

Why This Book?

Emerson once laid it down as a rule that when friends meet after a time apart, they should greet each other by asking one question: Has anything become clear to you since we were last together? The sense of his rule applies to the subject of the book now in the hands of the reader.

In the last decade the issue of how best to improve the rate of economic growth of the poorer nations of Africa, Asia, and Latin America has come to be approached along lines quite different from those in the decades after the Second World War. Economists in the academy and practitioners in national and international aid agencies—as well as influential participants in public debate—now increasingly hold that neither traditional development theory nor neoclassical economics fully answers the complex problems of economic development. The ascendant view is that *institutions*—as the term is used in what has become known as neoinstitutional economics—matter for economic development, and that they do so in a major way.

Neo and Other Economics

An interest in institutions is not new. A movement focused on business enterprises, labor unions, and other organizations that flourished in the United States in the 1920s and 1930s is associated with the names of Thorstein Veblen and John R. Commons. The movement, which relied heavily on description rather than mathematics, failed to gain respect among those neoclassical economists who focused on economic concepts rather than on organizations. The neoclassical school of economics can be thought of as an

updated version of the teachings of Adam Smith and later “classical economists” such as David Ricardo, John Stuart Mill, and Alfred Marshall. Neoclassical economists gradually extended their reach beyond microeconomics (the initial focus of classical economics) into macroeconomics (involving issues such as inflation and employment) and even into adjacent social science fields. When a new focus on institutions—concerned with the way rules, contracts, and property function in the economy—developed in the second half of the twentieth century, it was called neoinstitutional economics. The objective of the name was both to distinguish it from the institutional economics of the prewar period and to contrast it with neoclassical economics.¹

Neoinstitutional economics is associated with the names of two Nobel Prize winners of the 1990s, Ronald Coase and Douglass North. Ronald Coase’s Nobel citation states that he won the prize “for his discovery and clarification of the significance of transaction costs and property rights for the institutional structure and functioning of the economy.”² North’s contribution, according to his Nobel citation, was to renew “research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change.”³

North’s influential 1990 work—*Institutions, Institutional Change, and Economic Performance*—used history to illuminate the economic and institutional factors that have driven economic growth since the Middle Ages and that contribute to economic development in the third world today.⁴ In his analysis *institutions* means *rules*—not just legal rules but social norms and other determinants of behavior—rather than organizations.

North’s work, like all major intellectual achievements, had antecedents. Two equally remarkable figures who deserve consideration in the history of what is now called neoinstitutionalism are Max Weber and Friedrich Hayek. While Weber, usually thought of as a sociologist, is renown for his work in

1. On the influence of neoclassical and neoinstitutional economics on development policy, see Meier (2001, pp. 26–28, 37–39).

2. The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 1991 (nobelprize.org/economics/laureates/1991/index.html). Douglass North described the relevance of Coase’s work to his own in North (1987, p. 419).

3. North shared his Nobel Prize and citation with Robert Fogel, also an economic historian, who focused on U.S. history. Although the reference in the joint citation to the application of “quantitative methods” presumably refers primarily to Fogel’s work, North had published several influential quantitative articles. See The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 1993 (nobelprize.org/economics/laureates/1993/index.html). See also North and Wallis (1982) and North (1987).

4. North (1990).

many fields, two works stand out. The most famous is *The Protestant Ethic and the Spirit of Capitalism*, which was a forerunner in considering the relevance of culture to economic growth.⁵ But perhaps more directly relevant to this book is *Law in Economy and Society*.⁶

Perhaps a more immediately important predecessor is Hayek, also a Nobel Prize winner. He is particularly interesting in the context of any inquiry into legal institutions because of his focus on legal ideas, well conveyed in the titles of two of his most ambitious works, *The Constitution of Liberty* and *Law, Legislation and Liberty* (published in three volumes).⁷

Just as North's work had predecessors, so too many scholars have tried to expand on his concept of institutions. Dani Rodrik, whose work is relied on at various points in this book, has written on the various forms that institutional solutions take in different countries. One message of Rodrik's work is that there is no single institutional route to economic development.⁸ Masahiko Aoki, building in part on the experiences of such diverse venues as Japan, China, and Silicon Valley, has sought to broaden the perspectives of neoinstitutionalism to include private sector arrangements.⁹ More generally, Aoki emphasizes relations among institutions as the rules of the game, organizations—the players in the game, including not just governments and private parties—and the equilibrium these various players achieve over time across various domains.¹⁰

Since the purpose of this book is not to expand on the intellectual, historical, and economic aspects of neoinstitutionalism but rather to unpack its implications for legal institutions, the focus in later chapters is on the various legal issues that arise in any effort to spur economic growth through legal reform.

