

# Helpful Governments

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## Abstract

This paper provides an alternative way of testing the theory of legal origins, one based on a firm's perception of how helpful the government is for doing business. The author argues that an approach based on firm perceptions offers a number of advantages over existing studies. Specifically, the analysis demonstrates that heavier regulation in civil law compared with common law countries is not viewed by businesses as an efficient

and socially desirable response to disorder. Further, the findings show a strong effect of legal tradition on government helpfulness even after controlling for various institutional measures known to be correlated with the legal tradition of countries. This suggests that there is more to legal tradition than what existing studies have unearthed.

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## **Helpful Governments**

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## **1. Introduction**

A vast literature documents heavier regulation and poorer quality of institutions in civil law compared to common law countries. Specifically, studies show differences across the two legal traditions in the quality of property rights protection and contract enforcement (Djankov et al 2003a), number of procedures required to start a business (Djankov et al 2002), labor laws (Botero et al 2004) and investor protection and financial development (La Porta et al 1997, Djankov et al 2008). In short, common law governments seem to be more helpful to businesses than civil law governments.

The present paper proposes an alternative test of the quality of governance or government helpfulness (to businesses) across legal traditions, one based on firm perceptions of how helpful the government is for doing business. In addition to complementing existing studies (discussed above), our approach (of using firm perceptions) offers a few important advantages. First, Djankov et al (2003b) argue that institutional design is based on a delicate tradeoff between disorder and dictatorship and that understanding this tradeoff is the key to successful institutional reform. This raises an important question that has received very little attention in the literature. That is, do businesses view existing rules and regulations as socially desirable and efficient responses to disorder or as outcomes of governmental inefficiency and lack of concern for business needs? Our approach is ideally suited to address this question because firm perceptions on how helpful the government is factor in the desirability of regulations and government behavior. Our results show that firms view heavier regulation and bad institutions in civil law compared with common law countries as poor governance rather than an efficient response to disorder.

Second, surveying existing studies, La Porta et al (2007, p.20) note that: “The most important aspect of these results from our viewpoint is how pervasive is the influence of legal origins.” Our approach uses a broad-based measure of the quality of governance which allows us to capture all possible ways in which legal tradition may matter for governance. One advantage of this is that we are able to show that the effect of legal tradition on governance holds even after controlling for the known covariates of legal tradition (regulation, contract enforcement, etc). That is, there is more to legal tradition than what existing work has unearthed. Lastly, the use micro data allow us to deal with potential problems in existing work due to heterogeneity across data points.

The plan of the paper is as follow. In section 2 we describe our data and the main variables. Main empirical results are contained in section 3 and robustness checks in section 4. The concluding section provides a summary of the important results.

## **2. Data and Main Variables**

We use firm level data from the World Bank’s World Business Environment Survey (WBES, 1999), complemented with additional data sources for GDP, legal origin, etc. The WBES data are a stratified random sample of firms with a common questionnaire and sampling methodology for all participating countries.

The dependent variable, *Governance*, is based on the response of firms to the following statement in the WBES: “All in all, for doing business I perceive the state as: very helpful, mildly helpful, neutral, mildly unhelpful or very unhelpful.” We index firm’s response on a 1-6 scale with a higher value implying a more helpful government (*Governance*). In our sample, 15% of the firms reported government as very unhelpful,

20.8% as mildly unhelpful, 28.6% as neutral, 26% as mildly helpful and 9.6% as very helpful.

Our main explanatory variable, *English*, is a dummy variable equal to 1 if a country's legal structure is based on the English common law (18 countries) and 0 otherwise (French civil law, 30 countries). We exclude countries that follow the German, Scandinavian or the Socialist legal tradition and also the transition countries.<sup>1</sup>

La Porta et al (2007) note that omitted religious, cultural and political factors constitute the most serious threat to legal traditions. As a remedy, we follow their approach by controlling for the proportion of population in the country that is Catholic, Muslim and Protestant, an index of ethnolinguistic fractionalization (*ELF*) and a dummy variable equal to 1 if the electoral rule for the lower house is a form of proportional representation and 0 otherwise (*PR*). The religious variables and *ELF* are taken from La Porta et al (1999) and *PR* from World Bank's Database for Political Institutions (2004). Other controls include dummy indicators for firm-size (small and large, medium-sized firms is the omitted category) and measures of overall development proxied by (log of) GDP per capita (PPP adjusted, constant 2000 USD) for the year 2000 taken from the World Bank's World Development Indicators and regional fixed effects (Asia, Africa, Latin America and Caribbean, North America and Western Europe). The robustness section contains a number of additional variables for regulations, firm attributes, etc.

