

## **Judicial Reform and Economic Development:**

### **A Survey of the Issues**

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*Acknowledging the importance of sound judicial systems to good governance and economic growth, the World Bank and several other donor organizations have funded judicial reform projects in more than two dozen developing countries and transition economies during the last few years. Yet little is known about the actual effect of judicial reform on economic performance or even about what elements constitute a sound reform project. This article surveys a wide range of current research on judicial reform and finds some surprising results.*

The recognition that good governance is essential for economic growth has sparked renewed interest in projects to reform judicial systems. Since 1994 the World Bank, the Inter-American Development Bank, and the Asian Development Bank have either approved or initiated more than \$500 million in loans for judicial reform projects in 26 countries (Armstrong 1998). The U.S. Agency for International Development has spent close to \$200 million in the past decade on similar projects (GAO 1993), and other government and private groups are also funding programs to modernize the judicial branch of government (Metzger 1997; ACCT 1995; Blair and Hansen 1994). Today, the majority of developing countries and former socialist states are receiving assistance of some kind to help reform courts, prosecutors' offices, and the other institutions that together constitute the judicial system.

Although few now question the importance of judicial reform for development, little is known about the impact of the judicial system on economic performance. Nor is there any agreement on what makes for a successful judicial reform project. Some argue that reform

cannot be achieved without a societywide consensus, while others contend that the reform project can help create this consensus. Fears are also being expressed that judicial reform programs will repeat the mistakes of the law and development movement, an earlier, American-sponsored initiative that unsuccessfully sought to export the U.S. legal system wholesale to the developing world.

The design and implementation of judicial reform projects are complicated by a lack of knowledge about the relationship between formal enforcement of the laws through the courts, and traditional, extra-legal—or informal—means of enforcement. Coincident with the growing emphasis on judicial reform, a body of research has emerged showing that the formal legal system is just one way of ensuring compliance with society's laws. A variety of studies, in settings as diverse as medieval Europe and contemporary Asia, show that informal mechanisms based on incentives provided by repeat dealings can ensure the performance of contracts that no court has the power to enforce. One early, and surprising, finding of this research is that in some instances the sudden introduction of a formal mechanism to resolve legal disputes can disrupt informal mechanisms without providing offsetting gains.

### **:A Rationales for Judicial Reform**

Judicial reform is part of a larger effort to make the legal systems in developing countries and transition economies more market friendly. This broader legal reform movement encompasses everything from writing, or revising commercial codes, bankruptcy statutes, and company laws through overhauling regulatory agencies and teaching justice ministry officials how to draft legislation that fosters private investment. Although the line between judicial and legal reform blurs at the margin, the core of a judicial reform program typically consists of measures to strengthen the judicial branch of government and such related entities as the public prosecutor and public defender offices, bar associations, and law schools (Dakolias 1996; Shihata 1995; <sc>idb<xc>1994; Blair and Hansen 1994).<sup>1</sup> These measures aim to:

*Make the judicial branch independent.* Included here are changes in the ways in which judges are selected, evaluated, and disciplined to ensure that decisions are insulated from improper influences. In some cases, the budget for the judicial branch or the authority to administer the funds allocated for the judicial function is transferred from the ministry of justice or other executive branch agency to the judges themselves. Independence can also encompass giving judges the power to declare acts of the executive and legislative branches of government in violation of the country's constitution or some other higher law.

*Speed the processing of cases.* Providing management training, computers, and other resources to judges and court personnel reduces case backlogs and accelerates the disposition of new disputes. Revising the procedures for filing and resolving lawsuits helps to weed out procedures that invite delay and raise costs.

*Increase access to dispute resolution mechanisms.* The creation of mediation and conciliation services and other alternatives to resolving disputes in the courts reduces court costs, as does introduction of small claims courts or justices of the peace and the establishment of legal aid societies. Actions may also include transferring responsibility for noncontentious matters, such as name changes, the probate of uncontested wills, and the registration of property, to administrative agencies so that the courts have more time for disputed cases.

*Professionalize the bench and bar.* In-service training for judges, lawyers, and other legal professionals entails programs to establish codes of ethics and disciplinary procedures. Increasing the number of law schools, ensuring that these schools have adequate resources, and modifying the curriculum to reflect the demands of a market economy are also a part of this element.

The U.S. Agency for International Development (<sc>usaid<xc>) funds judicial reform as part of its larger effort to strengthen newly emerging democracies around the globe (Walker 1995; Blair and Hansen 1994; <sc>gao<xc> 1993). <sc>usaid<xc>'s projects originated in the early 1980s to assist the then fragile democratic government in El Salvador to bring individuals accused of human rights abuses to justice. A small program was initiated to train judges and law

enforcement personnel in investigative techniques. The program was subsequently expanded and then extended, first to the rest of Latin America and later to the nations of Central and Eastern Europe and the newly independent states of the former Soviet Union.