Stages in Economic Development Thinking

After World War II, and especially during the decades when many former colonies of Great Britain and France (as well as Belgium, the Netherlands, and Portugal) won their independence, practitioners in the field of economic development concerned themselves with the factors that might bring about

5. Weber (1958).

6. Weber (1954).

7. Hayek (1960, 1973, 1976, 1979). See also Mahoney (2001).

8. Rodrik (2000, 2003).

9. Aoki (2000).

10. Aoki (2001).

economic growth in those former colonies, most of which were quite poor. Three major stages in economic development thinking can be defined, albeit with considerable oversimplification and loss of interesting detail.

Initially, during the first few decades, the focus was on the simple economic proposition that production was a function of capital and labor. The poor countries of this time usually had a large supply of labor, with many unemployed or at least underemployed workers, and capital was scarce.¹¹ What could be simpler than transferring capital to these countries, thereby presumably increasing production? Economic aid programs in the developed world and the expansion of World Bank and regional development bank lending were directed toward this goal.¹²

Regrettably, many of the developing countries viewed industrialization as the primary goal and to that end cut themselves off from international trade by pursuing import substitution policies while using massive public expenditures to build infrastructure and to subsidize new industries. One unfortunate result was serious inflation in many countries, which in turn (especially with the fixed exchange rates that were the rule in those days) led to exchange controls to prevent the currency from depreciating. The exchange controls further reduced international trade.

The response to these problems, in the second stage of economic development thinking, was to apply the insights of neoclassical economic policy, not just to opening domestic economies to imports and to freeing prices from controls but also especially to macroeconomic stabilization.¹³ At the policy level these goals became embedded in what was called structural adjustment lending, where loans were made not for projects but for general government support in exchange for commitments to economic reform, prominently macroeconomic reform.¹⁴ The side effect of the focus on economic stability, however, was perceived to be (and often proved to be) slower economic growth than had been enjoyed in earlier decades. Emphasis broadened in the 1990s to include so-called microeconomic reforms, including privatization of state-owned industries and reforms of financial and labor markets.¹⁵

11. Meier (2001, pp. 14–16).

12. Easterly (2001, pp. 27–28).

13. Yusuf and Stiglitz (2001, pp. 229–32).

14. Easterly (2005); Dollar and Svensson (1998).

15. Krueger (2000). Krueger explained that the microeconomic reforms were divided into two stages: “big picture” reforms such as privatization of state-owned industries and “second generation reforms” concerned with labor and other markets. See generally Kuczynski and Williamson (2003) and Lora and others (2004, pp. 24–39).

The search for new solutions led to an increasing focus on how poorly many developing country governments functioned and especially on widespread inadequacies, even corruption, of public regulatory bodies and of the legal system. As this emphasis on the weaknesses of developing country governments grew, the intellectual rise of neoinstitutional economics seemed to provide an answer. Institutions came to matter in this third stage of economic development thinking. It is with the policy implications of this third stage, especially insofar as legal institutions are involved, that this book is primarily concerned.

Legal Institutions: The Law and Finance Literature

Toward the end of the 1990s, a group of economists, specializing in finance and building upon the emerging emphasis on institutions, conducted cross-country econometric research to determine what legal rules best contributed to strength in the financial sector and thereby to economic growth. Their studies in Law and Finance represented an unprecedented focus on micro-economic analysis of the influence of legal rules on economic growth.¹⁶ Their seminal work led to an explosion of research by other economists and by lawyers into the role of legal institutions in economic development.

A major conclusion reached in their studies was that countries whose legal systems originated in the English common law have enjoyed superior per capita income growth compared with so-called civil law countries, whose law is based on European codes, especially those countries whose law is based on the Napoleonic codes and hence on French law. As this book shows, their conclusions have drawn criticisms on various grounds, especially because many civil law countries—not only those in Western Europe but also some developing countries—have enjoyed superior economic growth and because many common law countries in the third world have done quite poorly in the economic growth tables.