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<sup>1</sup> We restrict the sample to only the fully private firms leaving out partially or fully government owned firms (6.3% of the sample). Keeping these firms in the sample makes virtually no difference to our results. We also experimented with including the transition/socialist countries in the sample by clubbing them with the French legal origin countries and also as a separate category (Socialist legal origin countries). These alternations did not change our main results discussed above much. Relative to French civil law countries, English common law countries showed the government as significantly more helpful (as above) and less helpful for the Socialist countries. These specifications were run without controlling for two variables included in the regressions above: ethnolinguistic fractionalization index (missing for many Socialist countries) and continental fixed effects (most Socialist countries are from one continent, Asia).

### **3. Estimation**

We use the ordered probit estimation method with all standard errors clustered on the country. Regression results for the main specification are reported in Table 1. The table shows marginal effects (evaluated at the mean) of the various explanatory variables on the probability of a firm reporting *Governance* as “very unhelpful” and “very helpful”.

In all the specifications we find that the English common law is associated with a more helpful government than the French civil law. Without any additional controls, the estimated probability of the government being very helpful rises by 7.1 percentage points (significant at less than 1% level) against the predicted probability of 9.5% when we move from a civil law to a common law country (column 2, Table 1). The corresponding figure for the government being very unhelpful is a decline by 8.2 percentage points (p-value of .017, column 1, Table 1) against the predicted probability of 13.4%.

Religious, cultural and political factors do not show any significant effect on the dependent variable and they hardly affect the results discussed above (columns 3 and 4, Table 1). The same holds for firm-size and regional fixed effects except that small firms find government to be significantly less helpful than medium and large firms (columns 4 and 5, Table 1). Lastly, GDP shows a positive effect on government helpfulness (significant at less than 1% level) and it causes the coefficient of the legal origin dummy (*English*) to decline but only by a small amount (columns 7 and 8, Table 1).

### **4. Robustness**

The literature on legal origins was initially motivated to explain differences across countries in the level of financial development and was later extended to various

regulatory measures. We control for these factors using private credit to GDP ratio (from Djankov et al 2007) and number of procedures required to start a business, number of procedures required to enforce a contract and an index of the difficulty of hiring labor (from World Bank's Doing Business project, 2004).

Regression results with these controls are reported in columns 1 and 2 of Table 2. English common law continues to show a positive and significant effect on the dependent variable. Private credit to GDP and all the Doing Business indicators show a significant relationship with the dependent variable in the expected direction.

Next, we control for the index of creditor rights from Djankov et al 2007 and measures of institutional quality as perceived by the firms (from WBES) which include: the level of confidence in the legal system for upholding contract and property rights in a dispute (*Property rights*), efficiency of courts in enforcing their decisions in business disputes (*Enforcement*), quality of power supply (*Power*), and the severity of business regulations, high interest rates and labor regulations as obstacles for the firm's operations. Each of the obstacles is ranked by firms on a 1-4 scale with a higher value indicating a more severe obstacle. *Property rights*, *Enforcement* and *Power* take values 1-6 with a higher value implying better quality. The motivation for the firm-level measures is to capture possible heterogeneity in their enforcement and how they affect firms.

Regression results in columns 3 and 4 of Table 2 show that controlling for the variables discussed above does not change our main results much. Most of the firm-level measures show significant effects on government helpfulness in the expected direction: better quality of institutions and less severe obstacle implies a more helpful government.



It is possible that firms that have multinational activity may choose to locate in countries with good governance which could create a selection bias with our results. To check for this we controlled for two dummy variables indicating whether a firm operates in more than one country and if any of its owners is a foreigner. Regression results with these controls are roughly similar to the ones reported in columns 5 and 6 of Table 2 where we have include one more variable to highlight a relatively neglected area in the literature. This variable is firm's perception of how easy it is to get information on various rules and regulations (1-6 scale, higher values imply information available more easily). These controls do not change our results much from above. Information availability is associated with a better perception of government helpfulness (significant at less than 1% level) while multinational presence shows no significant effect.

