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## Can We Rank Legal Systems According to Their Economic Efficiency?

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# Can We Rank Legal Systems According to Their Economic Efficiency?

Claude Ménard\*  
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## INTRODUCTION

The issue of the impact of law, particularly business law, on the economy and growth, has become the topic of hot debates over the last several decades within the academy and among policy makers, particularly in the development agency community. For policy makers, this interest grew out of disillusionment in the 1980s over the effect of structural adjustment policies that have led development agencies to focus on the implementation of structural reforms. This in turn rapidly introduced into the picture a need to reform institutions, with special attention to the legal framework. The issue became particularly prominent on policy maker's agendas with private foreign direct investments overriding public aid. Indeed, how could countries attract foreign investments without having the appropriate institutions providing guarantees for investors?

There were, of course, preliminary investigations among theoreticians about the role of legal institutions before the 1980s that paved the way for the ongoing research, although these prior investigations often are neglected by practitioners (and some

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researchers as well) who give the impression that they are reinventing the wheel. With regard to research about the impact of law and the legal system on economies, no one can ignore the seminal contributions of Ronald Coase. In his famous paper from 1960,<sup>1</sup> Coase showed that in absence of transaction costs, which is how mainstream economists were reasoning at the time, institutions such as legal systems do not matter and as a result that optimal solutions could be reached by agents through adequate renegotiations, regardless of the type of institutions. However, as soon as we enter a world with positive transaction costs, institutions play a crucial role in shaping the form that exchanges will take—and their costs. In this context, the impact of the legal system can not be ignored. Taking this approach as his point of departure, Douglass North developed an analysis of the crucial role of institutions over time for explaining development and growth but focused more on the political system than on the legal one.<sup>2</sup>

However, it may be the practitioner and ideological agitator who was trained along the coasian model,<sup>3</sup> Hernando de Soto, that contributed most significantly to the change of attitudes among development agencies. Examining the time and cost of setting up a new business in the poor suburbs of Lima, Peru, de Soto identified the weight that the absence of an adequate legal framework put on transactions in obliging parties to depend on the informal sector.<sup>4</sup> Indeed, he showed that: (i) poor are forced to remain within informality because the formal law is too complicated and cumbersome; (ii) informality imposes a dead weight loss, hindering the “hidden capital” of the poor to yield a proper return or to be used as collateral.<sup>5</sup> With adequate property rights and a simplified formal legal system, this “dead capital” could provide leverage, bolstering growth and development.<sup>6</sup>

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1. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 44 (1960).

2. DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE* (Cambridge University Press 1990).

3. HERNANDO DE SOTO, *THE OTHER PATH: THE ECONOMIC ANSWER TO TERRORISM* (Harper and Row 1989) (1986).

4. *Id.*

5. *Id.*

6. *Id.*

These ideas melted with other sources in the framework developed by La Porta, Lopez de Silanes, Shleifer and Vishny (“LLSV”), in the late 1990s.<sup>7</sup> In a series of papers, they linked the legal framework to the development of financial markets and, through finance, to growth and development.<sup>8</sup> The World Bank, among other institutions, caught these ideas and transformed what was initially a tentative correlation into normative guidelines.<sup>9</sup> It is the purpose of this Article to show and criticize this process. Indeed, it is our conviction that this issue deserves attention because it is likely to remain a prominent fixture on the agenda of law and economics research as well as development agencies for at least the coming decade.

Our analysis is developed as follows. Part I describes the history and methodology of the research conducted by LLSV. Part II examines the transformation of the correlation explored by LLSV into a normative approach that is illustrated particularly well by the series of reports from the International Finance Corporation (IFC—World Bank Group) on *Doing Business*.<sup>10</sup> Part III discusses the results exposed in these reports while considering the theoretical issues involved, which have to do with whether it makes sense to rank legal systems, and procedures considered for doing so. Part IV concludes with indications about what to expect from a sound comparative approach to legal systems combining law and economics.

## I. FROM CORRELATIONS TO CAUSALITY

The initial papers by LLSV started as an effort to discover whether there was a correlation between the legal framework of a

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7. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1155 (1998).

8. *Id.*

9. *See infra* note 10.

10. WORLD BANK / INTERNATIONAL FINANCE CORPORATION, *DOING BUSINESS IN 2004: UNDERSTANDING REGULATION* (World Bank, IFC and Oxford University Press 2004) [hereinafter *UNDERSTANDING REGULATION*]; WORLD BANK / INTERNATIONAL FINANCE CORPORATION, *DOING BUSINESS IN 2005: REMOVING OBSTACLES TO GROWTH* (World Bank, IFC and Oxford University Press 2005) [hereinafter *REMOVING OBSTACLES TO GROWTH*]; WORLD BANK / INTERNATIONAL FINANCE CORPORATION, *DOING BUSINESS IN 2006: CREATING JOBS* (World Bank, IFC and Oxford University Press 2006) [hereinafter *CREATING JOBS*].

country and the development of its financial system, with the following underlying assumptions: (a) that there is a benchmark for “good” financial markets (the US model) and (b) that extensive financial markets command growth.<sup>11</sup> The model was progressively transformed into a more general theory about the development of markets, ending up in a so-called “New Comparative Economics”<sup>12</sup> that inspired the normative approach proposed in *Doing Business*.<sup>13</sup> In this part, we examine this transformation from a broad, mainly inductive framework to a set of normative propositions.

