Can We Rank Legal Systems According to Their Economic Efficiency?

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I. Introduction

The issue of the impact of Law – especially Business Law – on the economy and especially on growth, has became the topic of hot debates over the last decades, within the academia as well as among policy makers, particularly in the development agencies community. For the latter, this interest grew out of some disillusion, in the 1980's, over the effect of structural adjustment policies that have led development agencies to focus on the implementation of structural reforms, which rapidly introduced in the picture the need to reform institutions and particularly the legal framework. The issue became particularly high on the agenda with private foreign direct investments overriding public aid: how could countries attract foreign investments without appropriate institutions for providing guarantees to investors?

Of course there existed preliminary investigations among theoreticians about the role of legal institutions before the 1980's, investigations that paved the way to the ongoing researches, although they are often neglected by practitioners (and some researchers as well) who give the impression they are reinventing the wheel. When it comes to 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 (COASE, 1960), he 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: optimal solutions would be reached by agents whatever the institutions. However, as soon as we enter in 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 could not be ignored. Taking this approach as his point of departure, although he focused more on the political system than on the legal one, DOUGLASS

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NORTH (1990) developed an analysis of the crucial role of institutions over time for explaining development and growth.

However, it may be a practitioner and ideological agitator trained along the coasian model, HERNANDO DE SOTO (1989), who contributed more significantly to the change of attitude among development agencies. Examining the time and cost of setting up a new business in the poor suburbs of Lima (Peru), he identified the weight that the absence of an adequate legal framework put on transactions in obliging parties to depend on the informal sector. 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. With adequate property rights and a simplified formal legal system, this "dead capital" could provide leverage, bolstering growth and development.

These ideas melted with other sources in the framework developed by LA PORTA, LOPEZ DE SILANES, SHLEIFER and VISHNY (LLSV, 1998) in the late 1990s. In a series of papers, they have linked the legal framework to the development of financial markets and, through finance, to growth and development. The World Bank, among other institutions, caught these ideas and transformed what was initially a tentative correlation into normative guidelines. It is the purpose of this paper to show and criticize this process. Indeed, it is our conviction that this issue deserves attention since it is likely going to remain high on the agenda of Law and Economics for at least the coming decade.

Our analysis is developed as follows. Section 2 examines the transformation of the correlation explored by LLSV into a normative approach particularly well illustrated by the series of reports from the International Finance Corporation (IFC - World Bank Group) on *Doing Business*. Section 3 discusses the results exposed in these reports with a view at the theoretical issues involved, which has to do with whether it makes sense to rank legal systems and procedures considered for doing so. Section 4 concludes with indications about what to expect from a sound comparative approach to legal systems combining Law and Economics.

II. From correlations to Causality.

The initial papers by LLSV started as an effort to find out if there was a correlation between the legal framework of a country and the development of its financial system, with the underlying assumptions: (a) that there is a benchmark for "good" financial markets (the US model); and (b) that extensive financial markets command growth. The model was progressively transformed into a more general theory about the development of markets, ending up in so- called "New Comparative Economics" (SHLEIFER et al., 2003) that inspired the normative approach proposed in *Doing Business*. In this section, 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 now often quoted paper by LA PORTA et al. (1998).[1] The starting point of this paper is that rights attached to securities and to the protection of shareholders and creditors is a major factor in explaining the development of financial markets. As stated in 1998 (p. 1113), "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". The second step of the argument focuses on the idea that these rights depend on legal rules and their enforcements, since this delineates what rights security

[1] From now on identified (as in many recent papers) as LLSV (1998).

holders have and how well their rights are going to be protected. 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. A last step consists in identifying these environments. Two so-called "legal families" with respect to commercial laws, representing polar cases, were identified in the 1998 paper, later nuanced in the 2003 paper: the common law tradition, in which legal rules pertaining to the rights of investors and their enforcement would be the strongest, and the civil law tradition (also identified as the French tradition) that would provide the weakest protection, the German and Scandinavian systems falling somewhere in-between.

While introducing several nuances, the 2003 paper by SHLEIFER 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 also 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.