The Inter-American Development Bank (<sc>idb<xc>) finances judicial reform projects for a combination of political and economic reasons (<sc>idb<xc>1995). On one hand it sees judicial reform as an indispensable element in consolidating democratic institutions in Latin America by protecting basic human rights and promoting harmonious social relations. At the same time, it recognizes that a well-functioning judicial system is important in the development of a successful market economy. Judicial reform is part of the <sc>idb<xc>'s recent initiative to help borrower countries modernize the machinery of government. Since this initiative was launched, <sc>idb<xc> has either approved or taken under consideration 16 separate reform projects (Armstrong 1998).

Judicial reform projects sponsored by the World Bank aim solely at enhancing a nation's economic performance. The Bank is enjoined by its Articles of Agreement from interfering in the political affairs of its members, a prohibition it interprets as preventing it from supporting judicial reform unless the project "is relevant to the country's economic development and to the success of the Bank's lending strategy for the country" (Shihata 1995: 170). In practice this means that it does not provide assistance to reform criminal codes, train police or criminal court judges, or manage penal institutions (World Bank 1995). This focus on the economic consequences of judicial reform has led to complaints that such projects are ineffectual. Becker (1997) asserts that the emphasis on narrow, technical issues comes at the expense of more important, but arguably political, questions. (For a recent critique of a World Bank-sponsored project in Venezuela by two human rights groups, see Lawyers Committee 1996.)

## **:A Judicial Reform and Economic Development**

Whatever the rationale for judicial reform, it is widely believed that reform will significantly improve economic performance (Sherwood 1995). One hypothesis focuses broadly on the importance of the judicial system in enforcing property rights, checking abuses of government power, and otherwise upholding the rule of law. A second, narrower one casts the relationship solely in terms of the judiciary's effect in enabling exchanges between private parties. Although neither hypothesis has been subjected to a rigorous empirical test, there is some indirect evidence, albeit tentative and inconclusive, supporting both.

The narrow hypothesis originates with the 16th century English philosopher Thomas Hobbes, who argued that without a judicial system, traders would be reluctant to enter into wealth-enhancing exchanges for fear that the bargain would not be honored. In Hobbes' words, when two parties enter into a contract, "he that performeth first has no assurance the other will perform after because the bonds of words are too weak to bridle men's ambitions, avarice, anger, and other passions without the fear of some coercive power ([1651] 1962:8)."

Twentieth century development economists have revived Hobbes's thesis. North (1990:54) asserts that the absence of low-cost means of enforcing contracts is "the most important source of both historical stagnation and contemporary underdevelopment in the Third World." In Williamson's (1995) view, a "high-performance economy" is one that is characterized by a significant number of long-term contracts—just the type of business relationship that is unlikely to thrive in the absence of a well-functioning judicial system. When the judiciary is unable to enforce contract obligations, a disproportionately large number of transactions take place in the spot market, where there is less opportunity for breaching contracts. Or, alternatively, firms circumvent the judicial system altogether by vertical and conglomerate integration, turning arms-length transactions into intrafirm ones. In either case, argues Williamson, the results are higher transaction costs and a "low-performance economy."

Survey evidence from Ghana supports Williamson's argument that the absence of a judicial system raises transaction costs—but not in the way he posited. As reported in Fafchamps (1996), businesses in Ghana rely upon a network of traders to serve as go-betweens.

Rather than solicit a supply of lumber, say, from an unknown company directly, a firm will enlist a trader that it knows and that knows the lumber company. The personal relationships provide the buyer and seller with some assurance that the lumber will be delivered and payment received, but at a price: the creation of intermediaries raises the costs of doing business.

Constructing a direct empirical test of Hobbes's hypothesis is a formidable task. As Sherwood, Shepherd, and de Souza (1994) note, it would require determining what transactions are not taking place and then quantifying the resulting losses. Clague and others (1995) proposed an indirect test instead, based on the assumption that the greater the percentage of money held in bank accounts and other financial assets, the more confidence citizens had in the judiciary and other institutions required to enforce bargains. Conversely, they reasoned that when a large percentage of the money supply was held outside banks and other financial institutions, the greater the likelihood that a substantial number of exchanges are consummated in simultaneous, spot-market transactions.