#### A. Revisiting LLSV: The “New Comparative Economics”

A standard reference for understanding the theoretical framework behind the *Doing Business* project is the often quoted paper by LLSV on “The New Comparative Economics.”<sup>14</sup> The starting point of the paper is that rights attached to securities, and the protection of shareholders and creditors is a major factor in explaining the development of financial markets.<sup>15</sup> As stated in 1998, “shareholders receive dividends because they can vote out directors who do not pay them, and creditors are paid because they have power to repossess collateral.”<sup>16</sup> The second step of the argument focuses on the idea that these rights depend on legal rules and their enforcement, since this delineates what rights security holders have legally and how well their rights are going to be protected.<sup>17</sup> The next step then, logically, argues that characteristics of these rules and the environment framing their implementation will determine the possibility for financial markets to fully develop.<sup>18</sup> A last step consists of identifying these environments. Two so-called “legal families” with respect to commercial laws, representing polar cases, were identified in the

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11. La Porta et al., *supra* note 7, at 1117–26.

12. Andrei Shleifer et al., *The New Comparative Economics*, 31 J. COMP. ECON. 595 (2003).

13. See *supra* note 10 and accompanying text.

14. La Porta et al., *supra* note 7.

15. *Id.* at 1113–17.

16. *Id.* at 1114.

17. *Id.* at 1116.

18. *Id.* at 1152.

1998 paper,<sup>19</sup> and were later nuanced in the 2003 paper:<sup>20</sup> first, the common law tradition, in which legal rules pertaining to the rights of investors and their enforcement would be the strongest, and second, the civil law tradition (also identified as the French tradition) that would provide the weakest protection, with the German and Scandinavian systems falling somewhere in-between.<sup>21</sup>

While introducing several nuances, the 2003 paper by Djankov et al. basically restated the same propositions, namely that: (a) laws differ markedly around the world, limiting more or less investors' rights, with a clear advantage to common law countries in that respect; (b) law enforcement differs a great deal around the world, and empirical observation would confirm that these differences reinforce the trend favorable to common law countries; and (c) different mechanisms, such as concentration, develop as a response to the poor protection of investors outside the common law countries, but they do the job quite inefficiently.<sup>22</sup>

However, the manifesto that is developed in the “New Comparative Economics” paper goes further in at least two aspects. First, it explicitly assumes that there is a close relationship between “good” institutional design and economic development, and that countries with poor investor protections, either because of their legal system or because of the enforcement rules of this system, severely suffer in their economic dynamics.<sup>23</sup> Demonstrating this relationship through statistical evidence is clearly the research strategy resulting from this proposition, a strategy that articulates the *Doing Business* project.<sup>24</sup> Second, and quite significantly, the 2003 paper switches the focus of the analysis from comparative legal systems and their impact, which is a difficult research program to implement rigorously, to the investigation of the role of regulations on economic development and growth.<sup>25</sup> Although the paper develops as if the regulatory approach would be rigorously embedded in the legal

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19. *Id.* at 1117–21.

20. Shleifer et al., *supra* note 12, at 604–09.

21. La Porta et al., *supra* note 7, at 1113–55; *see also* Shleifer et al., *supra* note 12.

22. Shleifer et al., *supra* note 12, at 595–619.

23. La Porta et al., *supra* note 7, at 1120–21.

24. *Id.* at 1113–55.

25. Shleifer et al., *supra* note 12, at 595–619.

system approach, we submit that these are two substantially different stories, as we will illustrate below.<sup>26</sup> However, the move had important consequences. In identifying legal systems as regulations implemented in different legal environments, it provided a way to deal with the measurement issue. In considering that regulations are representative of the legal systems in which they developed, LLSV reoriented the comparative analysis of legal system to the establishment of ranking procedures for ordering regulatory regimes according to their capacity to facilitate the organization of transactions. In providing support to the ranking of the different legal regimes, it opened the way to normative propositions, strongly oriented toward substituting common law regimes to other regimes whenever it is possible.<sup>27</sup>

#### *B. The “Doing Business” Reports*

Thus, the initial research program from LLSV progressively shifted toward the development of tools for ordering the relative efficiency of different systems, progressively identifying regulatory (administrative) regimes with the different legal systems in which they are more or less embedded. This move crystallized in the ongoing series of the IFC (World Bank Group) reports on *Doing Business*.<sup>28</sup> The qualitative breakthrough of these reports compared to the initial papers is twofold. First, the successive reports intend to develop an increasingly sophisticated tool for measuring the aggregate performance of different systems, particularly legal ones.<sup>29</sup> Second, the reports unambiguously intend to derive prescriptive propositions from the LLSV research results in order to define a benchmark for comparing and evaluating legal systems worldwide, and for establishing policy recommendations.<sup>30</sup> In this respect, the initial set of 1998 to 2000 papers from LLSV are undergoing a significant revision. However, the methodology has not changed

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26. *Id.* at 595.

27. *Id.*

28. *See supra* note 10 and accompanying text.

29. *Id.*

30. *Id.*

much in the new version of these papers when compared to earlier ones.<sup>31</sup>

## II. “DOING BUSINESS”: WHAT IS IT’S ANALYTICAL FRAMEWORK?

The research program and the policy agenda defined by “*Doing Business*” are produced in the 2004 report.<sup>32</sup> Although the wording of the subsequent reports (2005 and 2006) is more nuanced and polished, they are all derived from that initial framework.<sup>33</sup>

The agenda established in these reports is unambiguous: it is to formulate prescriptions for developing as well as developed countries in order to bolster growth.<sup>34</sup> The main tool for reaching this goal is to propose a standardization of law along the lines identified by the best legal practice, with the explicit proposal that “one size (can) fit all.”<sup>35</sup> From LLSV’s perspective, the analytical framework can be summarized in three main arguments.