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, do severely suffer in their economic dynamics. Demonstrating this relationship through statistical evidence is clearly the research strategy resulting from this proposition, a strategy that articulates the *Doing Business* project. 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. Although the paper develops "as if" the regulatory approach would be rigorously embedded in the legal system approach, we submit that these are two substantially different stories, as we will illustrate below. However, the move had important consequences. In identifying legal systems to 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, they 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 towards substituting common law regimes to other regimes whenever it is possible.

B. The "*Doing Business*" reports

Thus, the initial research program from LLSV progressively shifted towards 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.* 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. Second, the reports unambiguously intend to derive prescriptive propositions from the LLSV researches in order to define a benchmark for comparing and evaluating legal systems worldwide, and for establishing policy recommendations.

1. "*Doing Business*": What analytical framework?

The research program and the policy agenda defined by *"Doing Business"* are set in the 2004 report. Although the wording of the subsequent reports (2005 and 2006) is more nuanced and polished, they all derive from that initial framework.

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. 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" (*Doing Business* 2004, p. XVI). In that perspective, the analytical framework can be summarized under three main arguments.

1. In line with the property right theory as reformulated by DE SOTO, the capacity to define and implement property rights is a necessary condition for reducing informality, which is a major burden for economic growth since people working in the informal sector cannot leverage their assets and since informality raises the transaction costs because it generates high uncertainty among parties.

2. This is all the more so since the prevalence of informality when the property rights condition is not satisfied 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 in DE SOTO but that derives quite naturally from the LLSV approach. Indeed, when local financial markets are underdeveloped, the capacity to attract investors from abroad becomes a strategic factor.

3. Most of the time, informality is a by-product of a formal Legal framework which 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 main positive properties. First, it is oriented towards facilitating business: it is entrepreneur-oriented, especially facilitating business for foreign investors.[2] Second, it should be as simple as possible and should impose as low transaction costs as 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, to maximize guarantees that property rights will be enforced, and to minimize the costs of getting these results. The identification of the best legal system conforming to these criteria is a matter of empirical research. Hence the importance of the methodology adopted for measuring and comparing the performance of different legal systems.

2. The "*Doing Business*" methodology[3]

In *Doing* Business, the assessment of the "quality" of a country legal system is based on the quantification of the quality of several legal procedures. Five "items" (related to procedures involved in doing business) were evaluated in the 2004 report and seven in 2005; they are up to ten "items" in the 2006 report ("Data Notes", pp. 77 sq.). These items are selected according to their presumed impact, either on the business climate (e.g., the capacity to enforce contracts is crucial for the development of transactions), or on macroeconomic aggregates (e.g., information available on potential debtors is crucial for creditors, therefore fostering credit, investment, and, as a final result, the GDP).

[2] To illustrate, a bankruptcy law is stamped "good" in *Doing Business* only if it is oriented towards the quick and large recovery of debts by creditors, with no consideration for the positive effects that debtor's continuation of activity may have.

[3] Description of this methodology appears in *Doing Business* 2004 and in following reports in the "Data Notes" section.

Each procedure is documented through several indexes, built according to what *Doing Business* calls "a time and motion" approach. In order to build these indexes, the *Doing Business* team created a representative case for each item. This representative case is processed "as if" it was 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.

Detailed questionnaires, sometimes more than 10 pages long, are then sent to local lawyers and businessmen. The respondents have to compute the number of steps and the time and costs to perform each legal procedure pertaining to each case. They also answer questions about the presence of specific legal instruments within the country's legal framework. Data are thus collected country by country, for each selected case. Legal processes are represented through histograms. For many items, countries' data are used to compute a set of partial composite indexes. The resulting set of indicators is shown in Table [1].

Items	Sub indices	Time and Motion	Cost	Occurrence of Certain Legal Patterns	Others Quantitative Measure
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		
Getting Credit	Strength of legal index rights			Yes/No Type (score of 1 for the occurrence of a certain feature in the Law)	
	Depht 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 2005	25 (100%)	7 (28%)	6 (24%)	8 (32%)	4 (16%)

Table 1: Construction of the "Ease of Doing Business" index, *Doing Business* 2005[4].

