

Law and Development

By

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I

In his manuscript, *Lectures on Jurisprudence*, based on his lectures at Glasgow University in the early 1760's, Adam Smith stated that a factor that "greatly retarded commerce was the imperfection of the law and the uncertainty in its application" (Smith, 1978, p.528). This is still one of the main messages of the Law and Economics literature as it pertains to development. Law and Economics is a thriving subject in the US, and it is now being widely adopted in other countries, including in law schools of developing countries. But its Chicago origins and the general American mold may have given a particular slant to the development of the subject, which is not always quite appropriate for these countries. In this essay I shall focus very generally on some of the special issues that arise in the context of developing countries that the literature on Law and Economics needs to address if it is to be applicable there. These special issues arise primarily because the institutional, political and behavioral context in these countries is different from the usual context of the literature.

In this literature as well as that of recent Institutional Economics the major emphasis is on contract law and security of property rights. In the pervasive context of incomplete contracts the emphasis is rightly on the residual rights of control, and the security and predictability of these property rights are crucial for economic performance and long-term investment. Throughout history in any time-separated activity-- for example, if the seed planter cannot be secure in reaping the harvest, if a trap-setter cannot claim the

trapped game, or a lender is uncertain of being repaid-- economic life is hampered by insecurity of property rights. North and Weingast (1989) trace the success story of development in English history to the king giving up royal prerogatives and increasing the powers of the Parliament in 1688, thus securing private property rights against state predation and allowing private enterprise and capital markets to flourish. The more recent empirical literature has tried to quantify the effect of these property rights institutions-- or what they call in this literature the 'rule of law' variable (one standard measure combines indices of effectiveness and predictability of judiciary, enforceability of contracts and incidence of crime) -- on economic performance from cross-country aggregative data. Since these institutions may be endogenous (i.e. economically better-off countries may have more of those institutions, rather than the other way round), the literature tries to resolve the identification problem by finding exogenous sources of variations in those institutions. See Acemoglu, Johnson and Robinson (2001 and 2002)¹. Rodrik, Subramanian, and Trebbi (2002) use similar data to show that once the property rights institutions are accounted for, the role of other factors like geography or openness to trade in explaining cross-country variations in per capita income is minimal.

What is often ignored in this literature is that the 'rule of law' involves actually a whole bundle of rights, and we need to 'unbundle' it. Even for security of property rights, different social groups may be interested in different aspects of these rights. For example, the poor may be interested primarily in very simple rights like land titles, and also, to a very important extent, in protection against venal government inspectors or local goons; to them that is the most salient aspect of security of property rights. For the richer investors, however, a whole range of other issues like protection of the minority share holders in corporations, oversight of capital markets against insider abuse, bankruptcy laws, etc. loom large; these are what investors emphasise when they talk about security of property rights. As different groups are thus interested in different aspects of security of property rights, these rights may have differential political sustainability, depending on how politically influential the corresponding groups are in a given polity.

¹ For a discussion of the limitations of such exercises see Bardhan (2005), chapter 1.

‘Rule of law’ should also include other rights, some quite different from mere security of property rights. For example, one part may involve various democratic rights of political participation, association, mobilization, and expression of ‘voice’. An analysis of cross-country variations in human development indicators (which includes education or health variables like mass literacy or life expectation) shows that an institutional variable measuring ‘voice’ or participation rights is just as important as that measuring security of property rights as an explanatory variable-- see Bardhan (2005), chapter 1. In other words, the part of ‘rule of law’ that refers to democratic participation rights explains a significant amount of variations in human development indices across countries. Those who emphasize property rights often ignore the effects of participatory rights, and there is some obvious tension between these two types of rights included in the standard package of ‘rule of law’.