1. In accordance with the property rights theory as reformulated by de Soto, the capacity to define and implement property rights is a necessary condition for reducing informality. Reducing informality is a major hindrance to economic growth since people working in the informal sector cannot leverage their assets and because informality raises transaction costs by generating high rates of uncertainty among parties.<sup>36</sup>

2. The negative effects of informality are even greater when applied to property rights because it inhibits two major micro-economic components of growth: (a) the existence and development of entrepreneurship at the local level and (b) the capacity to attract foreign investments, which is a dimension that was not really significant to de Soto but that follows quite naturally from the LLSV approach.<sup>37</sup> Indeed, when local financial markets are underdeveloped,

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31. Simeon Djankov et al., *The Law and Economics of Self-Dealing* 4–6 (Nat’l Bureau of Econ. Research, Working Paper No. W11883, 2006), available at <http://www.istfin.eco.unisi.ch/flopez.pdf>.

32. UNDERSTANDING REGULATION, *supra* note 10, at viii.

33. See *supra* note 10 and accompanying text.

34. UNDERSTANDING REGULATION, *supra* note 10, at viii.

35. *Id.* at xvi.

36. REMOVING OBSTACLES TO GROWTH, *supra* note 10, at 33.

37. See *supra* notes 3 & 7 and accompanying text.



the capacity to attract investors from abroad becomes a strategic factor for development.

3. In most cases, informality is a by-product of a formal legal framework that is unduly complicated and/or full of barriers to entrepreneurship. Therefore, for all countries, and particularly for low developed countries, which are plagued with inexistent or largely underdeveloped financial markets, reforms should be implemented in the legal system that could be conducive to foreign investments. Such a legal system has two significant advantages. First, it is oriented toward facilitating business and entrepreneurship, especially toward facilitating business for foreign investors.<sup>38</sup> Second, it should be as simple as possible and should impose the lowest transaction costs possible. The central proposition derives from these two properties: legal systems should be evaluated and ranked according to their capacity to minimize delays in establishing a business and to maximize guarantees that property rights will be enforced, while the costs of getting these results should be minimized.<sup>39</sup> The identification of the best legal system conforming to these criteria is a matter of empirical research. Hence, the methodology adopted for measuring and comparing the performance of different legal systems is very important.

#### A. *The “Doing Business” Methodology*<sup>40</sup>

In *Doing Business*, the assessment of the quality of a country’s legal system is based on the quantification of the quality of several legal procedures.<sup>41</sup> Five “items” (related to procedures involved in doing business) were evaluated in the 2004 report and seven in 2005;

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38. REMOVING OBSTACLES TO GROWTH, *supra* note 10, at 67. To illustrate, a bankruptcy law is stamped as “good” in *Doing Business* only if it is oriented toward the quick and large recovery of debts by creditors, with no consideration for the positive effects that debtor’s continuation of activity may have.

39. *Id.* at 3.

40. A description of this methodology appears in UNDERSTANDING REGULATION and in following reports in the “Data Notes” section: UNDERSTANDING REGULATION, *supra* note 10, at 105–14; REMOVING OBSTACLES TO GROWTH, *supra* note 10, at 79–87; CREATING JOBS, *supra* note 10, at 77–89.

41. *See supra* note 10 and accompanying text.

there are up to ten “items” in the 2006 report.<sup>42</sup> These items were selected according to their presumed impact, either on the business climate (e.g., the capacity to enforce contracts as crucial to the development of transactions), or on macroeconomic aggregates (e.g., information available on potential debtors is crucial for creditors, therefore fostering credit, investment, and finally the GDP).<sup>43</sup>

Each procedure is documented through several indices that are built according to what *Doing Business* calls “a time and motion” approach.<sup>44</sup> In order to build these indices, the *Doing Business* team created a representative case for each item. This representative case is processed “as if” it were a sample, exemplifying the relationships that businessmen have with the country’s legal system in order to complete standard operations such as cashing an unpaid check, building a warehouse, etc.<sup>45</sup>

Detailed questionnaires, sometimes fairly lengthy, are then sent to local lawyers and businessmen.<sup>46</sup> The respondents have to compute the number of steps and the time and costs to perform each legal procedure pertaining to each case.<sup>47</sup> They also answer questions about the presence of specific legal instruments within the country’s legal framework.<sup>48</sup> Data is collected country by country, for each selected case using this method. Legal processes are represented through histograms.<sup>49</sup> For many items, countries’ data are used to compute a set of partial composite indices. The resulting set of indicators is shown in Table 1.

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42. *Id.*

43. *Id.*

44. *See supra* note 10 and accompanying text.

45. *Id.* at 11.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 12.

TABLE 1  
CONSTRUCTION OF THE “EASE OF DOING BUSINESS” INDEX,  
DOING BUSINESS 2005<sup>50</sup>

| Items                    | Sub indices  | Time and Motion | Cost                   | Occurrence of Certain Legal Patterns  | Others Quantitative    |
|--------------------------|--|-----------------|------------------------|---|------------------------|
| Starting a Business      | Procedures   | Number          |                        |   |                        |
|                          | Time   | Days            |                        |   |                        |
|                          | Cost   |                 | % of income per capita |   |                        |
|                          | Minimum Capital  |                 |                        |   | % of income per capita |
| Hiring and Firing Worker | Difficulty of hiring index (1/3 of rigidity of employment index) |                 |                        | Yes/No Type (score of 1 for the occurrence of a certain feature in the law) |                        |
|                          | Rigidity of hours index (1/3 of rigidity of employment index)    |                 |                        | Yes/No Type (score of 1 for the occurrence of a certain feature in the law) |                        |
|                          | Difficulty of firing index (1/3 of rigidity of employment index) |                 |                        | Yes/No Type (score of 1 for the occurrence of a certain feature in the law) |                        |
|                          | Hiring Cost  |                 | % of salary            |   |                        |
|                          | Firing Cost  |                 | weeks of salary        |   |                        |
|                          |  |                 |                        |   |                        |
| Registering Property     | Procedures   | Number          |                        |   |                        |
|                          | Time   | Days            |                        |   |                        |
|                          | Cost   |                 | % of property value    |   |                        |

50. REMOVING OBSTACLES TO GROWTH, *supra* note 10, at 89–109; CREATING JOBS, *supra* note 10, at 95–109. Eight indices in this table compute the occurrence of certain specific features in a country’s substantive law. They are mostly significant in expressing the distance between the legal framework of a country on one hand, and the analytical framework adopted in the *Doing Business* reports on the other hand. Therefore, they are the most likely to express structural biases, which may also appear in other indices. These eight indices amount to thirty-two percent of the final ranking.