4 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 *Doing Business* on the other hand. Therefore, they are the most likely to express structural biases (which may also appear in other indices). They amount to 32 % of the final ranking.

Based on these indicators, countries are then ranked according to each procedure. A country's rank for each item is the average of its ranks on partial indexes. The final step consists on ranking a country's global "Ease of Doing Business" according to the average of its partial ranks. *Doing Business* reports thus establish a scoreboard of countries. *Doing Business 2006* is the first of the reports having a worldwide coverage, from the Fiji Islands to the US.

The database established for *Doing Business* combines very attractive features. First it represents a huge number of data, very often collected directly for the needs of the database, for 10 different items (and several partial indexes for each of them) in 155 countries in the 2006 report (the database has significantly been extended from one report to the other). Second, the indexes used are easy to understand and to publicize. Third, data and the relevant indexes are then synthesized in a general scoreboard that can be easily advertised through mass media.

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[5]. However, this is the first time to our knowledge that a public international organization publishes such a "scoreboard"[6]. Moreover, this scoreboard is also used internally by the World Bank to determine conditionality imposed on borrowing countries. Therefore, the impact of *Doing Business* is far from negligible, not only in the 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/should be a "good" legal system, that is: a system maximizing speed and minimizing transaction costs, thus conducing to foreign investments and growth. The measures proposed are "deal oriented": they evaluate speed and costs of doing business at the point where a transaction is initiated and from the viewpoint of the party initiating the transaction.

III. Discussion of the results from "*Doing Business*"

The *Doing Business* reports have had an increasing impact both in the academia and on decision makers, at least at the level of ideological discussions. Indeed, changing "real" institutions in order to reach what would be an ideal benchmark is another story than discussing about 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, it deserves attention. There are two ways for discussing *Doing Business*. One is to reexamine carefully the underlying model as developed initially by LLSV.[7] The other is to look at the results developed in the reports and their underlying methodology. In what follows, we focus on the second approach.

Seven indices belong to the "time and motion" category, that is to say: they compute the time required and the number of procedures. Therefore, they mostly capture the administrative burden and not the "quality" of the substance of the Law in itself.

5 For a list of indexes, see *Doing Business* 2004, chapter 1, section: "Other Indicators in a Crowded Field".

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

7 Discussions in that direction are provided in several chapters of section III ("Legal Institutions of a Market Economy") in MENARD and SHIRLEY (2005).

A. A poor explanatory power[8]

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"). The explanatory power of the variables appears to be quite low and does not confirm the promises of their analytical framework, part of the weaknesses likely coming from the difficulties in 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, their should exist a strong relation between a „sound legal framework" and several macroeconomic variables, particularly Foreign Direct Investments (FDI), which is 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, trying to establish such a relationship. 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. The 2005 report identified „good performers" according to an "ease of doing business" index built as the average of several "item indexes"[9]. However, the comparison of 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 (2005) but also, to a certain extent, in DJANKOV et alii (2005). BLANCHET estimated a relatively simple regression 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.[10] The methodology is close to the one developed in GREGOIR and MAUREL (2003) who discussed the *World Economic Forum* report. Table 2 summarizes the main results of this simulation (the line with comments is ours)[11].

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[8] This section relies on a preliminary note by D. BLANCHET, "Rapport *Doing Business* 2005 de la Banque mondiale: évaluation de l'indice global de facilité à faire des affaires", Insee, mimeo, septembre 2005 (available on demand at : aed@u-paris10.fr). The 2006 report should facilitate more elaborated tests since it makes officially available the global composite index for all 155 countries reviewed in the database. 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 variables to be explained? In our discussion, we focus on this third dimension, which partially involves the second one. We thank STEPHANE SAUSSIER for his comments on this section.

[9] The composite index "ease in doing business" is constructed in three steps (2005, p. 87): (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.

[10] 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.

