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# Creating a Legal Framework for Economic Development

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*A modernizing nation's economic prosperity requires at least a modest legal infrastructure centered on the protection of property and contract rights. The essential legal reform required to create that infrastructure may be the adoption of a system of relatively precise legal rules, as distinct from more open-ended standards or a heavy investment in upgrading the nation's judiciary. A virtuous cycle can arise in which initially modest expenditures on law reform increase the rate of economic growth, in turn generating resources that will enable more ambitious legal reforms to be undertaken in the future.*

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It used to be common in the economic literature on development to enumerate the multitudinous sources of market failure and prescribe complex government interventions to cure them without paying much attention to the equally numerous sources, especially in poor countries, of governmental failure (Stiglitz 1994). A 1995 conference on legal reform, as well as other recent judicial reform initiatives (Rowat, Malik, and Dakolias 1995; Dakolias 1996), attest to the growing awareness that the failure of governments in poor countries to provide the basic framework of a capitalist economy may be an important factor in keeping poor countries poor. Markets are more robust than some market-failure specialists believe. But their vigor may depend on the establishment of an environment in which legal rights, especially property and contractual rights, are enforced and protected—an environment that is taken for granted in wealthy nations (see Gray 1991 and Rausser 1992 for good statements of this essentially Weberian point).

The citizens of wealthy countries take this legal machinery for granted because it works well enough most of the time and because it does not cost a great deal. In its ideal form (an important qualification), the machinery consists of competent, ethical, and well-paid professional judges who administer rules that are well designed for the promotion of commercial activity. The judges are insulated from interference by the legislative and executive branches of government. They are advised by

competent, ethical, and well-paid lawyers. Their decrees are dependably enforced by sheriffs, bailiffs, police, or other functionaries (again, competent, ethical, and well paid). The judges are numerous enough to decide cases without interminable delay, and they operate against a background of rules and practices, such as accounting standards, bureaus of vital statistics, and public registries of land titles and security interests, that enable them to resolve factual issues relating to legal disputes with reasonable accuracy and at reasonable cost to the disputants.

Countries differ, however, and even very wide deviations from this capitalist rule-of-law ideal may not seriously compromise economic efficiency. This is an extremely important point for any nation assailed by competing priorities. One need only reflect on the economic success of certain U.S. states that have elective, highly politicized judiciaries of questionable professional competence; on the economic success of East Asian nations such as China and Vietnam in which the rule of law is weak; and on the fact that England, with one of the finest judicial systems in the world, was for many decades among the poorer economic performers in the industrial world. Moreover, India, with a legal system modeled on England's, and with a vast number of lawyers, has underperformed China, which began its economic takeoff in the 1980s when it had only a rudimentary legal system.

## Legal Systems: Formal and Informal

What explains these cases? One possible explanation is that legal reform is too expensive, something wealthy nations often do not realize because the *relative* cost of the institutions that secure the rule of law is small (Posner 1996). Another is that a legal system does more than enforce contract and property rights; it may also enforce bad laws that reduce economic efficiency.<sup>1</sup> But perhaps the most important explanation is that there are many informal substitutes for the legal enforcement and protection of property and contract rights. These include arbitration, with or without the legal enforcement of the arbitrator's award; reputation, which may be accompanied by retaliation (such as blacklisting people who default on their contracts) (McGrory 1995); merger (so that disputes between independent firms become purely internal); bilateral monopoly, which can provide a substitute for legally enforceable employment contracts (Becker 1993);<sup>2</sup> strong-arm tactics, such as those used in illegal markets; and altruism, which enables many family-owned firms to operate effectively outside a legal framework (see Rubin 1994 for a discussion of the situation in Central and Eastern Europe). The importance of such substitutes is confirmed by the fact that property rights and contract enforcement are methods of coordinating and optimizing economic activity that long predate the state and formal legal institutions. Even in the highly litigious culture of the United States, the vast majority of contract and property disputes are resolved informally, and no doubt would be even

without a threat of resort to law, often an empty threat because of the expense of legal proceedings.

### *Significance for Economic Growth*

If it is not possible to demonstrate as a matter of theory that a reasonably well-functioning legal system is a necessary condition of a nation's prosperity, there is empirical evidence showing that the rule of law does contribute to a nation's wealth and its rate of economic growth (Posner forthcoming; Barro 1991; Scully 1988). It is plausible, at least, that when law is weak or nonexistent, the enforcement of property and contract rights frequently depends on the threat and sometimes the actuality of violence (Intriligator 1994; McGroarty 1995), on family alliances that may be dysfunctional in the conditions of a modern economy, and on cumbersome methods of self-protection. These are costly substitutes for legally enforceable rights, as are the discredited "command-and-control" methods used in communist economies. The hidden costs of these substitutes are a bias against new firms, which have no established reputation to persuade clients that they are reliable, and a bias in favor of simple, simultaneous exchanges over more complex transactions because it is unlikely that legal remedies can be invoked against nonperformance (Hendley, Ickes, and Ryterman 1997). The cumulative costs of doing without law in a modern economy may be enormous.