Seven indices belong to the “time and motion” category. Those in this category compute the time required and the number of procedures to navigate the legal system. Therefore, they mostly capture the administrative burden and not the “quality” of the substance of the law in itself.

| Items   | Sub indices                              | Time and Motion | Cost        | Occurrence of Certain Legal Patterns   | Others Quantitative |
|---|--|-----------------|-------------|--|---------------------|
| Getting Credit  | Strength of legal index rights           |                 |             | Yes/No Type (score of 1 for the occurrence of a certain feature in the law)                |                     |
|   | Depth of credit information index        |                 |             | Yes/No Type (score of 1 for the occurrence of a certain feature in the law)                |                     |
|   | Public registry coverage                 |                 |             |  | % of adults         |
|   | Private bureau coverage                  |                 |             |  | % of adults         |
| Protecting Investors (Strength of investors protection index) | Extent of disclosure index (1/3)         |                 |             | Yes/No Type: value from 0 to 10 according to the occurrence of certain features in the law |                     |
|   | Extent of director liability index (1/3) |                 |             | Yes/No Type: value from 0 to 10 according to the occurrence of certain features in the law |                     |
|   | Ease of shareholders suits index (1/3)   |                 |             | Yes/No Type: value from 0 to 10 according to the occurrence of certain features in the law |                     |
| Enforcing contracts   | Procedures                               | Number          |             |  |                     |
|   | Time                                     | Days            |             |  |                     |
|   | Cost                                     |                 | % of debt   |  |                     |
| Closing a Business  | Time                                     | Years           |             |  |                     |
|   | Cost                                     |                 | % of estate |  |                     |
|   | Recovery rate                            |                 |             |  | Cents on the dollar |
| Average: "ease of doing business" index in DB 2006            | 25 (100%)                                | 7 (28%)         | 6 (24%)     | 8 (32%)  | 4 (16%)             |

Based on these indicators, countries are then ranked by percentile according to each procedure. A country's percentile rank for each item is the average of its percentile ranks on partial indices. The final step consists on ranking a country's global "Ease of Doing Business" according to the simple average of its partial percentile ranks. *Doing Business* reports therefore establish a scoreboard of countries.<sup>51</sup> *Doing Business 2006* is the first of these reports having a worldwide coverage, from the Fiji Islands to the U.S.<sup>52</sup>

### B. The Fascination of Ranking

The database established for *Doing Business* combines very attractive features. First, it represents a huge amount of data, very often collected directly for the needs of the database, for ten different items (and several partial indices for each of them) in 155 countries in the 2006 report (the database has significantly been extended from one report to the other).<sup>53</sup> Second, the indices used are easy to understand and to publicize. Third, data and the relevant indices are then synthesized in a general scoreboard that can be easily advertised through mass media.<sup>54</sup>

This "Ease of Doing Business" index, publicized by the IFC (World Bank Group), is not the only benchmark available for assessing the "quality" of legal framework or institutions.<sup>55</sup> However, this is the first time to our knowledge that a public international organization has published such a "scoreboard."<sup>56</sup> Moreover, this scoreboard is also used internally by the World Bank to determine the conditionality imposed on borrowing countries.<sup>57</sup> Therefore, the

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51. CREATING JOBS, *supra* note 10, at 110–61.

52. *Id.*

53. See *supra* note 10 and accompanying text.

54. *Id.*

55. *Id.* For a list of indices, see UNDERSTANDING REGULATION, ch. 1 (the section entitled, "Other Indicators in a Crowded Field").

56. *Id.* The OECD's report on "Going for Growth" does not publicize its data in the form of a scoreboard.

57. Peter Bakvis, *How the World Bank & IMF Use the Doing Business Report to Promote Labour Market Deregulation in Developing Countries*, Mimeo, ICFTU/GLOBAL UNIONS (2006), available at <http://www.icftu.org/displaydocument.asp?Index=991224958&Language=EN>.

impact of *Doing Business* is far from negligible, not only in academia, but also, and even more so, among policy makers and development agencies worldwide.

To summarize, the *Doing Business* reports develop positive indicators in order to draw normative conclusions about what is and should be a “good” legal system, that is: a system maximizing speed and minimizing transaction costs, thus conducive to foreign investments and growth.<sup>58</sup> The measures proposed are deal oriented because they evaluate the speed and the costs of doing business at the point where a transaction is initiated and from the viewpoint of the party initiating the transaction.<sup>59</sup>

### III. DISCUSSION OF THE RESULTS FROM “DOING BUSINESS”

The *Doing Business* reports have had an increasing impact both in academia and on decision makers, particularly on the level of ideological discussions. Indeed, changing “real” institutions in order to reach what would be an ideal benchmark is another story than discussing the virtues and vices of different legal systems. However, notwithstanding their imperfection and biases, the reports have the merit of having put high on the agenda the analysis of institutions, particularly of legal regimes, as a key factor for understanding development and growth as well as inhibitions of economic forces. As such, the reports deserve attention. There are two ways for discussing *Doing Business*. One is to reexamine carefully the underlying model as developed initially by LLSV.<sup>60</sup> The other is to look at the results developed in the reports and their underlying methodology. In the following parts, we focus on the second approach.