Cross-country regressions for a large sample of industrial and developing countries using a measure of the stock of money held in the financial system yielded the predicted results. The greater the percentage of the economy's money in the system, the higher the level of investment and, to some extent, growth. But as Castelar Pinheiro (1998) observes, these results are problematic. A large portion of the money held in financial institutions consists of currency and other liquid assets available for immediate withdrawal. Hence, it cannot readily be assumed that a high ratio of funds held inside the system necessarily means that fewer spot or simultaneous transactions are taking place.

Surveys of Latin American entrepreneurs provide somewhat more, if also indirect, support for Hobbes's thesis. In Peru almost a third of those responding to a World Bank poll said they would not switch from a trusted supplier to a new one—even if a lower price were offered—for fear the new supplier could not be held to the bargain (Dakolias 1996). A similar survey in Ecuador found that businesses were hesitant to invest because of the uncertainty of and potential lack of timeliness in enforcing contract rights. In-depth interviews of Brazilian

entrepreneurs suggest that domestic investment would increase 10 percent if the Brazilian judiciary were on a par with those in the advanced market economies (Castelar Pinheiro 1998).

A second—far broader—hypothesis posits a more complex relationship between judicial reform and economic development. This view holds that economic development depends upon a legal system in which not only contracts between private parties are enforced, but the property rights of foreign and domestic investors are respected and the executive and legislative branches of government operate within a known framework of rules (World Bank 1992, 1994, 1997; Dakolias 1996; Shihata 1995). This way of defining the rule of law assigns a prominent place to the judicial system: "[T]he judiciary [is] in a unique position to support sustainable development by holding the other two branches accountable for their decisions and underpinning the credibility of the overall business and political environment (World Bank 1997:100)."

The argument that the rule of law fosters economic development has been made many times. The 15<sup>th</sup> century jurist John Fortescue ([1471?] 1979) asserted that medieval England's prosperity was traceable to the quality of English legal institutions. Almost 300 years later Adam Smith ([1755] 1980: 322) observed that "a tolerable administration of justice," along with peace and low taxes, was all that was necessary to "carry a state to the highest degree of opulence." Max Weber, the 19<sup>th</sup> century German sociologist, was the first to look carefully at the relationship among the rule of law, a well-functioning judiciary, and economic development (Trubek 1972), but according to Hayek (1960), credit for recognizing the judiciary's importance in enforcing the rule of law belongs to the writers of the American constitution and the German philosophers who elaborated the concept of the *Rechtsstaat*.<sup>2</sup> The former showed why judicial review of legislative actions was crucial, while the latter demonstrated the importance of subjecting the actions of the executive and its administrative agencies to judicial scrutiny.

Weber's comparative analysis of the role of law in China and the West was perhaps the first systematic effort to develop empirical support for the claim of a relationship (Bendix 1960). Most recently, in a survey of 3,600 firms in 69 countries, more than 70 percent of the respondents said that an unpredictable judiciary was a major problem "in their business

operations." (World Bank 1997: 36). The report also found that the overall level of confidence in the institutions of the government, including the judicial system, correlated with the level of investment and measures of economic performance.

But rigorous econometric methods for verifying the rule-of-law hypothesis and the role played by the judicial system are still in their infancy. Castelar Pinheiro (1998) reviews three recent efforts using cross-country regression analysis: Knack and Keefer (1995), Mauro (1995), and Brunetti and Weder (1995). Each uses a proxy for judicial system performance, such as entrepreneurs' perception of the political risk involved in conducting business in a given country, to explore the correlation between a better judicial system and higher rates of investment, growth, and other indicators of economic performance. All three studies report a relationship between the proxies selected and different indicators of economic development, but as Castelar Pinheiro notes, each suffers from several methodological problems that make the results suggestive at best. The proxies for judicial system performance are often questionable, and there are problems with the endogeneity of the independent variables. These studies also do not rule out competing explanations such as increases in trade and investment or even the effects of other institutional reforms such as the introduction of an independent central bank.

Nor do cross-country regressions settle the question of the direction of causality. It may be that higher levels of development permit the state to spend more on the judicial system (Posner 1998). Or as Pistor (1995) observed in a review of judicial and economic reform in the transition economies, the same factors that contribute to economic reform and development may also be responsible for improvements in the judiciary. Both may be a result of preexisting attitudes and beliefs in society at large, or what has recently been termed "social capital" (World Bank 1997; Ellickson 1997; Solow 1995).