Despite such criticisms of these economists' specific results, the idea that institutions and especially legal institutions are crucial to the process of economic development is now broadly accepted in the academies and in the research departments of international financial institutions such as the World Bank. The term "crucial" is not meant to imply, however, that legal institutions are necessarily more important than other aspects of government policy. Educational and health care institutions have their own crucial roles to

16. See, for example, La Porta and others (1998). For a fuller discussion, see chapter 2.

play in advancing economic growth. One can say that they complement good legal institutions in the way that separate fingers of the hand combine to make for a solid grip; it is pointless to argue over which finger has the highest priority.

The Dual Aims of This Book

What has just been said lies behind the dual aims I have set for this book. The first is to analyze the reasons why legal institutions are important to economic development, and what aspects of the law are of particular importance. The second and related aim is to try to grapple with a task too seldom addressed—perhaps because it is shot through with slippery imponderables. The task I have undertaken is to lay out the policy implications and especially the policy means for following through on the new accent on legal institutions as a major factor in economic development. In short, the key question I address is what it means to act on the premise that the *rule of law* is essential to economic development.

I bring to the matter at hand the perspective of a law professor in the law and economics tradition, an early interest in comparative law, and extended experience as a policymaker at the “nuts and bolts” subcabinet level in three U.S. administrations between 1971 and 2002. I know through personal involvement in traditional debates over economic development that it is easy and convenient for policymakers to call for more economic assistance to distressed countries and to insist on their adherence to better fiscal and monetary policies. Today it is even easier to deliver sermons about the need for “good government”—or, to use the current phrase, “better governance.”

I also know that the first instinct of lawyers, which is simply to transplant world-class legal institutions to developing countries, will most likely produce little more than a harvest of dead leaves. The institutions important to development are more likely to bear fruit if they evolve out of roots already growing in the soil of particular countries. How to do that systematically is, of course, still well beyond the current state of the art. Nevertheless, despite the problems and the complexities of the analysis to unfold in this book, there is an urgent need for policymakers, in both the developed and developing worlds as well as in the international institutions that are the financial and technical intermediaries, to grasp the relationship between institutions—legal institutions in particular—and economic growth. The reason can be compressed into a single declarative sentence. Parts of the developing world have ceased to develop. Put differently, per capita incomes are failing to

increase significantly in all too many countries. And to use a more popular term, the poor in those unfortunate countries remain trapped in poverty.

Economic Regulation and Corruption

If everything must be treated in a book, nothing can be. To limit the inquiry to manageable proportions, I have necessarily and regretfully excluded from the discussion certain topics that fall within the framework of law and institutions.

In rough order of importance, the first topic that is *not* discussed is economic regulation of business, labor markets, land use, and new business formation.¹⁷ The World Bank has focused particular attention on this last topic—the question of how many, and what kind of, legal steps must be taken to start a new business. The reasons for this focus can be deduced from two extracts from a recent World Bank study:

It takes 2 days to start a business in Australia, but 203 days in Haiti and 215 days in the Democratic Republic of Congo. There are no monetary costs to start a new business in Denmark, but it costs more than 5 times income per capita in Cambodia and over 13 times in Sierra Leone. Hong Kong (China), Singapore, Thailand, and more than three dozen other economies require no minimum capital from start-ups. In contrast, in Syria the capital requirement is equivalent to 56 times income per capita, in Ethiopia and Yemen, 17 times, in Mali, 6 times.

Teuku, an entrepreneur in Jakarta, wants to open a textile factory. He has customers lined up, imported machinery, and a promising business plan. Teuku's first encounter with the government is when registering his business. He gets the standard forms from the Ministry of Justice, and completes and notarizes them. Teuku proves that he is a local resident and does not have a criminal record. He obtains a tax number, applies for a business license, and deposits the minimum capital (three times national income per capita) in the bank. He then publishes the articles of association in the official gazette, pays a stamp fee, registers at the Ministry of Justice, and waits 90 days before filing for social security. One hundred sixty-eight days after he commences the process, Teuku can legally start operations. In the meantime, his customers have contracted with another business.¹⁸

17. World Bank (2005, p. 108).

18. World Bank (2004a, p. xi).

In truth, economic regulation has not received the attention it deserves, in part perhaps because it is often a highly technical subject, with the nature of regulation differing from sector to sector and from regulatory agency to regulatory agency, even within a single government. A recent book by William Lewis, based on the work of the McKinsey Global Institute, argues rather powerfully that a prime cause of development failure is overregulation.¹⁹ He refers not to typical public utility regulation so well known to economists, political scientists, and lawyers, but rather to regulation of the minutiae of everyday business life. To take two examples, Lewis points out that India has reserved hundreds of products for small-scale producers (which in practice are so small that they are high-cost producers) and that Indian zoning laws rule out large retail stores of the kind so well known in the developed world. Since average per capita incomes are ultimately correlated with productivity levels, economic regulation is a neglected aspect of legal institutions. (After all, regulation is usually written into law and often administered by a special regulatory body with enforcement responsibilities.)