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58. See *supra* note 10 and accompanying text.

59. *Id.*

60. See La Porta et al., *supra* note 7. Discussions in that direction are provided in several chapters of section III, Legal Institutions of a Market Economy, in MENARD and SHIRLEY.

A. A Poor Explanatory Power<sup>61</sup>

Technically speaking, the results proposed in *Doing Business*' reports are actually quite disappointing, particularly when it comes to the significance of their global index ("ease of doing business").<sup>62</sup> The explanatory power of the variables appears to be quite low and does not confirm the promises of their analytical framework. However, part of its weaknesses are likely rooted in the difficulties of building an adequate database on these issues.

According to the assumptions developed in *Doing Business* and derived from LLSV (1998), and conditional to the quality of the database and the calculations based on these data, there should exist a strong relationship between a "sound legal framework" and several macroeconomic variables, particularly Foreign Direct Investments (FDI), which are underlying the entire project, and Gross Domestic Product (GDP), which is its primary target.

The 2005 report went as far as possible in that direction in trying to establish such a relationship.<sup>63</sup> The 2006 report, which is not discussed here, goes a step further, in that it uses the data to rank all 155 countries of the database.<sup>64</sup> The 2005 report identified "good performers" according to an "ease of doing business" index built as the average of several "item indices."<sup>65</sup> However, the comparison of

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61. This section relies on a preliminary note by Didier Blanchet, "Analyses exploratoires des indices proposés par les Rapports *Doing Business* 2005 et 2006 de la Banque mondiale" written in September 2005 and its 2006 revision based on the 2006 *Doing Business* report. The main results are published in *Des Indicateurs Pour Mesurer le Droit?* by du Marais. See *infra* note 66. As emphasized in Blanchet, three dimensions should be considered when evaluating the methodology of a project like *Doing Business*. First, what is the quality of the data collected? Second, what is the quality of the aggregated indicators (when they result from aggregation)? Third, how significant are the variables thus constructed with respect to the unexplained variables? In our discussion, we focus on this third dimension.

62. See *supra* note 10.

63. REMOVING OBSTACLES TO GROWTH, *supra* note 10.

64. CREATING JOBS, *supra* note 10.

65. REMOVING OBSTACLES TO GROWTH, *supra* note 10, at 87. The composite index "ease in doing business" is constructed in three steps: (i) Variables in the database are transformed into ranking variables; (ii) For each of the seven domains covered in 2005, simple averages are calculated (it should be noted that not all variables for each domain are taken into account, with no obvious explanation for variables dropped from the calculation); (iii) resulting ranks for the seven domains are then averaged as well, giving way to the final rank for each country on the database. *Id.*

this composite index with statistics on FDI, the growth of GDP, and the rate of investments, provides poor indications that the index is really significant, as pointed out in Blanchet,<sup>66</sup> but also, to a certain extent, in Djankov et al.<sup>67</sup> Blanchet estimated a relatively simple regression analysis between the “ease of doing business index” and variations in four macroeconomic variables considered as particularly significant in the *Doing Business* reports as well as in the underlying model.<sup>68</sup> The methodology is close to the one developed by Gregoir and Maurel who discussed the *World Economic Forum* report.<sup>69</sup> Table 2 summarizes the main results of this simulation and our comments on the coefficients.<sup>70</sup>

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66. Didier Blanchet, *Analyses exploratoires des indices proposés par les Rapports Doing Business 2005 et 2006 de la Banque mondiale*, in DES INDICATORS POUR MESURER LE DROIT? LES LIMITES METHODOLOGIQUES DES RAPPORTS DOING BUSINESS (Bertrand du Marais ed., 2006).

67. Simeon Djankov et al., *Regulation and Growth*, 92 ECON. LETTERS 395 (2006).

68. Blanchet, *supra* note 66. Since the exact methodology for weighting variables is not explicated in the 2005 report and in the associated database posted on the World Bank website (<http://rru.worldbank.org/doingbusiness>), Blanchet reconstituted the weighted composite index, with results that are close enough to the one obtained by the World Bank team to make these results significant. *Id.*

69. Gregoir, Stephane & Françoise Maurel, *Les Indices de Compétitivité des Pays: Interpretations et Limites*, in CONSEIL D'ANALYSE ECONOMIQUE, COMPETITIVITE, RAPPORT 40 (Michèle Dubonneuil & Lionel Fontagné eds., 2003).

70. T-Students are negative since the composite index defines rank variable as increasing with the difficulty to do business: the more difficult it is to do business, the higher rank a country has (e.g., in the 2006 report, New Zealand is ranked first, Switzerland 17, Botswana 40, France 44, and Congo (Rep. Dem.) being the last (155)).



TABLE 2  
THE EXPLANATORY POWER OF THE “EASE OF DOING BUSINESS  
INDEX”

| Dependent variables              | $\Delta$ GDP<br>(between 1999 and 2003) | FDI<br>(as % of GDP) | INVESTMENTS<br>(as % of GDP) | HDI                  |
|----------------------------------|---|----------------------|------------------------------|----------------------|
| Independent variables            |   |                      |                              |                      |
| Control Variable<br>(GDP/capita) | -0.000962<br>(-3.21)                    | 0.0000998<br>(1.58)  | -0.0001327<br>(-1.73)        | 0.0000069<br>(4.77)  |
| Ease of Doing Business index     | -0.0315936<br>(-4.24)                   | -0.009475<br>(-0.60) | -0.04367<br>(-2.29)          | -0.002371<br>(-6.61) |
| Constant                         | 4.82913<br>(7.05)                       | 4.113988<br>(2.85)   | 25.59038<br>(14.67)          | 0.8121173<br>(24.60) |
| R <sup>2</sup>                   | 0.1229                                  | 0.055                | 0.0398                       | 0.5897               |
| Comments on coefficients:        | Significant                             | Non significant      | Significant (but low)        | Significant          |
| Explanatory power:               | Marginal                                | Nul                  | Low                          | Significant          |

Note: Parentheses=T-Student.