The idea of security of property rights has been extended to the case of intellectual property rights for the preservation of incentives for innovation. Since innovations are the main source of economic growth, laxity in the enforcement of international patents and copyrights in developing countries for products that are knowledge-intensive or require expensive investments in research and development is often regarded as harmful for long-term economic growth. This has been the rationale for the incorporation of TRIPS (trade-related intellectual property rights) in WTO rules, when developing countries accepted these rules under some pressure from rich countries. While keeping incentives alive for new research and innovations is extremely important, the question from the point of view of a developing country is usually if the enormous costs (including the often exorbitant monopoly prices charged by the patent holder for a prolonged period²) are always worth the benefits and if there are better alternative ways of encouraging research. It is recognized now by many scientific researchers that existing patents often act as an obstacle to further research that tries to build on earlier findings (in developing countries this includes research for adapting new technology to the special conditions there). This

² Even when the original patent tends to run out, the transnational company holding the patent often has various ways of effectively extending it --by slightly changing the composition of ingredients in the product and then taking out a new patent, bribing or intimidating the potential producers of the generic substitute, and through high-pressure advertisement keeping many of the customers hooked on to the original brand.

is linked with the question of the optimal patent *breadth*, which is about how broadly the protection of existing innovations ought to extend to related innovations in the future.³ The alternative method of subsidizing research *inputs* (rather than rewarding research *output* with temporary monopoly) has the advantage of encouraging information sharing and collaborative research. Of course, upfront funding carries with it the moral hazard problem that researchers, once having secured funding, may be tempted to pursue activities or lines of research other than those most desired by the public sponsor. This problem may be mitigated if researchers expect to apply for public funding in future.

The problem of international patents in life-saving drugs in poor countries recently caught public attention in connection with the controversies about the prices of anti-retroviral drugs for AIDS patients in Africa. The major problem in corporate drug research is that only a tiny fraction of what the companies spend on finding new diet pills or anti-wrinkle creams is spent on drugs or vaccines against major killer diseases of the world's poor, like malaria or TB, and the situation has not changed with the onset of TRIPS or is not expected to change even with a more stringent enforcement of TRIPS in poor countries. So alternative avenues of encouraging such research have to be sought. There are now the beginnings of some international attempts to make credible arrangements on the part of international organizations like WHO in collaboration with NGO's like *Medecins sans Frontieres*, private Foundations (like the Gates Foundation) and donor agencies and governments to a commitment to purchase vaccines to be developed by pharmaceutical companies against some of these diseases. For a discussion of the incentive issues in vaccine purchase commitments, see Kremer (2001). For other diseases (like diabetes or cancer) which kill large numbers of people in both rich and poor countries the incentive argument for enforcing patents in poor countries is weak, since that research will be carried out by the transnational drug companies in any case as the market in rich countries is large enough (provided resale can be limited).

³ For a discussion of some of these issues see the articles of Gallini and Scotchmer (2001) and Kremer (2001).

We have earlier commented upon the different kinds of security of property rights being relevant for different social groups. In the case of intellectual property rights as well the transaction costs may limit the symmetry of access of different groups to those rights. Khan and Sokoloff (1998), in a historical comparison of the patent systems in the US and Britain in the first half of the 19th century, show that while the British system used to effectively limit access to intellectual property rights to the relatively wealthy and well-connected, access in the American system was much more broad-based, and this contributed to a much more vigorous and wider spread of patenting activity in the US in that period.

II

While nobody will deny the importance of innovations in the process of economic growth, in the case of manufacturing technology in most developing countries the problem is really in adaptation of technology theoretically available elsewhere. Much of the effective use of that technology particularly in these alien circumstances is not codified, but implicit or tacit, and cannot be just transplanted from abroad. Learning by doing and domestic efforts to adapt and assimilate are critical, costly and time-consuming, and in this government investment in market-supporting infrastructure and in research and training and extension are quite important. Just putting in place a legal system facilitating private efforts may not be enough. As Pack (2003) points out, in recent years many developing countries have liberalized domestic and international trade regulations but have not realized high total factor productivity, in the absence of a set of institutions constituting a national innovation system and extension services that facilitate appropriate training and technology absorption.

There are also corresponding implications for the inadequacy of just a legal framework in developing credit and equity markets or the requisite financial infrastructure in general.