Hirschman's (1994) suggestion about the relationship between political and economic progress may apply equally to the relationship between judicial reform and development. He argues that political and economic progress are not tied together in any straightforward functional way. Rather, given the historical record, the relationship is probably better modeled

as a series of on-and-off connections, or of couplings and decouplings. At some stages in the development process, the two may be interdependent, while at other stages they may be autonomous. There is no reason not to believe that a similar dynamic may be at work in the interplay between the evolution of the judiciary and economic growth, and the legal transplant school of comparative law has marshaled an enormous body of evidence showing that substantive law develops independent of economic and social variables (Ewald 1995).

In sum, while history and comparative analysis support the view that a better judicial system fosters economic growth, as Weder (1995) observes, there is no clear, empirical evidence showing the economic impact of a weak judicial system. The most that can be said at the moment is that the weight of opinion and evidence suggests the existence of some type of relationship.

#### **:A The Prerequisites of Successful Judicial Reform**

Judicial reform can threaten those with a stake in the status quo. As both Eyzaguirre (1996) and Blair and Hansen (1994) note, inefficiencies in court procedures and management often provide opportunities for rent-seeking by attorneys, judges, and judicial support personnel. In Argentina, for example, the judicial clerks have protested a proposal by Fundacion de Investigaciones Economicas Latinoamericanas (Ewald 1996) that they work more than the current 132 days a year. (The increase would raise the work year to at least 163 days, the average for executive branch personnel, if not to the 231 average for Argentine private sector employees.) The support staff is also challenging a recommendation to curb their power over case management and courtroom scheduling.

Reform may also engender opposition from the nation's organized bar. In Uruguay lawyers objected to the introduction of procedures that would speed up civil and criminal trials, fearing that speedier trials would mean less work for them (Vargas 1996). Reform can threaten lawyers' incomes in other ways as well. The practice of law is almost invariably a state-

sanctioned guild or cartel, but as Posner (1995) explains, unlike an oil or steel cartel, "legal services" are difficult to define. The state must therefore specify what tasks are for lawyers and what tasks can be performed just as well by nonlawyers. In Peru, for example, attorneys and public notaries vigorously opposed measures to cut the costs of registering land belonging to the urban poor because the measures would allow engineers, architects, and other professionals to provide services that had once been the exclusive preserve of the legal profession (World Bank 1997).

Given the opposition that judicial reform is certain to generate, one view holds that no program should be undertaken absent a broad consensus in the country on the need for significant change. Dakolias (1996) recommends extensive consultation with committees representing judges, members of the bar, and other affected groups during the preparation and implementation of the project. Shihata (1995) adds that this consensus must include a long-term commitment on the part of the government to provide the resources required for an effective judiciary.

Blair and Hansen (1994) reached a similar conclusion in an evaluation for <sc>usaid</sc> of judicial reform projects in Argentina, Colombia, Honduras, the Philippines, Sri Lanka, and Uruguay. Absent a high level of support from the ministry of justice, senior executive branch officials, legislators, and judges, the authors argue that judicial reform is unlikely to succeed. When such support is lacking, they recommend that both public and private donors forgo judicial reform altogether. Instead, they suggest that donors concentrate on building a consensus for reform by opening a dialogue with the government and by encouraging bar associations, business groups, and other nongovernmental organizations to campaign publicly for reform.

In the six cases examined, Blair and Hansen found that training judges, improving management systems, and supplying computers and other resources to the judiciary had little impact in countries where a consensus for judicial reform was lacking. The lesson they draw is that these traditional components of judicial reform, often termed "institutional strengthening,"

should not be initiated until more basic reforms have been achieved. Legal changes permitting the use of alternative dispute resolution mechanisms, creating or broadening legal aid programs, and ensuring that judges are appointed on the basis of merit should come first. Only after such structural reforms and access-enhancing measures are in place, do they support institutional strengthening.

Several other evaluations of judicial reform in Latin America appeared to confirm Blair and Hansen's findings. Even before their results were published, the U.S. General Accounting Office (GAO 1993), in an analysis of USAID-sponsored programs in Central American and Colombia, concluded that providing computers, training, and other technical assistance to the judiciary in countries where a strong commitment to reform was lacking had not been productive. Buscaglia, Dakolias, and Ratliff (1995) report that Latin American judges often questioned the value of training in the absence of more fundamental reforms to the judicial system. In many cases once a judge had been trained, he or she quickly left the bench for a more lucrative position in the private bar.

In a study of judicial reform projects in 15 Latin American countries, Martínez Neira (1996) found there had been too much emphasis on increasing the number of judges, courts, buildings, and computers at the expense of more fundamental changes to the legal system. He contends that this imbalance resulted from a lack of consensus on the scope of reform. Without such a consensus, judges, clerks, attorneys, and other actors in the legal system are free to pursue their own agendas. Pérez Perdomo (1993) makes a similar point, arguing that too many Latin American reform programs reflect only the needs and perspectives of judges and others with an institutional role in the judicial system.