In other terms, a basic test used by macroeconomists shows the weak explanatory power of the synthetic index built in *Doing Business*. The one exception is the variation in Human Development

Index (HDI), for which the explanatory power of the index is significant. However, this relationship is difficult to interpret unambiguously; it could very well be that HDI and the “ease of doing business” are both dependant on the level of the GDP or another factor. More important, the index seems to provide no explanation at all about the effect of law and regulations on FDI and very little hint on its effect on growth. Regressions between the same dependent variables and the seven specific indices of the 2005 report do not perform better. Last, even when constructing a new estimated index of “the ease of doing business” by changing the parameters in the seven indices in order to simulate different results improves the results a bit, it does not really exhibit significantly better explanatory power of the composite index.

We are aware, of course, that these tests remain somewhat too simplistic. There may be many reasons why the explanatory power remains weak. The structure of the model should be explored more carefully and variables not related to the index should be taken into consideration. For example, more refined tests should include more control variables, e.g., when testing the impact of the “ease in doing business index” on FDI. One problem is that FDI is itself a rather ambiguous variable. Its variations are hard to explain and may be more related to physical and human capital available than to institutional variables such as the legal system. Moreover, some recent empirical studies suggest that FDIs are best correlated to institutions when using gravitation models.<sup>71</sup>

What is even more striking is that the test done by the *Doing Business* team itself is not more conclusive. While testing the “ease of doing business” index against GDP growth, for example, Djankov et al. found that their index is positively and significantly related with growth.<sup>72</sup> However, the explanatory power of the index is very low, even with standard control variables.<sup>73</sup>

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71. Agnès Bénassy-Quéré et al., *Institutional Determinants of Foreign Direct Investment* (CEPII Working Paper No. 2005—05, 2005).

72. Djankov et al., *supra* note 67, at tbl.2. Its impact on the variation of GDP has a coefficient of 4.55.

73. The T-Student is at -1.138 and the R<sup>2</sup> is 0.09.

*B. Methodological Issues at Stake: What to Measure and How to Measure It?*

We believe that these rather weak results are the consequence of the methodology used by the *Doing Business* team while constructing the index. In what follows, we would like to challenge several aspects of the research strategy adopted, providing examples of the biases that it introduced.

1. What to Measure?

The underlying and ultimate goal of the *Doing Business* project is to measure the comparative efficiency of legal systems, understood as a set of laws and regulations.<sup>74</sup> This was clearly stated in the initial 2004 report, which is aligned to the LLSV model that inspired the project.<sup>75</sup> However, this goal is less emphasized in the following reports, maybe because the authors became aware of the difficulties involved. Nevertheless, we share with the *Doing Business* team involved in this project the idea that a comparative approach is definitely needed to assess strength and flaws of different legal systems, and that we should implement measures whenever it is possible. However, in order to proceed convincingly in that direction, determining exactly what must be measured is crucial. In our view, there are very decisive choices to be made in that respect that not only have a methodological dimension, but also an analytical background and even some philosophical dimensions. Let us illustrate the difficulties at stake by examining several questions that a project like *Doing Business* must answer.

2. Laws or Administrative Procedures?

As already mentioned, the methodology adopted in *Doing Business* is mainly oriented toward computing the time and cost of the different stages that a legal framework requires in order to

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74. See *supra* note 10 and accompanying text.

75. UNDERSTANDING REGULATION, *supra* note 10, at ix, xvi; see La Porta et al., *supra* note 7, at 16–17 and accompanying text.

perform a given economic transaction.<sup>76</sup> Therefore, *Doing Business* really does not examine the efficiency of specific laws.<sup>77</sup> It rather focuses on the administrative process imposed on businesses as a (partial) extension of the legal system. In other words, it examines the administrative burden of a given system rather than the efficiency or inefficiency of the laws.<sup>78</sup> This is no surprise since *Doing Business* deals with “investigating the regulations that enhance business activity and those that constrain it.”<sup>79</sup> However, it also means that it is very difficult to disentangle the costs of administrative inefficiencies from costs of the characteristics of the legal regime. The goal assigned to the report, as suggested by the quotation above, well illustrates this ambiguity: “regulation” is difficult to clearly define and identify since it encompasses laws applicable to firms, and the processes used by public agencies and bureaus to implement these laws.

### 3. Laws as Established Formally or Their Enforcement?

Indeed, the ambiguity noted above extends to a mix between the domain of validity of a law and the conditions of its enforcement. Laws are usually established to cover a relatively wide variety of situations. Their implementation and enforcement form an intermediate body of rules oriented towards the application of general laws to specific cases. This is so in both the Civil Code tradition and the Common Law tradition. *Doing Business* does not seriously consider the implications of the complex relationship between these two dimensions.<sup>80</sup> Instead, it basically considers enforcing mechanisms as common and similar for all types of contracts, and even assumes the same for all types of business transactions.<sup>81</sup> On the contrary, as is well known by lawyers and judges, observation of legal commercial systems show that the more sophisticated the legal frameworks have more specific enforcement mechanisms. To a

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76. UNDERSTANDING REGULATION, *supra* note 10, at 2–7.

77. *Id.*

78. *Id.*

79. CREATING JOBS, *supra* note 10, at 1.

80. *See supra* note 10 and accompanying text.