For additional robustness, we included the following in the list of controls above (data sources in brackets): level of corruption (International Country Risk Guide, 2000), a dummy for exporting firms, industry and type of ownership fixed effects (WBES), number of procedures required to register a property, an index of the difficulty of firing workers and an index of investor protection (World Bank, Doing Business, 2003-04), a dummy indicating if a country has a public registry or a private credit bureau (Djankov et al 2007), incidence of bribe payment (WBES), percentage of firm's senior management's time spent with government officials (WBES). With all these controls, the estimated effect of *English* equaled 6.3 percentage points (p-value of .017) for the government being "very helpful" and -8.1 percentage points for "very unhelpful" (p-value of .007).<sup>2</sup>

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<sup>2</sup> Our main results in the paper do not change much when we control for the degree of legal formalism as measured by Djankov et al (2003a) and age of the firm. However, these controls cause the sample size to decline from 48 countries above to 42 countries (legal formalism) and 31 countries (age of the firm).

## **5. Conclusion**

The paper uses firm perceptions on how helpful the government is to provide an alternative test of the theory of legal origins. Our findings show that relative to civil law countries, firms in common law countries find government to be significantly more helpful and this holds even after controlling for various institutional and governance measures that are known to be correlated with the legal tradition of countries. In a nutshell, existing studies have discovered only a subset of channels through which legal tradition affects the quality of governance. Further, most regulatory measures lower a firm's perception of how helpful the government is. Hence, it is unlikely that heavier regulation is an efficient or desirable response from the firms' point of view to disorder.

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**Table 1: Marginal effects for ordered probit regressions (Main specification)**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	<u>Model 1</u>		<u>Model 2</u>		<u>Model 3</u>		<u>Model 4</u>	
Dependent variable:	Very unhelpful	Very helpful	Very unhelpful	Very helpful	Very unhelpful	Very helpful	Very unhelpful	Very helpful
<i>Governance</i>								
<i>English</i>	-.082*** (.002)	.071** (.017)	-.080*** (.010)	.069** (.025)	-.078** (.014)	.066** (.029)	-.068*** (.003)	.057*** (.008)
Catholic (proportion of population that is Catholic)			.067 (.181)	-.052 (.180)	-.019 (.696)	.015 (.699)	-.039 (.408)	.030 (.421)
Muslim (proportion of population that is Muslim)			.055 (.504)	-.043 (.494)	.068 (.486)	-.052 (.473)	.050 (.519)	-.038 (.506)
Protestant (proportion of population that is Protestant)			.224* (.068)	-.174* (.054)	.155 (.422)	-.120 (.406)	.261 (.112)	-.200* (.092)
<i>ELF</i> (Ethno-linguistic fractionalization index)			.054 (.248)	-.042 (.264)	.112* (.100)	-.087 (.115)	.035 (.488)	-.027 (.490)
<i>PR</i> (electoral rule for the lower house is a form of proportional representation)			.008 (.765)	-.006 (.765)	.012 (.704)	-.009 (.704)	.024 (.261)	-.018 (.245)
<i>Small</i>					.036*** (.001)	-.027*** (.001)	.033*** (.004)	-.024*** (.003)
<i>Large</i>					-.014 (.199)	.011 (.211)	-.011 (.284)	.009 (.289)
Regional fixed effects (continental dummies)					Yes	Yes	Yes	Yes
GDP per capita (log values)							-.067*** (.000)	.051*** (.000)
Predicted probability	.134	.095	.131	.092	.129	.090	.125	.086
Sample Size (countries)	4320 (48)	4320 (48)	4320 (48)	4320 (48)	4320 (48)	4320 (48)	4320 (48)	4320 (48)

1) p-values in brackets; all standard errors are clustered on country; significance level is denoted by \*\*\* (1% or less), \*\* (5% or less) and \* (10% or less).

2) Columns 1, 3, 5 and 7 show the marginal effects of the various explanatory variables on the probability that a firm reports *Governance*=1 (government is “very unhelpful”) rather than *Governance* value higher than 1 (government is mildly unhelpful, neutral, mildly helpful or very helpful). Similarly, columns 2, 4, 6 and 8 show the corresponding marginal effects for *Governance*=6 (government is “very helpful”) rather than a lower value of *Governance*.