Not everyone agrees with these criticisms, however. In a response to the General Accounting Office's critique, USAID (1993) contended that such programs can be seen as the vehicles for developing a consensus. The collaboration between outside experts and judges and others within the country and the ensuing public discussion can help to generate the necessary political commitment, the agency maintained.

Hammergren (1998), who subscribes to this view as well, also takes issue with Blair and Hansen's recommendation that institutional strengthening should always follow structural reforms and measures to increase access to the judicial system. She observes that institutional strengthening can pave the way for broader reforms that, if attempted first, may engender such strong opposition that reform will be stalled. She argues that institutional strengthening measures do not have to end up simply serving the needs of judges, lawyers, and others with a stake in the status quo. Such measures can include ways of making the judicial system more accountable to the public and, as MacLean (1996) has stressed, give it a public service orientation. Hammergren also cautions that nongovernmental organizations also have their own interests that may be at odds with a broader reform agenda. Business groups may, for example, be interested solely in the creation of commercial courts or steps that reduce legal fees.

#### **:A The Law and Development Movement**

Are the legal technical assistance programs sponsored by the World Bank ignoring the lessons learned in earlier attempts to foster development through law (McAuslan 1997; Thome 1997)? In the 1960s <sc>usaid<xc>, the Ford Foundation, and other private American donors underwrote an ambitious effort to reform the judicial systems and substantive laws of countries in Asia, Africa, and Latin America. This "law and development" movement engaged professors from Harvard, Yale, Stanford, Wisconsin, and other leading law schools and within a few years had generated hundreds of reports on the contribution of law reform to economic development (Merryman 1977). Yet after little more than a decade, both key academic participants (Trubek and Galanter 1974; Merryman 1977) and a former Ford Foundation official (Gardner 1980) declared the program a failure, and support quickly evaporated.

The guiding assumption of the law and development movement was that law is central to the development process. A related belief was that law was an instrument that could be used to reform society and that lawyers and judges could serve as social engineers. As Merryman

(1977) notes, not everyone subscribed to this view. A few participants in the movement argued that only minor changes could be effected through legal reforms, and others contended that law reform should follow broader changes in society, that is, that the proper aim of reform was to adjust the legal system to social and economic changes that had already taken place. But the dominant view of law and development practitioners and theorists alike, although still unproven (Vorkink 1997), was that law reform could lead social change, that law itself was an engine of change.

A second important belief was that educating the bench and bar in developing countries would advance reform efforts. The gap between the law on the books and the law in action in developing countries was widely appreciated, and one of the solutions advanced was professional education (Burg 1977). It was thought that if lawyers and judges were properly educated about law's role in development, they could be enlisted to close the gap. The idea was to turn members of both professions into legal activists through education. Yet as one sympathetic chronicler of the movement observed, this idea was supported by nothing more than "hopeful speculation" that education could overcome values instilled by family, class, religion, and other social forces (Lowenstein 1970, pp. 246-47).

The postmortems on law and development identify a number of pitfalls that advocates of judicial reform ought to bear in mind (Trubek and Galanter, 1974; Merryman 1977; Gardner 1980; Burg 1977). One is that the movement lacked any theory of the impact of law on development. Practitioners thus had no way to prioritize reforms or predict the effects of various measures. A second failing was too little participation by the lawyers and others in the target country who would either have to carry out the reforms or who would be affected by them. Foreign legal consultants, through a combination of expertise and access to funding, were often able to dictate the content and pace of reform. A third problem was that the movement focused on the formal legal system to the exclusion of customary law and the other informal ways in which many in developing nations order their lives (Trubek and Galanter 1974).

But perhaps the most significant reason for its failure was the naive belief that the American legal system (and the legal culture generally), which Trubek and Galanter (1974:1062) refer to as "liberal legalism," could be easily transplanted to developing countries. In the United States judges play a significant role in policymaking, and as a result, lawyers are often able to engineer significant changes in policy through litigation. This is not true in civil law systems or indeed even in the United Kingdom and other nations that share the same common law background as the United States. As Merryman (1977: 479) put it, the law and development movement reflected the American "legal style," and this was a style that those in other cultures did not find particularly attractive.