81. *Id.*

certain extent, the multiplicity of specific enforcement mechanisms may be a cause of inefficiency, so that a legal system that remains at too high a level of generality may be more costly than a system with better defined laws because it needs so many intermediations, an issue that is debated among researchers comparing legal systems.<sup>82</sup> Conversely, a law that says nothing about its specific enforcement mechanisms may well provide incentives for using informal structure. In order to be more convincing, *Doing Business* should take into account these problems, or at least point out the difficulties they raise. Currently, the various reports simply ignore this aspect, which seriously weakens the ranking they intend to establish.<sup>83</sup>

#### 4. Legal Regimes or the Actual Life of Legal Regimes?

The “time and motion” methodology adopted for establishing *Doing Business* does not capture the actual practice of laws, such as the way case laws or statutes are interpreted, the probability and effects of conflicts among different laws, or the behavior of economic agents playing with these rules in order to expedite their transactions.

Any of these three limitations resulting from the methodology adopted in *Doing Business* could explain why the scores of countries from the European Union vary so widely.<sup>84</sup> Indeed, if we look at the data provided by the 2006 report on the fifteen initial member states of the European Union, the dispersion is very large, even with respect to items for which laws among these countries have been quite exhaustively harmonized long ago.<sup>85</sup> Clearly, the explanation for these variations lies in factors other than the laws. This question also arises when we look at the overall scoreboard for all countries, for items where international laws set minimum standards, such as labor laws. In that respect, the implicit judgment and implication derived from *Doing Business*’ reports by their authors, who suggest that there could be advantages in suppressing protections of the labor force set

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82. See Gillian K. Hadfield, *The Many Legal Institutions that Support Contractual Commitments*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 175 (C. Ménard & M. Shirley eds., Springer 2005).

83. See *supra* note 10 and accompanying text.

84. *Id.*

85. See CREATING JOBS, *supra* note 10.

by the International Labor Organization's minimum standards is quite surprising.<sup>86</sup> Indeed, these standards are implemented even among the best performing countries and are considered an important tool for ensuring fair international competition.<sup>87</sup> Once more, *Doing Business* is clearly missing or confusing something here that may be related to a methodology that weighs all items similarly, thus overstating or undervaluating some of them.<sup>88</sup>

### C. How to Measure?

These problems, among others, are indubitably rooted in a difficult issue: how to measure the economic impact of legal systems and, more generally, of institutions. In that respect, we must be grateful to the IFC (World Bank Group) and the authors of the successive reports for putting this question high on the research agenda of economists (and, to a lesser degree, of lawyers specializing in comparative analysis), and taking the risk of proposing measures. Nevertheless, there are some surprising aspects in the way the reports have proceeded so far. A few examples are detailed below.

#### 1. Ex Ante v. Ex Post

Economists are usually careful about the differences in measuring an economic phenomenon *ex ante* (e.g., estimating the anticipated growth rate) and measuring its *ex post* outcome (e.g., actual investments and their impact on growth). When it comes to the analysis of the impact of the legal system on the economy of a country, one would expect a careful distinction between trying to assess legal efficiency *ex ante*. For example, economists would normally look at the potential costs that a legal system can impose on transactions, and evaluate its consequences *ex post*, which involves taking into account the actual conditions of implementation and enforcement of this legal system.

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86. See *supra* note 10 and accompanying text.

87. *Id.*

88. *Id.*

As already suggested in the previous subsection, *Doing Business* reports are somewhat ambiguous in that respect.<sup>89</sup> They intend to establish a comparative *ex ante* assessment of the efficiency of law through a quasi-physical computation of the legal process involved in an actual economic transaction.<sup>90</sup> Doing so, they miss a very crucial issue: the conditions under which laws are actually implemented. Indeed, implementation of laws is often extremely different from the rationale behind a law's design. In that respect, it is amazing that the reports do not take into account a major factor: the capacity of a legal system, through its implementation, to reduce or eliminate legal uncertainties surrounding transactions, and the existence (or not) of a legal system that can enforce deals made by parties in a contractual arrangement.<sup>91</sup> Another puzzling black hole is the total absence of consideration for parties other than businessmen, such as consumers, suppliers, fiscal authorities, and agencies in charge of environmental policies, who may bear a significant part of the consequences of the legal systems in their different capacities to get rules of the game implemented. In sum, the reports tend to entirely neglect the indirect costs and benefits of different legal systems as well as their social costs and value.

## 2. How to Build a Universal Benchmark Without Biases?

Another weakness that is quite surprising in reports that intend to take into account fundamental institutions involved in the easiness or difficulty of doing business is that they neglect some basic rules for effective comparative studies. Unfortunately, the reports ignore these well-known rules to all those involved in comparative studies because the reports are so eager to establish the universal superiority of some systems over others. Again, let us illustrate briefly.

In order to make international comparison easier, the team in charge of *Doing Business* defines and uses the same sample of case

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89. *Id.*

90. *Id.*

91. This statement requires an important nuance: *Doing Business* devotes a specific chapter to contract enforcement. However, as we will show below, the approach adopted for doing so is highly questionable from a methodological standpoint.

studies for all countries under review.<sup>92</sup> The goal is clearly and respectably to make the analysis and the propositions it supports universal, with general validity. However, the implementation of this method by selecting specific cases that would be the same for each country endorses a very strong and implicit assumption, which is that in all countries the same legal patterns are used to solve the same type of business issues. As lawyers specializing in comparative analysis of legal systems have known for centuries, this is not so. The real issue is identifying and comparing the many ways through which the same issue is tackled in different legal environments and in different countries.