[11] T-Students are negative since the composite index defines a rank variable, with the rank 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, Congo (Rep. Dem.) being the last (155)).

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

(Parentheses: T-Student)

Table 2: The explanatory power of the “Ease of Doing Business index”

In other terms, a basic test that macroeconomists routinely do shows a 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 really significant. However, this relation is difficult to interpret unambiguously: it could very well be that HDI and the “Ease of doing business” are both depending on the level of the GDP, etc. More importantly, 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 indexes of the 2005 report do not perform better. Last, constructing a new estimated index of “the ease of doing business” through changes in the parameters in the seven indexes in order to simulate different results improves the results a bit, but 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; 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 well 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 (BENASSY-QUERÉ, 2005).

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

and alii (2005) found that their index is positively and significantly related with growth (its impact on the variation of GDP has a coefficient of 4.55). However, the explanatory power is very low, even with standard control variables (the T-Student is at -1.138 and the R^2 is 0.09).

B. Methodological issues at stake: What to measure and How to measure?

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 aspect 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. This was clearly stated in the initial report (2004, p. XVI), which is align to the LLSV model that inspired the project. However, this goal is less emphasized in the following reports, maybe because the authors became aware of the difficulties at stake. Nevertheless, we share with the 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 have not only a methodological dimension, but also an analytical background and even some philosophical dimension. Let us illustrate the difficulties at stake by examining several questions that a project like *Doing Business* must answer.

Laws? or Administrative Procedures?

As already mentioned, the methodology adopted in *Doing Business* is mainly oriented towards computing the time and cost of the different stages that a legal framework requires in order to perform a given economic transaction. Therefore, *Doing Business* does not really examine the efficiency of specific laws. It rather focuses on *the administrative process* imposes on businessmen as a (partial) extension of the legal system. In other terms, it examines the administrative burden of a given system rather than the efficiency or inefficiency of the Laws. This is no surprise since *Doing Business* deals with “investigating the regulations that enhance business activity and those that constrain it.” (*Doing Business* 2006, p. 1). However, it also means that it is very difficult to disentangle costs coming from administrative inefficiencies from costs coming from the characteristics of the legal regime per se. The goal assigned to the report, as suggested by the quotation above, well illustrates this ambiguity: “Regulation” is not that easy to clearly define and identify since it encompasses legislations applicable to firms as well as the process used by public agencies and bureaus to implement these legislations.

Laws as established formally (by Legislatures; by Courts)? 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. It is so in the Civil Code tradition as well as in the Common Law tradition. *Doing Business* does not pay attention to the subtle arrangement between these two dimensions. It basically considers enforcing mechanisms as common and similar for all types of contracts, let alone all types of business transactions. On the contrary, as is well known by lawyers and judges, the observation of legal commercial systems shows that the more sophisticated the legal framework is, the more specific are its enforcement mechanisms. To a 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 (see HADFIELD, 2005). Conversely, a Law that says nothing about its specific enforcement mechanisms may well provide incentives for going informal. In order to be really convincing, *Doing Business* should take into account these problems, or at least point out the difficulties they raise. As they are so far, the various reports simply ignore this aspect, which seriously weakens the ranking they intend to establish.

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, that is: the way case laws or statute laws are interpreted, or 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 limits resulting from the methodology adopted in *Doing Business* could explain why the scores of countries from the European Union vary so widely. Indeed, if we look at the data provided by the 2006 report on the 15 initial member states of the European Union, the dispersion is very wide, even with respect to items for which Laws among these countries have been harmonized long ago and quite exhaustively. Clearly, the explanation for these variations lies in factors other than the Laws. Similarly, 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 by the International Labor Organization's minimum standards is quite surprising. Indeed, these standards are implemented even among the "best performing countries" and are considered an important tool for ensuring fair international competition. Once more, *Doing Business* is clearly missing (or confusing) something here.

2. How to measure?

These problems, among others, are indubitably rooted in a difficult issue, which is about 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 to have put this question high on the research agenda of economists (and, to a lesser degree, of lawyers specializing in comparative analysis), and to have taken the risk of proposing measures. Nevertheless, there are some surprising aspects in the way the reports have proceeded so far. Let us provide a few examples.