At a 1995 conference hosted by the British Council, participants debated whether the mistakes of the law and development movement are likely to be repeated. Faundez (1997:13) argued that although the old programs and the Bank's new initiatives appear to be quite similar on the surface, the context in which the Bank's current programs are being carried out is significantly different. Behind the law and development movement was the premise that the state "would initiate and promote the process of economic development." By contrast, today the Bank sees law as facilitating market transactions by defining property rights, guaranteeing the enforcement of contracts and maintaining law and order. Because the state is no longer the protagonist of social change, as in the law and development model, there is less room for error.

Yet as his analysis proceeded, Faundez seemed to be less sure that the mistakes of the law and development movement would be avoided. He recognized that current development theories, inspired by the work of Douglas North and other neo-institutional economists, still contemplate a role for the state. It is, to be sure, a different one from the activist theory implicit in the law and development movement, and it is one that is informed by economic analysis. "But it is unlikely that by shifting the focus of attention from legal institutions to economic analysis this new approach will manage to avoid the problems which so frustrated and disappointed members of the law and development movement" (Faundez 1997:14). His concern is that all the unanswered questions that lurked behind the law and development movement—the role of law

and the formal legal system in development, the relationship between law and politics, and among democracy, authoritarianism, and development—still remain.

If Faundez is ultimately uncertain that the Bank will not repeat the mistakes of the law and development movement, both McAuslan (1997) and Thome (1997) have no doubts that it will. McAuslan advances a series of reasons why this is likely to happen. Like Faundez, McAuslan underlines the absence of any empirical data connecting reform with development and the consequent disagreement even among reformers over priorities and strategy. In a commentary on McAuslan's article, Thome goes a step a further. He believes the problem is not so much a lack of empirical data as the failure to reflect the data that is available. He asserts that all law reform, and judicial reform in particular, rests on three premises: first, that development requires a modern legal framework resembling that in the United States; second, that this model establishes clear and predictable rules; and third, that the model can be easily transferred. Yet, he says, empirical research has refuted all three assumptions.

McAuslan is also critical of what he argues is the Bank's focus on law reform to facilitate market transactions. The emphasis should be on promoting good governance and alleviating poverty. An efficient and equitable market economy requires well-functioning state-run institutions that can curb the abuses likely to arise as the market economy develops. He fears that in emphasizing the role of the judiciary in fostering economic growth these considerations will be pushed aside. He cites as an example land-grabbing by elites as property rights are defined and allocated by the state. Without judicial and administrative bodies capable of curbing such behavior, income inequalities will be exacerbated and political instability may result.

McAuslan and Thome are not entirely negative. They do note that some Bank projects reflect the lessons of the law and development movement. The Financial and Legal Management Upgrading Project <sup>in</sup> Tanzania, for instance, has involved local lawyers from the beginning, both in studying the legal system and in developing proposals for change. Even the legislative drafting project for China, which they say is premised on an extreme view of the importance of law in the development process, is training local lawyers in the skills necessary for

market reform. But even though the failings of the earlier law and development programs may be clear, both critics assert that pressures to produce results quickly will work against the gradual and incremental approach to law reform warranted by our current state of knowledge about the relationship between law and development.

### **:A Integrating Judicial Reform with Informal Enforcement Mechanisms**

Judicial reform aims to buttress the rule of law and assure entrepreneurs that contracts will be enforced. Yet other institutions within society perform these same functions. Accountants and auditors issue standards and render judgments evaluating the performance of various economic actors. Credit bureaus provide an incentive to consumers and businesses alike to observe contracts by disseminating information about those who have failed to perform. And the media and nongovernmental organizations are often the first to detect and publicize arbitrary or illegal actions by government officials. Judicial reform projects that build upon or enhance the operation of such informal enforcement mechanisms will yield greater returns than those that do not. At the least, designers of reform projects must take the presence of these informal mechanisms into account. Otherwise, as Greif (1997) warns, the projects could backfire.

A forthcoming study by Kranton and Swamy of the effect that the introduction of formal courts had on rural credit markets in India illustrates just how a judicial reform project can go awry. Before there were formal courts, moneylenders relied on informal enforcement mechanisms to ensure that clients paid their debts. Resort to these mechanisms was costly and usually required the acquiescence of local leaders. Entry into the moneylending business was thus retarded and competition lessens. Although lack of competition meant that interest rates remained high, it also gave lenders a cushion that allowed them to extend payment terms and otherwise accommodate debtors experiencing difficulties in meeting their obligations.

The introduction of courts by the colonial authorities brought new entrants into the market. Interest rates declined, robbing lenders of the financial cushion that had allowed them to

carry borrowers in bad times. When drought hit, lenders went to court to foreclose on farmers' land. Riots and widespread social unrest followed.

