in lower-middle, upper-middle and high-income ones. Among high-income economies, 25% have a minimum capital requirement ranging from 1.5% to 230% of income per capita—from about \$1,500 in Malta to more than \$50,000 in Bahrain. Bahrain and Oman require new limited liability companies to deposit the equivalent of more than 200% of income per capita in bank accounts to complete registration and commence business operations.

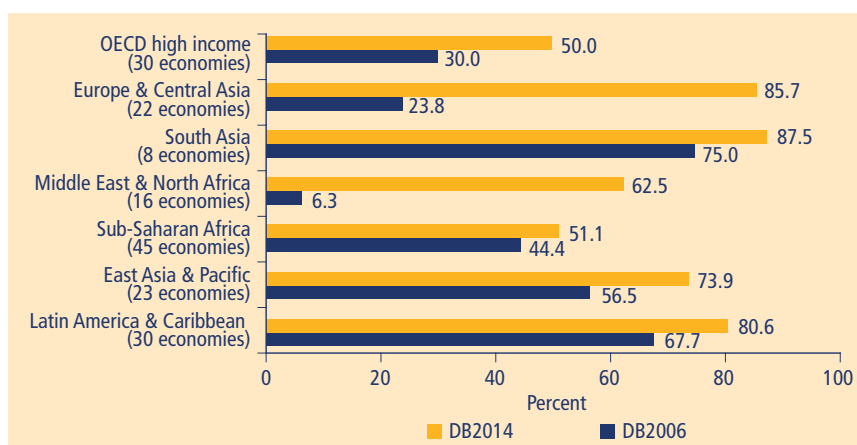
Of the 34 low-income economies studied, 18 do not have minimum capital requirements. Among the other 16, 11 are members of the Organization for the Harmonization of Business Law in Africa,⁶ which has fixed the minimum capital requirement at about \$2,000.

DO MINIMUM CAPITAL REQUIREMENTS FULFILL THEIR REGULATORY FUNCTIONS?

The minimum capital requirement finds its roots in continental Europe of the 20th century.⁷ Back then, the minimum paid-up capital was stipulated by law and its primary legislative purpose was to protect creditors and nurture confidence in financial markets. Nowadays, despite the financial burden that minimum capital requirements impose on potential entrepreneurs, some argue that they protect investors and consumers from new firms that are set up carelessly, might not be financially viable and will likely close soon after launching. Advocates of this argument claim that minimum capital requirements enable prospective investors to consider investments more cautiously.

But this regulatory fix does not adequately address the problem. Paid-in minimum capital is often a fixed amount that does not take into account firms' economic activities, size or risks. In some cases it is the same for different types of companies as well. For instance, a small company

FIGURE 4.2 Share of economies where the minimum capital requirement is less than 5% of income per capita



Note: The data sample for DB2006 (2005) includes 174 economies. The sample for DB2014 (2013) also includes The Bahamas, Bahrain, Barbados, Brunei Darussalam, Cyprus, Kosovo, Liberia, Luxembourg, Malta, Montenegro, Qatar and San Marino, for a total of 185 economies. DB2006 data have been adjusted for data revisions and changes in methodology and regional classifications of economies.

Source: *Doing Business* database.

in the services industry with low start-up capital has to pay as much as a large manufacturing company with high initial capital in Gabon, despite the difference in business activity and size. Moreover, funds tied up in minimum capital requirements, particularly in economies where the amount is sizable, could impose financial constraints on companies that have other needs, such as hiring, buying equipment or developing services.⁸

Others argue that minimum capital requirements shield firms from insolvency and so protect creditors and investors.⁹ But lenders tend to base their decisions on commercial risks rather than government-imposed minimum capital requirements.¹⁰ Creditors usually prefer to evaluate firms' income statements, business plans and other representative indicators. Thus, many economies have found other ways to protect investors, particularly with limited liability companies. For instance, Hong Kong SAR, China outlines solvency safeguards in its Companies Act and does not require a specific amount of paid-in minimum capital for business incorporations. Furthermore, companies have different probabilities of becoming insolvent. Even with a minimum capital requirement there is no guarantee that a firm would not face insolvency because of other factors such as poor management and decision making, bad business conditions and market changes.¹¹

