Economic Development and the Quality of Legal Institutions

One reason the development community is fostering legal and judicial reform is the belief that, beyond their intrinsic worth, such reforms will help improve economic performance. This belief in the power of legal and judicial reform to spur economic development is supported by a growing body of research showing that economic development is strongly affected by the quality of institutions – including the quality of a nation's legal institutions. But while this work makes the case for reforming legal institutions on economic grounds, it tells little about what institutions to reform and how. It is very hard to measure the quality of legal institutions, harder still to sort out the strength of the causal relationships between their quality and economic development, and virtually impossible at this stage to sort out the complex and contingent relationship between the different components of real-world institutions.

Why institutions affect economic development

While early work on economic development took for granted the existence of institutions that established clear and enforceable property rights, kept the costs of transacting business to a minimum, and reduced the threat of coercion, more recent work has shown that this is rarely the case. Indeed, current research suggests that the capacity of national institutions to protect property rights, reduce transaction costs, and prevent coercion may be decisive in determining whether economic development takes place.

Furthermore, researchers have started to pay more attention to how institutions that affect the governance of a nation affect economic performance. Government officials respond, at least in part, to the incentives created by political and legal institutions. Therefore, the structure and quality of political institutions can affect whether the government facilitates or inhibits economic development. Stated most simply, the incentives institutions create for government decision-makers will determine whether the government uses its power to create a framework for productive economic activity or to redistribute wealth to itself or its supporters.

How institutions affect economic development

These arguments establish a strong basis for the claim that a successful economy requires appropriate institutions. But, although we can conclude that institutions "matter" in a broad sense, it is still difficult to assess institutional quality in practice. Institutions are by their nature quite complex, and many important aspects of institutional structure are not easily observed. Moreover, the economic impact of a particular set of institutions often depends on context. For example, certain institutions make it difficult for the government to institute policy changes. In some contexts, this is beneficial for economic development, since it makes government commitments more credible (Brunetti and Weder 1994; Henisz 2000).

On the other hand, in times of economic crisis or rapid change, these same institutions can hinder a government's ability to respond effectively (Tsebelis 1995). An independent constitutional court may encourage foreign investment by ensuring the executive does not arbitrarily seize property, but if it were to prevent the rapid adoption of policies needed to counteract a financial crisis, it might also discourage

investment. The consensus seems to be that, in developing countries, maintaining credibility tends to be more economically important than retaining flexibility, but the example illustrates the complexity involved in assessing the net economic impact of institutions.

Despite the difficulty inherent in measuring the quality of institutions, progress is being made in investigating the link between "institutional quality" and economic development. Despite all the problems with measuring the quality of institutions, almost all empirical work on the subject has concluded that institutional quality – in one form or another – correlates strongly with economic development. Nonetheless, while this basic correlation seems to be valid, correlation does not equal causation. While there are strong reasons to suppose that good institutions facilitate development, it is also plausible that high levels of economic growth spur the development of better institutions. Indeed, many researchers believe that the causality runs in both directions, thus suggesting "multiple institutional equilibria" (Chong and Calderon 2000). In other words, there may exist both a vicious circle, in which low growth leads to weak institutions causing continued low growth, etc., and a virtuous circle, in which high growth leads to stronger institutions, which facilitate more growth, etc. If this is indeed the case, it poses a challenge for development planners. Moving from the vicious circle to the virtuous circle requires understanding the strength of the causal relationships between institutional quality and economic growth, and vice versa, something that is still not known with much certainty at all. Indeed, moving out of the vicious circle may require reforming several things at once.

Measuring institutional quality

All research on the effect of institutional quality on economic growth requires devising some way to measure "institutional quality". Existing studies have adopted one or more of three strategies. Some simply use easily observable characteristics of formal institutions (such as the "law in books"). Examples of this are several recent articles that correlate the formal legal protections afforded creditors and shareholders with investment levels (La Porta et al. 1997, 1999). More sophisticated variations analyze the structure of government to determine how easy it is to change policy (Henisz 2000). This approach has the virtue of making the explanatory variable relatively easy to observe and measure. However, it's only applicable to a limited set of formal institutions. Informal institutions are obviously not observable, and, more seriously, since the operation of formal and informal institutions are often thought to be interdependent, neglecting informal institutions may not only limit the domain of study, it may also seriously skew the findings.

A second approach also uses measures that are relatively easy to observe, but instead of trying to observe the characteristics of institutions directly, it uses data thought to be a good proxy for some aspect of institutional quality that is more difficult to measure. For example, the frequency of coups and revolutions is taken as a proxy for the stability of government (Barro 1991). Some researchers have used the frequency with which the government loses those court cases to which it is a party as a good proxy for the quality of judicial independence (Clark 1975); others have suggested using turnover of high court justices as a proxy for the same thing. Frequently-used proxies for the effectiveness of economic institutions include the size of the black market and the percentage of national income in "contract-intensive" activities (Clague et al.1996). The attractiveness of these approaches

depends heavily on the quality of the proxy – some are clearly much better than others. Also, it is important that the proxy not make the research question trivial. If, for example, the proxy used for institutional quality is the overall level of investment, then showing that this variable correlates highly with economic growth shows only that investment is related to growth – not much of a finding. The ideal proxy is something that one has a strong prior reason to suspect is correlated with the explanatory variable (institutional quality) but no reason to suspect is connected to the dependent variable (economic development) except via the explanatory variable of interest.

A final approach to the measurement of institutional quality is the use of expert evaluations, frequently collected by private firms specializing in providing foreign investors information on country risk (Mauro 1995, Knack and Keefer 1995). These firms usually survey professionals who have done business in the country in question and ask a series of questions about the business environment – the risk of nationalization, the prevalence of corruption, the efficiency of dispute resolution procedures, etc. Other research in somewhat different areas uses a similar technique – for example, some research on judicial independence and activism asks country experts to rank different countries. And some of the most well-known indexes of political and civil rights use a variant of essentially the same technique. The advantage of this approach is that it allows researchers to capture the whole of the institutional environment, including those aspects that are difficult to measure otherwise. However, there are potentially serious problems with relying on this sort of data. First, the evaluations are highly subjective, and it's not clear what a survey respondent's point of reference is when he rates a country "high" or "low" on a particular dimension. This is especially true when the evaluators only have experience in that country and their home country. Second, the methods of data collection and the construction of the indices is often opaque. Third, as with the previous approach, there is a danger of picking a measure that proxies more for the dependent than the independent variable. For example, countries thought by foreign investors to be bad investment risks may grow more slowly, but it's hard to infer anything more than that, when there's little investment, there's little growth.

In sum, there are strong reasons to suppose that institutions matter – and perhaps are critical – for the successful economic development. However, although some broad lessons can be drawn from the existing research, more investigation is needed in order to address a number of difficult and important unanswered questions. While development planners should take the importance of institutions to heart, care must be exercised in both the diagnosis of institutional flaws and the prescription of institutional reforms.

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