As Kranton and Swamy note, the lesson is not that judicial reform is never appropriate, but that where other markets, such as those for insurance and futures, are missing, care must be taken to ensure that judicial reform does not have unintended consequences. Fafchamps' (1996) study of contracting in Africa supports this view. He found that rigid compliance with the terms of a written contract was difficult, if not impossible, in developing countries. Their economies are simply subject to too many exogenous shocks for contracts to be strictly enforced, which is why informal contract enforcement mechanisms build in such flexibility.

The problem in every case comes in determining how judicial reform will affect informal enforcement mechanisms, for a general theory of informal mechanisms and their interplay with formal mechanisms has yet to be advanced (Ellickson 1991). What is known is that when formal systems are deemed illegitimate, as they were in Moslem Central Asia after the Soviet takeover in the 1920s, disputes will be directed away from the formal system (Massell 1968). Ellickson (1991) submits too that the division of labor between formal and informal mechanisms is affected by the technical complexity of the issues involved. He found, for example, that in northern California disputes between neighboring ranchers about the cost of a fence, which raised simple questions of fact and technology, tended to be resolved informally. By contrast, disputes involving the allocation of groundwater supply, where the facts were difficult to ascertain and resolution of the contested issues involved complex technical questions of return flow and allocation during shortages, were more likely to be presented to a court for adjudication.

The informal enforcement mechanisms that have drawn the most attention are reputation-based systems that permit merchants to carry on extensive trading relations over time and space in the absence of a court system that could ensure contract performance. Greif (1989) describes a system used by traders in North Africa and the Mediterranean in the 11th century, and in a later paper (1997), he shows similar reputation mechanisms at work in settings as diverse as the

Wisconsin lumber industry, the New York diamond trading business, long-distance commerce in medieval Europe, and parts of contemporary Asia, Africa, and Latin America. The common denominator in all these examples is that the gains from repeat dealings provide the incentive necessary to ensure performance. That is, the discounted present value of the earnings stream that can be realized from future transactions exceeds the one-time wealth increase realizable from breaching the current agreement (Klein 1985).

The incentive to maintain a good reputation operates in other settings besides merchant-to-merchant relations. Credit bureaus, business associations that exchange information about the payment history of their customers, count on consumers' desire to buy on credit in the future to assure payment of current obligations (Klein 1992). A similar principle is behind consumer testing laboratories, better business bureaus, and other groups that market seals of approval or provide quality guarantees (Klein 1997). When these groups certify that a product or business meets a certain standard, they are providing a visible sign of good reputation that can be used to generate future sales.

Development itself can affect the mix of formal and informal mechanisms in an economy. According to Besley (1995), one of the reasons informal financial institutions such as rotating savings and credit associations continue to operate in the developing world is that they spend far less than do banks and other formal financial institutions to ensure that borrowers repay their debts. Because their borrowers typically come from the same village, these institutions can rely on group pressure and other informal methods to see that the loans are repaid. Besley predicts that these institutions will lose their comparative advantage as the number of close-knit communities declines with the changes brought by economic development and that they will ultimately be supplanted by formal firms.

Milgrom, North, and Weingast (1990) too stress how increases in the costs of operating an informal enforcement mechanism lead users to turn to the formal legal system. They model a reputation-based system that resembles the one devised by long-distance traders in medieval Europe. Enforcement depends upon each trader determining if the other party to the

contemplated exchange has failed to honor a contract, or cheated, in the past. If the other party is a cheater, the honest trader refuses to exchange with him. The threat of a boycott deters cheating.

But traders incur costs in ascertaining the past history of those with whom they contemplate exchanging, costs that increase as the economy grows. The number of potential trading partners on which information must be gathered expands, and the number of queries rises as the number of potential exchanges increases. Accordingly, Milgrom, North, and Weingast argue that eventually the costs to traders will exceed the costs of operating a formal judicial system. Rising transaction costs, they note, explain why national courts replaced the Law Merchant system of informal enforcement in Europe during the late Middle Ages.

Although the value of their analysis is its explicit focus on transaction costs and how changes in these costs dictate the choice between an informal and formal enforcement mechanism, to the extent that their work implies that development always makes informal mechanisms more costly than formal mechanisms it is misleading. Development lowers at least some of the costs involved in operating an informal enforcement mechanism. The use of faxes, computers, and other technologies, for example, reduces the costs of compiling and disseminating information about the credit history of consumers and businesses (Ellickson 1991). How these increases and decreases net out, however, remains to be explored.