If the enforced minimum capital requirement is too high, it might impede the development of start-ups. It could block potential entrepreneurs seeking to start businesses as alternatives to unemployment.¹² In Ethiopia the official unemployment figure is more than 20%, yet the minimum capital requirement is 184% of income per capita. Though the minimum capital requirement alone does not account for Ethiopia's high unemployment, it does hamper the development of small and medium-size formal businesses that might be a source of employment.¹³

Some researchers also argue that high minimum capital requirements distort healthy competition by putting at disadvantage entrepreneurs with less financial capacity.¹⁴ A firm is expected to use its financial resources to establish the business and day-to-day operations. So

freezing capital in a bank account may undermine a company's growth. In Bolivia and Ghana minimum capital can be withdrawn in full only after a company's dissolution. Moreover, high minimum capital requirements can enable fraudulent activities that they are supposed to prevent. Entrepreneurs eager to incorporate companies but lacking the required funds, often falsify company incorporation forms or withdraw funds soon after incorporation.¹⁵

If the capital requirement is too low, it fails to screen out potentially unviable businesses. A low requirement does little to protect creditors if a company undergoes financial distress.¹⁶ In many economies the requirement is merely symbolic because governments and company registries cannot predetermine how much money might be needed to cover companies' liabilities if they become insolvent.¹⁷ For example, France, Germany, Japan and Jordan have minimum capital requirements of less than \$5. In addition, a minimum capital requirement does not limit company debt because once the capital amount has been established, there are usually no limits on the borrowing of companies.¹⁸

Minimum capital requirements are especially futile if funds can be withdrawn and possibly used to cover expenses unrelated to the business soon after a company is incorporated. For instance, in Estonia, Luxembourg and Thailand entrepreneurs can withdraw start-up capital immediately after incorporating a business—so minimum capital requirements provide no security to potential creditors.¹⁹

A better way to make markets more efficient and protect creditors would be to enforce mandatory disclosure of information, such as mandatory filing of annual financial accounts in company registries and enhancing the supervisory role of company registries. Other forms of creditor protection already exist in many economies, including corporate governance monitoring, setting of interest rates and contractual provisions such as bond indentures and loan agreements.²⁰ The United States, for instance, once imposed significant requirements on how much capital had to be contributed and maintained in a corporation. But those

rules have lost virtually all of their value for stockholders and creditors because better approaches have been developed. Today creditors must rely primarily on negotiated contractual protections, as stipulated in statutory and incorporation agreements.²¹

A study of 5 EU economies shows that eliminating minimum capital requirements makes it easier to start small and medium-size enterprises. The number of registered businesses has increased in 4 of the economies studied that have lowered or abolished minimum capital requirements (France, Germany, Hungary and Poland). Research also shows that, in addition to significantly increasing the total number of limited liability companies, such legal reforms have raised the number of new firms created.²²

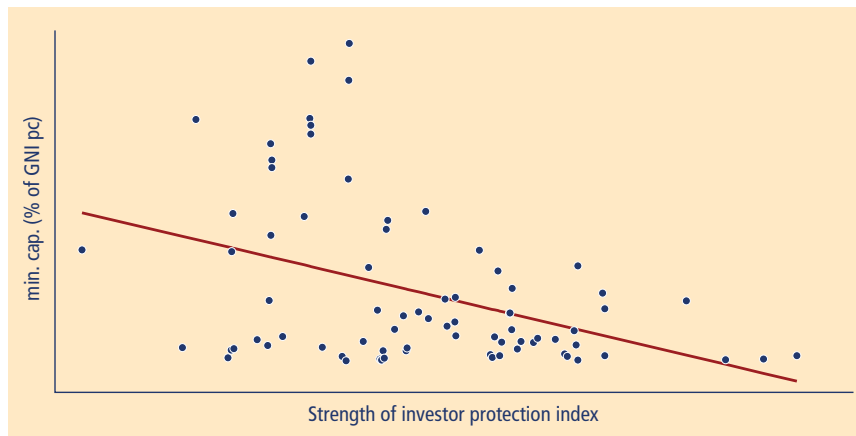
Another study on the effects of deregulation of corporate laws on company incorporation shows that entrepreneurs have taken advantage of recent rulings by the European Court of Justice allowing them to select the economy where they incorporate regardless of their initial location. For instance, cross-country incorporation from businesses in other EU economies increased significantly in the United Kingdom, driven by low capital requirements and start-up costs.²³

WHAT IS THE ECONOMIC RELEVANCE OF MINIMUM CAPITAL REQUIREMENTS?