Unfortunately, there may be a chicken and egg problem: a poor country may not be able to afford a good legal system, but without a good legal system it may never become rich enough to afford such a system. Gray (1997) argues that legal and economic reform should be pursued simultaneously. She notes that without economic reform, demand for legal reform may be weak because the most powerful economic actors will have alternatives to obtain their ends, such as prohibitive tariffs and government bailouts. (And, as noted, the absence of law will hurt new firms the most, implying that it may actually help established firms.) Economic reform is thus important on both the demand and supply sides of legal reform: to stimulate the former and to generate the resources necessary for the latter.

But this problem must not be exaggerated. As I noted at the outset, economic progress is possible without much—perhaps without any—law. As a modernizing country gradually becomes more prosperous, it will have additional resources for improving its legal system. Given the risk that too heavy an initial investment in legal reform could deprive the productive economy of necessary resources and thus stifle legal and economic reforms, the prudent choice is to defer legal projects that are costly and ambitious and instead to begin modestly.

In a discussion of this approach, Hay, Shleifer, and Vishny (1996) examine the possibility of inexpensive legal reforms that may assist in creating preconditions (or at least in facilitating conditions) for the operation of efficient markets. The authors

point out that it is more costly and time-consuming to create efficient legal institutions than to enact efficient rules for the existing inefficient institutions to administer. The creation and dissemination of a rule involves small fixed costs and (like other information goods) negligible marginal costs, while legal institutions require heavy inputs of high-priced, educated labor. This implies that the rules-first strategy is more advantageous in more populous countries because the average costs are lower. China, the most populous poor country, followed this approach by introducing modern, commercially oriented rules of law at the same time that it liberalized the economy (Potter 1994).

**RULES FIRST.** This strategy can serve as the starting point of several short-term measures for improving legal institutions as well. It is important to emphasize that such measures be both efficient and, less obviously, rules, and to distinguish between *substantive* and *procedural* efficiencies. A rule is substantively efficient if it sets forth a precept that internalizes an externality or otherwise promotes the efficient allocation of resources: a rule forbidding the use of another person's property without consent is an example. A rule is procedurally efficient if it is designed to reduce the cost or increase the accuracy of using the legal system.

Examples are: a requirement that contracts be in writing to be legally enforceable; a rule that no claim of infringement of legal rights is enforceable unless filed within three years of the alleged infringement; a requirement that certain disputes, say between employers and employees or between securities brokers and their customers, must be referred to binding arbitration; and a rule entitling the winner of a judgment for damages to receive interest on the judgment at the market rate from the date the suit was filed. The first two of these rules are designed to reduce the information costs of the legal system, the third to reduce the judicial workload by shunting certain disputes to an alternative method of dispute resolution, and the last to enable judges to use delay to cope with a heavy workload without destroying the utility of the legal system to persons whose rights have been infringed.

The rule requiring arbitration has additional importance as a method of encouraging the formation of trade associations and other business groups, useful intermediaries between the state and the individual or family in a commercial society (Casella 1996). Lawyers tend to ignore such procedural rules, even though they consider themselves experts on procedure, and to emphasize legal doctrine at the expense of methods that actualize it. The procedural rules listed here have received much less attention from lawyers than have the intricacies of doctrine.

**ADMINISTRATIVE CONSIDERATIONS.** I want to make the point that these are "rules" rather than "standards" because determining whether they have been violated is a relatively *mechanical*, cut-and-dried process rather than one requiring the exercise of discretion or the determination of numerous facts. The trespass rule requires

determining, for instance, where the boundary line is, whether it has been crossed, and whether there was consent; a statute of limitations requires determining only the date on which the alleged infringement occurred and the date on which the suit was brought; and so on. Lawyers being what they are, the actual administration of rules is more complex than I am letting on. But it is simpler than the administration of standards, such as negligence, bad faith, unreasonable restraint of trade, and unconscionability—at least if professional judges rather than lay jurors are used to determine violations. This is an important qualification. Standards, to the extent that they are intuitive (such as the concept of due care, which is the heart of the negligence standard), may be easier to understand, accept, and apply than rules, which may be simplified to the point of arbitrariness, as in the case of statutes of limitations. Because understanding and acceptance are important to achieving voluntary compliance as well as to the sensible decision of cases by lay adjudicators, a mixture of rules and standards is optimal. But in poor countries with weak legal traditions, the tilt should be in favor of rules because they are easier to administer.