Another problem that I have omitted from this discussion is corruption. It is a huge subject, and arguably the most important factor inhibiting economic development in several countries. World Bank research estimates the total of annual bribe payments in the world at \$1 trillion annually.²⁰ Corruption is, of course, related to issues of social norms that I do discuss. More important, corruption can influence the way in which legal rules operate in practice: “Not only do formal rules matter, but also the institutional environment in which those rules are applied and enforced,” write three World Bank economists.²¹ I have assumed, without attempting to prove, what seems to me obvious—that honesty and trustworthiness in commercial dealings and an absence of corruption in dealings with government agencies, including the judiciary, would be conducive to more rapid economic growth. But honesty and trustworthiness do not appear to be fully achievable goals for public policy, although, of course, a legal system may cause dishonest and untrustworthy businessmen to act in a way that they would not act if they were inherently honest and trustworthy. What the elements of such a legal system are, especially to the extent that culture and social mores work against the legal system rather than complementing it, is one of the major themes of this book.

The problem of corruption, however, is a bit different. Although here too culture and social norms play a role, the legal changes and government

19. Lewis (2004).

20. World Bank (2004b).

21. Kaufmann, Kray, and Mastruzzi (2005, p. 39).

programs best able to combat corruption are not obvious. Government policies may themselves invite corruption. For example, the complex requirements for starting a business not only invite corruption but in some cases may indeed have been imposed as a lure for bribes for those who dispense the needed licenses and permissions. In any event, I have decided to leave the question of corruption for another day.

To put the case directly, I focus in particular on rule-of-law issues: the protection of property rights, the enforcement of contracts, and the role of the judiciary in achieving those goals. And I illustrate the applications of these institutional questions in a few especially important economic sectors: land (since most developing countries are primarily agricultural, and legal improvements such as titling and land registries are common proposals for reform) and, in keeping with the Law and Finance literature, equity and credit markets. My hope is that concentrating on this subset of legal issues will provide a framework for further work on the role of legal institutions in economic development.

Economic Growth: The Big Picture

Since this book is about economic development, it is best to say straight off that the overall record of economic growth in the half century from 1950 to 2000 is not to be dismissed as, to use the American vernacular, “peanuts.” In that period the developed world grew roughly fourfold in real per capita income and the developing world threefold.²² The “onefold” is a big difference, certainly not peanuts; it is, of course, necessarily equivalent to average per capita real incomes in 1950. Yet the growth in the developing world as a whole was much greater than had been predicted at the outset of the period.²³ Moreover, in the 2001–04 period, emerging economies grew two and one-half times faster than advanced economies, which were plagued by recessions, and, in Europe and Japan, by uncommonly slow growth.²⁴

Not least of all, the developing country growth was much better when viewed from two more points of comparison and contrast. First of all, the 2.3 percent annual per capita growth in the developing world as a whole from 1960 to 2000 was much more rapid than the 0.6 percent growth from 1820 to 1950. Second, and more striking, the developing world’s 2.3 percent growth in the four decades from 1960 to 2000 exceeded the U.S. growth rate of

22. Maddison (2003).

23. Cooper (2005).

24. “Coming into Flower; Emerging Economies,” *Economist*, October 16, 2004.

1.8 percent during the heyday of its pathbreaking development during the half century before World War I; it was also better than British growth of only 1.3 percent during the half century from 1820 to 1870.²⁵

Still, the variability in growth rates between countries in the developing world has been remarkably large, with whole regions suffering subpar economic growth for long periods. And many countries have in recent decades experienced a serious slowdown in growth.²⁶

TO RESTATE THE aim of this book, I address the implications of the view, now in the ascendancy in the academy and many international organizations, that institutions—and the rule of law in particular—provide the keys to unlocking the full growth potential of the developing world. Second, I examine the preconceptions about the role that different legal systems may play in economic development. The thrust of the analysis is to unpack the still rather general notions of the kinds of problems that the ascendant view would call upon developing countries to confront and the legal rules and arrangements that could be expected to address those problems successfully.

25. Rodrik (2005); Maddison (2001, p. 265, table B-22).

26. Maddison (2002, pp. 36–37).