Through the analysis of minimum capital requirements it is possible to identify 2 main types of correlations: one relating minimum capital requirements to other types of regulations and another relating minimum capital requirements with economic outcomes, such as the size of the informal economy. All the results presented here are based on correlations and cannot be interpreted as causal.

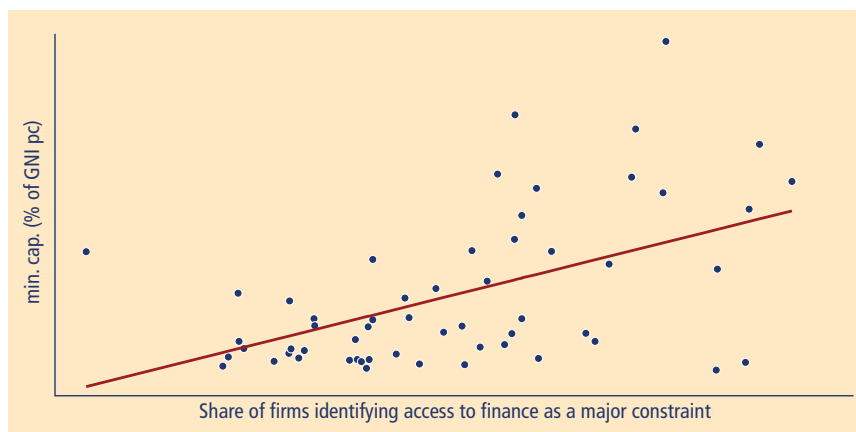
The analysis shows that minimum capital requirements are related to 2 types of regulations: insolvency laws and its implementation and minority shareholder protection. The efficiency of insolvency laws is measured by the *Doing Business* recovery rate indicator. The regression analysis suggests that minimum capital

FIGURE 4.3 Higher minimum capital requirements are associated with weaker investor protection



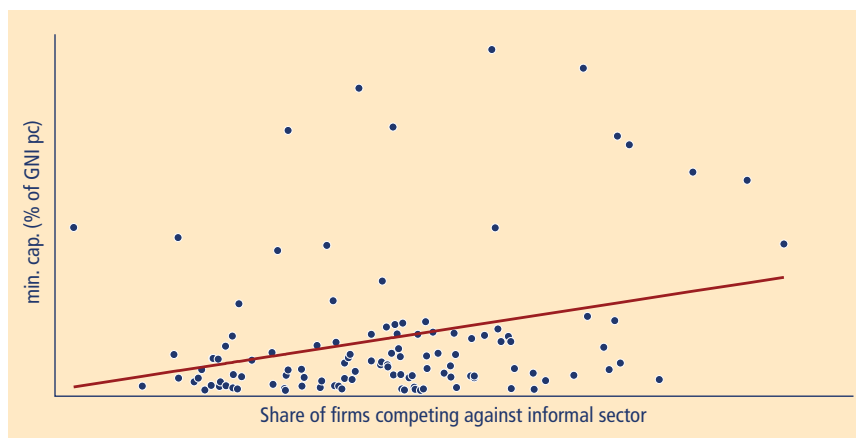
Source: Doing Business database.

FIGURE 4.4 Higher minimum capital requirements are associated with less access to finance for small and medium-size enterprises



Source: World Bank Enterprise Surveys, 2012.

FIGURE 4.5 Higher minimum capital requirements are associated with more informality



Source: World Bank Enterprise Surveys, 2012.

requirements might not help creditors recover their investments. There is a strong negative association between such requirements as measured as a percentage of an economy's income per capita and the recovery rate of creditors. The recovery rate for investors tends to be higher in economies that do not have minimum capital requirements.²⁴ So, indeed, such requirements do not play a crucial role in safeguarding creditors against company bankruptcies.