The relative simplicity of rules has two consequences for the kind of weak judiciary that one is apt to find in a poor country. The first is that the application of rules places fewer demands on the time and the competence of the judges and is therefore both cheaper and more likely to be accurate. The accuracy is a little illusory, because it is a property of governance by rules that they never quite fit the complex reality that they govern. But this observation is consistent with their being more efficient than standards if administered by a judiciary that has a limited capability for the kind of nuanced and flexible decisionmaking that standards require. Second, rules facilitate monitoring of the judges and so reduce the likelihood of bribery and the influence of politics in the judicial process. The less discretion a judge has in making decisions, the easier it will be to determine whether a case has been decided contrary to law or whether there is a pattern of favoring one class or group of litigants over another.

### *Adoption of Foreign Laws*

The adoption of such a set of rules is much more easily said than done, but perhaps not *so* much more easily. There is, to begin with, a long tradition of what is called the “reception” of foreign law. When the American colonies broke away from Great Britain, each new state decided how much of the common law of England would be received into and made a part of the law of the state (Wood 1969). This pattern is typical in former colonies; for example, half a century after independence, the Indian legal system retains the strong imprint of its English origins. But the reception of foreign law is not limited to cases of original imposition. The Japanese and Chinese also borrowed extensively from European legal codes (Ma 1995; Ford 1996). After

World War II the occupying powers imposed a variety of legal changes on Germany and Japan, for example in competition law and (in Japan) criminal procedure, that have taken root. European Community law is becoming incorporated into the domestic law of the member nations.

Such grafts do not always take: a notable example was the adoption by most South American countries in the nineteenth century of constitutions modeled on that of the United States. Some of the Western-inspired constitutions in the former communist nations of Central and Eastern Europe may encounter the same fate. But constitutional law is a special case; its effectiveness depends on a particularly complex cultural and institutional matrix. In other areas, the prospects for transplanting Western law are good.

A poor country might do worse than adopt portions of the U.S. Uniform Commercial Code (or its European counterpart), a simple and successful set of rules and standards governing primarily sales of goods, negotiable instruments such as checks and letters of credits, and secured transactions such as mortgages. The poor country might want to modify or delete some of the standards in the Code, such as the standard of good faith, and to require (assuming that illiteracy is not widespread) that more contracts be in writing. And it might want to extend the Code, again with various modifications, to transactions that in the United States are left to the common law, such as contracts involving the sale of services rather than goods—for example, insurance and construction contracts.

This proposal has, I admit, a somewhat roundabout character. Historically, commercial law originated in the customs of merchants enforced privately by arbitration or equivalent informal methods and only later adopted by the courts. The Uniform Commercial Code is in part an attempt to codify commercial practices. To the extent that the business community in a poor country has its own law, it may be better to codify that law than to try to borrow another country's model. But the law may be underdeveloped in a poor country—may in fact be a cause of underdevelopment or a symptom, or both—and the task of codification may require technical skills of drafting and organization that are in short supply. In these circumstances the adoption of a foreign code may be the more sensible move. The important point is that both foreign law and the application of local custom as formal law are well-trying methods by which a nation can adopt a legal code without starting from scratch—or needing a Napoleon.

It is important, however, to adapt the imported code to the local culture (Rubin 1994), a task for local, not foreign, lawyers, who know something about the country whose law they are borrowing. I do not advise dispatching European or American lawyers to tell a country how to adapt foreign laws to its legal and social institutions and stage of economic development. One approach might be to establish a law reform commission to rationalize, unify, and modernize national laws, borrowing wherever possible from established foreign models.

## The Judiciary

The fundamental tradeoff is between making a rather modest investment in better rules and making a big investment in the judiciary. And it is a tradeoff. If judicial salaries are high enough and tenure sufficiently secure, the judiciary of even a poor country will be able to attract competent and honest lawyers. But highly educated people, who are needed to staff a good court and also to appear before it as advocates, are a very scarce resource in poor countries, making the opportunity costs of a first-rate judiciary and its associated bar of practitioners very high. And if the salaries of one class of officials far exceed those of other officials, it could create a ripple effect throughout the entire civil service, resulting in large fiscal costs and a large drain on the limited talent of the nation. Finally, the political authorities will be reluctant to create a corps of truly independent officials who may constitute a rival center of power; or they may lack the power to protect the judges from private violence if they stand up to powerful interest groups. Moreover, if the political authorities are weak or corrupt, generous compensation may simply increase the value of a judgeship as a patronage plum and result in an actual decrease in judicial quality.