Investment in learning by doing is not easily collateralizable and is therefore particularly subject to the high costs of ‘imperfect information’. At an early stage (which can be prolonged in poor countries) when firms are not yet ready for the securities market (with its demands for codifiable and court-verifiable information), there is often a need for some support and underwriting of risks by some centralized authority (with, of course, its attendant dangers of political abuse). There is also the problem of interdependence of investment decisions with externalities of information and the need for a network of proximate suppliers of components, services and infrastructural facilities with large economies of scale. Private financiers willing and able to internalize the externalities of complementary projects and raise large enough capital from the market for a critical mass of firms are often absent in the early stage of industrialization. Historically, the state has played an important role in resolving this kind of coordination failure by facilitating and complementing private sector coordination--as the examples of state-supported development banks in 19th-century France, Belgium, and Germany, and more recently in Japan, Korea, Taiwan and China suggest. There are, of course, many examples of state failures in this respect and politicization of financial markets in other developing countries. In much of the literature on Law and Economics, as in Institutional Economics, the importance of the state is recognized only in the narrow context of how to use its power in the enforcement of contracts and property rights and at the same time how to establish its credibility in not making confiscatory demands on the private owner of those rights. The history of the successful as well as failed cases of state as a coordinator of technology assimilation and financial market development has lessons which should be analyzed in a framework that goes beyond this narrow context.

Why doesn't a society always adapt its legal and institutional set-up to facilitate productivity-enhancing innovations? Such innovations have gainers and losers, but in most cases the gainers could potentially compensate the losers. The problem is that it is politically difficult for the gainers from a change to credibly commit to compensate the losers *ex post*.⁴ As Acemoglu (2003) puts it, there may not be any *political* Coase

⁴ For a review of the theoretical political economy literature on credibility of commitment see Bardhan (2005), chapter 4.

Theorem, whereby politicians and powerful social groups could make a deal with the rest of society, giving up some of their control on existing rules and institutions that are inefficient, allow others to choose policies and institutions that bring about improvements in productivity, and then redistribute part of the gains to those politicians and groups. Such deals have severe commitment problems; those in power cannot credibly commit to not using this power in the process, and others cannot credibly commit to redistribute once the formerly powerful really give up their power for the sake of bringing about new rules and institutions.

A central issue of development economics is thus the persistence of dysfunctional regulations and institutions over long periods of time, as we discuss in Bardhan (2005), chapter 2. In particular, the history of underdevelopment is littered with cases of formidable institutional impediments appearing as strategic outcomes of distributive conflicts. Acemoglu and Robinson (2002) develop a theory where incumbent elites may want to block the introduction of new and efficient technologies because this will reduce their future political power; they give the example from 19th century history when in Russia and Austria-Hungary the monarchy and aristocracy controlled the political system but feared replacement and so blocked the establishment of rules and institutions that would have facilitated industrialization. These replacement threats are, of course, often driven by extreme inequality in society.

In explaining the divergent development paths in North and South America since the early colonial times, Engerman and Sokoloff (2002) have provided a great deal of evidence of how in societies with high inequality at the outset of colonization rules and institutions evolved in ways that restricted to a narrow elite access to political power and opportunities for economic advancement. Initial unequal conditions had long lingering effects, and through their influence on public policies (in distribution of public land and other natural resources, the right to vote and in secret, primary education, patent law, corporate and banking law, etc.) tended to perpetuate those institutions and policies that atrophied development. Even in countries where initially some oligarchic entrepreneurs are successful in creating conditions (including securing their own property rights) for

their own economic performance, as long as that oligarchy remains powerful, they usually get away with regulations that raise entry barriers for new or future entrepreneurs, and this blocks challenges to their incumbency and thus sometimes new technological breakthroughs. See Acemoglu (2003) for a theoretical analysis of this kind of dynamic distortion in oligarchic societies even when property rights are protected for the initial producers. The classic example of inefficient rules and institutions persisting as the lopsided outcome of distributive struggles relates to the historical evolution of land rights in developing countries. In most of these countries the empirical evidence suggests that economies of scale in farm production are insignificant (except in some plantation crops) and the small family farm is often the most efficient unit of production. Yet the violent and tortuous history of land reform in many countries suggests that there are numerous road blocks on the way to a more efficient reallocation of land rights put up by vested interests for generations.

Inequality in power distribution in society also influences the social legitimacy of laws enacted or decreed by the powerful and the degree of commitment of the general population to the rule of law. When the state is captured by a narrow clique, or when the state is weak so that there is an 'oligopoly' of coercion and authority (as opposed to the 'monopoly of violence' that Max Weber attributed to the state) shared by various protection rackets and corrupt officials (police, judges, bureaucrats), there is usually a big gulf between laws that are in the statute books and their enforcement, and, most importantly, a deficiency in every citizen's expectations about others' compliance, which form the foundation of the rule of law. Along with the underlying power distribution and enforcement mechanisms in society, some overarching social norms and political commitments provide the main structure within the confines of which the formal legal system operates, and compared to the former the latter--which is the focus of much of the Law and Economics literature-- is often in a secondary role.