Ex ante versus 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 asses legal efficiency ex ante, e.g., looking at the potential costs that a legal system can impose on transactions, and evaluating its consequences ex post, which involves taking into account the actual conditions of implementation and enforcement of this legal system.

As already suggested in the previous subsection, *Doing Business* reports are somewhat ambiguous in that respect. 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. Doing so, they miss a very crucial issue: they ignore in their measures the conditions under which Laws are actually implemented. Indeed, implementation of Laws is often extremely different from what such laws were designed for. In that perspective, 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 elimi-

nate legal uncertainties surrounding transactions, and the existence (or not) of a court system that can enforce deals made by parties to a contractual arrangement[12]. Another puzzling black hole is the total absence of consideration for parties other than businessmen, e.g., consumers, suppliers, fiscal authorities, agencies in charge of environmental policies, etc., who may bear significant part of the consequences of the legal systems and their different capacities to get rules of the game implemented. In other terms, the reports tend to entirely neglect the indirect costs and benefits of different legal systems as well as their social costs and value.

How to build a universal benchmark without biases?

More generally, and this is quite surprising in reports that intend to take into account fundamental institutions involved in the easiness or difficulty of doing business, the reports are so eager to establish the universal superiority of some systems over others, that they neglect some basic lessons, well-known from all those involved in comparative studies. Again, let us illustrate briefly.

In order to make international comparison easier, the team in charge of *Doing Business* defined and uses the same sample of case studies for all countries under review. 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 of 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 legal studies have known for centuries, this is not so. The real issue is to identify and compare 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 case 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 in SHLEIFER et al. (2003). 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 sentence to jail. 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, the “getting credit index” is based, for 50 %, on two measures of the information coverage: public credit registry and/or private credit bureau. In order to enter into the index, these public or private institutions must meet the criterion that they collect data, both negative and positive, on debtors. 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.” 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. 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

[12] 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 point of view.

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.[13]

To summarize, the efforts of the team of *Doing Business* to identify and isolate a sample of cases making possible comparisons across countries may appear as a sound methodological choice at first sight. However, a more careful examination of how this procedure is implemented shows major biases because the authors neglected some basic lessons 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, the ex post conditions that determine the actual costs of doing business in these different environment. Building a relevant index would require taking into account both ex ante and ex post conditions, as the experience of measuring and comparing GDP illustrates so well: 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 asses 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.

We can therefore look at *Doing Business* reports as merely an assessment of the distance between a sample of cases that reflects an ideal model of Law, or rather the legal system that the authors are accustomed to, and the diversity of ways different countries with different legal systems are dealing with when confronted to these cases. As *Doing Business* rightly points out, this variety may to a certain extent stem from phenomena opposed to sound economic growth, e.g., heritage from legal tradition, rent seeking behaviors, and so forth. 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!

IV. Conclusion: Ranking vs. 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's going on in economies as they are. This may come as a surprise to the layman not used to the jargon and evolution of economics, but this is already a long way from a time when institutions were considered as exogenously given and of no interest for economic analysis (or, at best, falling out of its domain of investigation). Notwithstanding substantial changes in that respect, there is still a long way to go, which makes particularly relevant the development of programs on Law and Economics and, more generally, on the interaction between institutions and economies.

In this paper, 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. Apparently, *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, establishing the "rank" of these countries according to certain variables, particularly their capacity to attract foreign investments (*Doing Business,* 2005 and especially 2006). 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 ranking countries according to a set of indexes in which the real properties and specificities of legal systems are almost never captured. Looking at the model and the data collected shows that, notwithstanding the interest one can find in the tentative, the reports end up with superficial ranking rather then actually measuring the real impact of specific legal instruments. What they actually identify is less the role of legal systems as determinants for

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

foreign direct investors than the market power of some countries in fixing the rules of the game, that is, the legal tools used in making transactions.

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 a decisive 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 essential to not embark on the wrong boat, 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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