The more costly it is to create a high-quality independent judiciary, the more beneficial it is to focus legal reform on the adoption of substantively and procedurally efficient rules. In emphasizing this point, however, I do not propose to abandon entirely the task of improving legal institutions. Indeed, if the law's administrative infrastructure is sufficiently weak, even good rules may simply be ignored. This appears to be the case in Russia, which has several modern legal codes on its books. Although a regime of rules reduces the likelihood of financial or political corruption, rules cannot be the complete answer. Countries may also need to alter the structure of judicial salaries. Specifically, the more that judicial compensation is "backloaded" in the form of generous pension rights that are forfeited if the judge is removed from office for incompetence or venality, the greater the incentive of the judge to behave with integrity (Becker and Stigler 1974). If the cost is very great, even if the likelihood of being detected is slight, the appointee may be deterred. Another corruption-fighting incremental change worth considering is having judges sit in panels—or with juries—rather than by themselves, to increase the transaction costs of bribery and the likelihood of discovery. Unlike the compensation adjustment, this proposal would cost something because more judges would be needed—even if lay juries were used—since jury trials take longer.

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### *Issues of Enforcement*

Where the suggested approach emphasizing rules over institutional reform is most likely to fall short is in securing people against the threat of government confiscation. It is all very well to have well-defined private property rights determine legal rem-

edies against the invasion of those rights by private parties and to devise an effective system of contract rights to exchange property among private owners and entrepreneurs. But these rights may mean little if the state can seize the fruits of successful investment (North and Weingast 1989). Although certain rules, if enforced, will prevent this—rules such as forbidding the state from taking property without just compensation or forbidding discriminatory taxation—their efficacy depends on the willingness of the judges to stand up to government officials. It looks as though we are back to needing the competent, ethical, well paid, and politically independent judiciary so unlikely to be feasible for a poor nation.

A solution to this dilemma may be to establish a special court, as in France, whose sole mission is to restrain the government, the *Conseil d'État* (Merryman 1996). The judges of this court must be competent, ethical, and well paid, but because the court's jurisdiction will be so circumscribed, the resources required to equip it will be modest. If the court is confined to purely economic issues, moreover, the political authorities may be willing to tolerate its independence, especially if they understand its importance for the economy. An alternative may be to turn over judicial authority to a regional or international court, although enforcing the decrees of that court against the government of the country may be problematic.

### *Issues of Commitment*

It should be obvious that effective legal reform depends ultimately on a political will to reform, which in turn is likely to depend on a political will to implement economic reform. If the dominant political groups in society want economic prosperity and are willing to risk the loss of political control over the economy that modern economic conditions dictate, they will also want legal reform. If they do not want economic reform, the will to adopt legal reform is likely to be absent.

I emphasize the importance of modest fiscal outlays in creating a virtuous cycle of legal and economic reform. Remember that economic progress is possible with little—perhaps with no—law and can be stifled by excessive investment in public-sector projects, including legal reform. A small expenditure on law reform can increase the rate of economic growth, which will in turn generate additional resources for more ambitious legal reforms later.

## Criminal Law

I have talked only about property and contract rights, and fleetingly about concepts such as trespass that back up property rights. I have said nothing about the criminal laws or human rights, which are often reciprocals: many basic human rights protect citizens against the overvigorous enforcement of criminal laws. It is sometimes ar-

gued that economic rights are inseparable from political rights. Drèze and Sen 1995 have pointed out that countries with a free press do not suffer from famines; and the right to vote and the right of free speech place constraints on government that may in turn protect business interests against the risk of confiscatory measures. I am not very confident about the empirical significance of these points, however. Given the role of technology, it is hard to imagine a country concealing a major famine even if its own media are gagged; North Korea has certainly failed. And democracy may not do much for the economy; India has not been economically more progressive than the nondemocratic nations of Asia.

As for granting extensive rights to criminals, this is bound to undermine the efficacy of the criminal laws, and by doing so, unsettle property rights. Rights make it harder to convict the guilty as well as the innocent. Sophisticated police forces and prosecutors can apprehend and convict the guilty without trampling on rights; but sophisticated law enforcement is costly. This point is especially salient in countries such as Russia where acquisitive crime is so rampant that it retards economic development. In such countries a strict criminal law and a corresponding de-emphasis on the protection of civil liberties may be an important part of legal reform and an important tool for the protection of property and contract rights.

So my message is a modest, and perhaps a harsh, one. Legal reform is an important part of the modernization process of poor countries, but the focus of such reform should be on creating substantive and procedurally efficient rules of contract and property rather than on creating a first-class judiciary or an extensive system of civil liberties. This is a general prescription, however, and the proper legal structure for an individual country will depend on a host of considerations that I have not attempted to canvas in this overview.

## Notes

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1. This may explain the negative correlation across countries between the number of lawyers and the rate of economic growth (Murphy, Shleifer, and Vishny 1991). The correlation is misleading because much of the output of lawyers consists of nonmarket goods; but these may not be as important in poor countries as in wealthy ones.

2. An employee with firm-specific skills is likely to have a better job at this firm than at a different one. Such an employee will be reluctant to quit and the employer will be reluctant to dispense with his or her skills.

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