The line between formal and informal mechanisms may be fuzzy, however. In some cases a hybrid system appears. For example, the courts may enforce social customs or practices sanctioned by merchants (Benson 1989). Or bankers may hold titles to farmers' land while their loans are outstanding, as in Thailand (Siamwalla and others 1993) and Honduras (Stanfield and others 1990). Although actual possession gives the banks no formal legal right to foreclose on the land in case of default, bankers consider the leverage from holding the title to be a sufficient guarantee of repayment.

Much remains to be learned about the working of informal enforcement mechanisms and their relationship to the formal legal system. But at least some of the ways in which judicial

reform can build upon or complement informal systems are already apparent. Some are obvious. Projects should capitalize on the power of the media to police reform efforts by providing as much information about the judicial system as possible. In Argentina, for example, [Fidel \(1996\)](#) has proposed releasing information regularly about judicial caseloads, case backlogs, and other indicators of judicial productivity.

At a minimum, reform measures should try to bolster or complement informal enforcement mechanisms. In the case of reputation mechanisms, this could mean disclosing the identity of the parties to lawsuits, the status of cases in litigation, and the disposition of closed cases, including the amount of any damages awarded. Going further, current laws need to be reviewed to be sure they pose no obstacles to the easy and inexpensive dissemination of truthful public information about firms and individuals.

Whenever reputation information circulates, there is the possibility for abuse. False and defamatory material may be disseminated, jeopardizing privacy interests and compromising opportunities to make a fresh start. There are, however, many ways to strike a balance between these interests and the interests served by a well-functioning reputation system. In the United States, the Federal Fair Credit Reporting Act provides one model for balancing debtor and creditor interests. Another is Brazil's juridically sanctioned process for publicizing information about those who have failed to pay their debts (World Bank 1997).

Often, enforcing reputation mechanisms depends upon an agreement among the participants to boycott anyone who has a history of breaching an agreement (Milgrom, North, and Weingast 1990). But some U.S. courts have ruled that a boycott is illegal when one or more of the firms participating in the boycott is a competitor of the party boycotted ([ABA \(1997\)](#)). These rulings have been sharply criticized for misapprehending the nature of anticompetitive agreements (Heidt 1986), but their influence may still be reflected in competition law. Accordingly, a program to foster informal contract enforcement mechanisms should also encompass a review of the applicable competition law.

Based on research in Ghana, Fafchamps (1996) recommends helping local business communities develop systems to share information about the reliability of suppliers and customers. Klein's (1992) analysis of credit bureaus shows that free-rider problems and other market failures are endemic in the start-up phase and can prevent the formation of credit reporting entities. In the United States credit bureaus began as small, nonprofit associations, often run as an adjunct to the local chamber of commerce. Members were drawn from a tight-knit group of local merchants, and social ties supplied the incentives to overcome the problems of market failure. Where such incentives are missing, alternative ways of fostering the growth of credit reporting agencies should be considered. In Taiwan, the government's check clearinghouse serves as a substitute for a private credit bureau, charging a small fee for information about individuals who have bounced checks (Winn 1994).

Several other measures can be included in judicial reform projects to complement informal enforcement. One possibility is to transfer the responsibility for matters such as the registration of property rights to administrative agencies. This transfer can foster hybrid enforcement mechanisms. For example, technology now permits the creation of essentially paperless registries for land and other types of property. But paper titles may serve a purpose by permitting the development of a type of informal mortgage based on physical possession of the certificate.

## **:A Conclusion**

Although judicial reform projects are an accepted part of the development landscape, crafting an effective project poses several challenges. Many questions about how judicial reform affects the economy, and society generally, remain to be answered. Not surprisingly, one result is that no consensus on the prerequisites for a successful project has emerged. Accordingly, in the absence of a better theoretical understanding of the impact of judicial reform, care is required in designing and implementing projects (Greif 1997; Dakolias 1996; World Bank 1995;

<sc>idb<xc> 1995). Reform must be preceded by an in-depth analysis of country needs, an analysis that must be continually reviewed as implementation proceeds.

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## Notes

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<sup>1</sup> An exhaustive list of potential interventions appears in Dakolias (1996). Other useful discussions of the range of possible reforms the several articles collected in Rowat, Malik, and Dakolias (1995).

<sup>2</sup> Although *Rechtsstaat* is frequently rendered into English as "rule of law," as Fletcher (1996) notes, this translation can be highly misleading. The word "law" in the English phrase "rule of law" can mean either positive law, that is, any law enacted by a duly constituted government; or it can mean natural law, that is, precepts that meet some test of morality and justice. The German *Recht* is far closer in meaning to the latter than to the former, and thus a more accurate translation of *Rechtsstaat* would be "state ordered or ruled by natural law or justice." Similar translation problems arise with other European languages that, like German, have different terms for positive and natural law.