The negative correlation between minimum capital requirements and the strength of investor protection index (which measures legally required minority shareholder protections provided by law) is also significant (figure 4.3).^{25,26} Economies that do not have minimum capital requirements or set them very low tend to better protect investors by being more likely to promote transparency in corporate transactions, provide easy access to corporate information and have stricter director liability standards.

With regards to economic outcomes, the analysis shows that in economies with high minimum capital requirements, small and medium-size firms have less access to bank financing.²⁷ The analysis also reveals a strong correlation between the amount of minimum capital required and the percentage of small and medium-size enterprises that cite access to finance as a major constraint to their business operations (figure 4.4).

Furthermore, there is a strong positive association between minimum capital requirements and the percentage of firms in economies who say that the informal economy severely constrains their growth (figure 4.5). If entry costs are prohibitively high, entrepreneurs might be disinclined to formalize their businesses. There is also a strong negative relationship between the number of years that firms operate without formal registration and the burden of minimum capital requirements.²⁸ Based on this relationship, higher minimum capital requirements are associated with longer periods when firms operate without formal licenses. The less money that firms have to spend on minimum capital requirements, the less likely they are to compete against informal businesses as

those firms have a greater incentive to become formally registered.

There is also a strong negative association between minimum capital requirements and the number of new formal businesses.²⁹ This result supports the argument that minimum capital requirements deter entrepreneurial activity, creating obstacles for business development.

CONCLUSION

Despite its shortcomings, minimum capital requirements remain a reality for many economies, especially in the Middle East and North Africa and Sub-Saharan Africa. But every year more economies slash or eliminate how much money entrepreneurs must deposit to start businesses. Governments can take various other steps to protect investors and creditors, minimize risks of bankruptcy and safeguard consumers from potentially hazardous products.

NOTES

This case study was written by Valentina Saltane and Paula Garcia Serna.

1. vanStel, Storey and Thurik (2007); Blanchflower, Oswald and Stutzer (2001); Klapper and Love (2011); Dreher and Gassebner (2011).
2. The paid-in minimum capital measured by the starting a business indicator represents the amount an entrepreneur needs to deposit within 3 months of business incorporation. In the following sections it is referred to as minimum capital.
3. For instance, in Belgium the required minimum capital is defined in the Company Code, in Ecuador in the Companies Act and in Togo in the Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA) Uniform Act on the General Commercial Law.
4. vanStel, Storey and Thurik (2007); Blanchflower, Oswald and Stutzer (2001).
5. Belarus, Bulgaria, Kazakhstan, Kosovo, Lithuania, FYR Macedonia, Romania, Serbia, Ukraine and Uzbekistan.
6. OHADA members are Benin, Burkina Faso, Cameroon, the Central African Republic, Chad, the Comoros, the Republic of Congo, Côte d'Ivoire, the Democratic Republic of Congo, Gabon, Guinea, Guinea-Bissau, Mali, Niger, Senegal and Togo.
7. The German AktG of 1937 and the Italian Civil Code of 1942.
8. Chan 2009.
9. Miola 2005.
10. Djankov 2009; Ewang 2007; Alonso Ledesma 2007.
11. Mülbart 2006.
12. Hornuf and others 2011.
13. World Development Indicators 2012 and *Doing Business* database.
14. Chan 2009.
15. Chan 2009.
16. Miola 2005.
17. Ewang 2007.
18. Alonso Ledesma 2007.
19. Miola 2005.
20. Miola 2005.
21. Booth 2005.
22. Hornuf and others 2011.
23. Becht, Mayer and Wagner 2008.
24. The results are significant at the 5% level after controlling for income per capita.
25. The strength of the investor protection index is the average of the extent of the disclosure index, the extent of the director liability index and the ease of the shareholder suits index. The index ranges from 0 to 10, with higher values indicating more investor protection.
26. The results are significant at the 5% level after controlling for income per capita.
27. The results are significant at the 5% level after controlling for income per capita.
28. The results are significant at the 5% level after controlling for income per capita.
29. The results are significant at the 5% level after controlling for income per capita.