**Table 2: Marginal effects from ordered probit regressions (Robustness)**

	(1)	(2)	(3)	(4)	(5)	(6)
	<u>Model 5</u>		<u>Model 6</u>		<u>Model 7</u>	
Dependent variable: <i>Governance</i>	Very unhelpful	Very helpful	Very unhelpful	Very helpful	Very unhelpful	Very helpful
<i>English</i>	-.063 <sup>***</sup>	.052 <sup>**</sup>	-.065 <sup>**</sup>	.052 <sup>**</sup>	-.063 <sup>**</sup>	.049 <sup>**</sup>
	(.010)	(.017)	(.019)	(.030)	(.031)	(.045)
Religion, <i>ELF</i> , <i>PR</i> , Regional fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
<i>Small</i>	.038 <sup>***</sup>	-.026 <sup>***</sup>	.034 <sup>***</sup>	-.021 <sup>***</sup>	.034 <sup>***</sup>	-.022 <sup>***</sup>
	(.000)	(.000)	(.006)	(.003)	(.005)	(.002)
<i>Large</i>	-.003	.003	-.003	.002	.002	-.001
	(.745)	(.747)	(.788)	(.790)	(.836)	(.836)
GDP per capita (log values)	-.016	.012	.028	-.019	.027	-.019
	(.342)	(.341)	(.143)	(.144)	(.161)	(.160)
Private credit to GDP ratio (log values)	-.049 <sup>***</sup>	.037 <sup>***</sup>	-.044 <sup>***</sup>	.031 <sup>***</sup>	-.041 <sup>**</sup>	.028 <sup>**</sup>
	(.002)	(.003)	(.004)	(.004)	(.012)	(.011)
Number of procedures to start a business (Doing Business)	.006 <sup>*</sup>	-.005 <sup>**</sup>	.006 <sup>*</sup>	-.004 <sup>*</sup>	.006 <sup>*</sup>	-.004 <sup>**</sup>
	(.026)	(.022)	(.054)	(.053)	(.049)	(.048)
Number of procedures to enforce a contract (Doing Business)	.150 <sup>**</sup>	-.113 <sup>**</sup>	.172 <sup>**</sup>	-.119 <sup>**</sup>	.163 <sup>**</sup>	-.112 <sup>**</sup>
	(.042)	(.042)	(.014)	(.013)	(.025)	(.022)
Difficulty in hiring index (Labor laws, Doing Business)	.001 <sup>**</sup>	-.001 <sup>**</sup>	.001 <sup>**</sup>	-.001 <sup>**</sup>	.001 <sup>**</sup>	-.001 <sup>**</sup>
	(.042)	(.041)	(.020)	(.019)	(.040)	(.038)
Creditor Rights index			.014 <sup>*</sup>	-.010 <sup>*</sup>	.014 <sup>*</sup>	-.010 <sup>*</sup>
			(.095)	(.084)	(.098)	(.086)
<i>Property rights</i> (higher values imply better quality)			-.028 <sup>***</sup>	.019 <sup>***</sup>	-.025 <sup>***</sup>	.017 <sup>***</sup>
			(.000)	(.000)	(.000)	(.000)
<i>Enforcement</i> (higher values imply better quality)			-.011 <sup>***</sup>	.008 <sup>***</sup>	-.009 <sup>***</sup>	.006 <sup>***</sup>
			(.001)	(.001)	(.008)	(.005)
<i>Power</i> (higher values imply better quality)			-.019 <sup>***</sup>	.013 <sup>***</sup>	-.016 <sup>***</sup>	.011 <sup>***</sup>
			(.000)	(.000)	(.000)	(.000)
Business regulations are an obstacle			.004	-.003	.002	-.001
			(.339)	(.346)	(.684)	(.686)
Labor regulation is an obstacle			.009 <sup>*</sup>	-.006 <sup>*</sup>	.007	-.005
			(.070)	(.066)	(.192)	(.185)
High interest rate is an obstacle			.010 <sup>**</sup>	-.007 <sup>**</sup>	.011 <sup>**</sup>	-.008 <sup>**</sup>
			(.026)	(.024)	(.015)	(.013)
Operations in other countries					.003	-.002
					(.679)	(.678)
Owner of the firm is a foreigner					.003	-.002
					(.723)	(.721)
Information on rules and regulations is easily available					-.016 <sup>***</sup>	.011 <sup>***</sup>
					(.000)	(.000)
Predicted probability	.121	.082	.114	.069	.113	.068
Sample Size (countries)	4320	4320	3211	3211	3105	3105
	(48)	(48)	(48)	(48)	(47)	(47)

p-values in brackets; all standard errors are clustered on country; significance level is denoted by \*\*\* (1% or less), \*\* (5% or less) and \* (10% or less). Religion includes the proportion of population that is Catholic, Muslim and Protestant (as in Table 1). Sample size varies due to missing data. For the interpretation of the estimates, see footnote 2 in Table 1.