Let us illustrate this with the important example of contract enforcement (the item: “enforcing a contract”, in *Doing Business* reports). The authors of the reports substantiate this item through the specific case of the easiness (in terms of time, and therefore of costs) of recovering a bounced check, which is the approach already chosen by Djankov et al.<sup>93</sup> Unfortunately, this example is not relevant in many countries, where failing to pay a check is a criminal offense, as for instance in Australia. In many countries, a bounced check is punished by a prison sentence. Therefore, the amount of time and the associated costs of getting a bounced check paid are actually irrelevant in terms of the efficiency of contract enforcement. A criminal penalty may or may not be a sufficient deterrent, and may or may not coexist with cumbersome enforcement procedures. Assessing the comparative efficiency of as “simple” a procedure as recovering a bounced check thus requires taking into account very different ways of dealing with the same problem.

The same critique can be raised against many of the “regulation items” covered in *Doing Business*. For instance, fifty percent of the “getting credit index” is based on two measures of the information coverage: public credit registry and/or private credit bureau.<sup>94</sup> In order to enter into the index, these public or private institutions must meet the criterion that they collect data, both negative and positive,

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92. UNDERSTANDING REGULATION, *supra* note 10, at x.

93. Shleifer et al., *supra* note 12.

94. CREATING JOBS, *supra* note 10, at 82–83.



on debtors.<sup>95</sup> For private bureaus, for example, the reports state that “credit investigative bureaus and credit reporting firms that do not directly facilitate information exchange between financial institutions are not considered.”<sup>96</sup> Therefore, all information available by other means than private credit bureaus, e.g., through the financial information developed by the private industry, which often originates in specific filing obligations, is not taken into account and leads to a “zero” score.<sup>97</sup> This clearly introduces a major bias regarding the quality of information available to creditors in most legal systems. Moreover, it is highly questionable to build an index about the quality of the information for “getting credit” that is expressed as a percentage of the adult population, while the goal of the index is to assess the information available for businessmen.<sup>98</sup>

In sum, the efforts of the *Doing Business* team to identify and isolate a sample of cases making possible comparisons across countries may appear as a sound methodological choice at first glance. However, a more careful examination of the procedure’s implementation shows major biases because the authors neglected some basic rules known to specialists of comparative studies. Indeed, building *ex ante* a sample of specific cases that would be valid universally does not capture the variety of solutions devised by each national legal system and, therefore, relying on the *ex post* conditions to determine the actual costs of doing business in these different environment is inadequate. Building a relevant index would require taking into account both *ex ante* and *ex post* conditions. This idea is illustrated through attempts to measure and compare GDP because it shows that it is meaningless to determine the income per capita without taking into account the purchasing power of those receiving this income. Similarly, it is meaningless to assess the costs of doing business in different legal systems without taking into account the many different ways adopted by different legal systems for dealing with similar issues.

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95. *Id.* at 83.

96. *Id.*

97. *Id.*

98. *Id.* This ratio is even more surprising if we consider the specific questionnaire used by the *Doing Business* team to document this index because it asks the number of *firms* surveyed by public registries or private bureaus.

We can therefore look at *Doing Business* reports as merely an assessment of the distance between a sample of cases, which reflect an ideal model of law, or rather the legal system that the authors are accustomed to, and the diversity of ways with which different countries with different legal systems are dealing when confronted with these particular cases. As *Doing Business* rightly points out, this variety may, to a certain extent, stem from phenomena opposed to sound economic growth such as heritage from legal tradition or rent seeking behaviors.<sup>99</sup> However, we cannot ignore that this variety also reflects ways to efficiently address social and economic specificities of different countries. In that respect, having competing systems may be better than wanting full homogeneity!

#### CONCLUSION: *RANKING V. MEASURING*

There is now a general agreement among economists and among scholars working in the area of law and economics that legal systems matter for understanding what is going on in economies as they are. Institutions are no longer considered as exogenously given and of no interest for economic analysis or falling out of its domain of investigation. Notwithstanding substantial changes in that respect, there is still a long way to go, which makes the development of programs particularly relevant on law and economics, and on the interaction between institutions and economies.

In this Article, we have discussed the recent reports from the IFC (World Bank Group) about *Doing Business*, to illustrate the difficulties facing scholars and policy makers who want to take into account the crucial role of institutions in explaining development and growth.<sup>100</sup> It seems as though *Doing Business* made a major breakthrough, first in ranking legal traditions (*Doing Business*, 2004), then in measuring the “efficiency” of the legal environments of different countries, and finally establishing the “rank” of these countries according to certain variables, particularly their capacity to attract foreign investments (*Doing Business*, 2005 and especially

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99. See generally UNDERSTANDING REGULATION, *supra* note 10, at 1–2.

100. See *supra* note 10 and accompanying text.

2006).<sup>101</sup> However, we have argued that in their existing approach, the reports create an illusion. They pretend to measure the role of legal systems according to their economic efficiency. What they actually do is rank countries according to a set of indices in which the real properties and specificities of legal systems are almost never captured. Analyzing their model and the data collected shows that, notwithstanding the interest one can find in the tentative, the reports end up with a superficial ranking rather than actually measuring the real impact of specific legal instruments. Instead, they identify the market power of some countries in fixing the rules of the game, that is, the legal tools used in making transactions rather than the role of legal systems as determinants for foreign direct investors.

However, our critique does not intend to deter future research on the central issue raised by *Doing Business*. It is actually quite the opposite. We consider it a significant step that an organization like the World Bank began to look seriously at institutions, and particularly at legal systems as a key determinant in the explanation of development and growth. However, we also consider it to be essential that we not embark on the wrong path, going to the wrong place or, even worse, going nowhere. Measuring the economic impact of legal systems is a complex business that needs more conceptual refinement and the careful development of an appropriate methodology. Otherwise, it reflects only ideological biases. We still have a long way to go in order to find the right direction.

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101. *Id.*