These important elements of the institutional, political and social framework are ignored in a recent burgeoning of empirical literature on the effects of legal origins of a system. La Porta et al (1997, 1999) have called attention to the superior effects, across countries,

of the Anglo-Saxon common-law system based on judicial precedents over the civil-law system based on formal codes, on corporate business environment both in terms of more flexibility with changing needs of business and in terms of better protection for external suppliers of finance to a company (whether shareholders or creditors). Apart from some doubts about the establishment of causality in these cross-national studies⁵, one can also question the historical evidence even in the rich countries themselves. Lamoreaux and Rosenthal (forthcoming) have done a comparative study of the constraints imposed by their respective legal system on organizational choices of business in the US (with its common law system) and France (with its civil law codes) during the middle of the 19th century around the time when both countries were beginning to industrialize. They conclude that there was nothing inherent in the French legal regime that created either a lack of flexibility or a lack of attention to the rights of creditors or small stakeholders. Many of the rules in the US for minority shareholder rights actually came *after* the insider scandals of the Great Depression period. Franks et al (2003) point out that in the UK it was not until as late as 1948 that the Parliament began to enact limited legislation to protect minority shareholder rights. Rosenthal and Berglof (2003) also question the primacy of legal origin in explaining institutions of investor protection; drawing upon the legislative history of US bankruptcy law they show how the US, with an English common-law legal origin, ended up with a bankruptcy regime quite different from that in the UK, and how political and ideological forces shaped financial development. Several legal scholars—see, for example, Roe (2003)—have pointed out how the nature of corporate governance even in American large firms depends more on socio-political factors than on the form of corporate laws.

In any case, as we have indicated earlier, how important the legacy of the formal legal system is rather moot where much too frequently in developing countries the enforcement of whatever the laws are in the statute books is quite weak, and the courts are hopelessly clogged and corrupt. Take the two largest developing countries, China and India. India has inherited the English common-law system, and being a democracy legal rights there

⁵ For example, among developing countries many French legal origin countries are in Africa or Latin America and it may be standing as a proxy for other (unmeasured) deficiencies in state capacity in several of these countries.

are more well-defined and the legal system less subject to political discretion than in China under the monopoly control by a Communist Party. And yet, according to the World Bank Report on *Doing Business in 2005*, it is China which seems less disadvantaged in most indicators of regulatory and judicial effectiveness in business matters. For example, registering property requires 67 days and costs about 14 per cent of property value in India, whereas in China it is 32 days and 3 per cent of property value. In enforcing debt contracts it requires 425 days and costs about 43 per cent of debt value in India, whereas in China it is 241 days and 26 per cent of debt value. On closing an insolvent business it takes about 10 years in India, in China 2.4 years.

In many developing countries the efficiency of courts as mechanisms of resolving disputes or enforcing contracts is shaped by a rather warped system of incentives: judges, even when they are not corrupt, do not care about delays, lawyers earn more when court proceedings are prolonged, appeals are too easy and some defendants deliberately seek continual delay in judgment. Courts are congested because of too lengthy procedures and built-in incentives for over-litigation, apart from administrative delays in appointments of judges. Such low judicial effectiveness in commercial law, apart from raising transaction costs all around, has important effects on the size and structure of firms. This is because the more effective the judicial process, the more you can have relatively complex contracts, larger firms can thrive and more complex goods produced.

III

Finally, we are going to comment on some of the broad presumptions of the Law and Economics literature which may need to be changed or made more flexible if it is to be applied to developing countries. One relates to the scale of economic activity. In small peasant communities where the scale of economic activity is not large informal relational contracts may be more efficient than rule-based contracts supported by elaborate legal-

judicial procedures. Breaches of relational contracts are often observable by other community members even when not verifiable by courts, and punishment is usually through social sanctions and reputation mechanisms. Another advantage is flexibility and ease of renegotiation. But as the scale of economic activity expands, as the need for external finance becomes imperative, and as large sunk investments increase the temptation of one party to renege (and as increased mobility and integration with the outside world improve exit options), relational contracts and reputational incentives become weaker.⁶ As Li (2003) points out, relation-based systems of governance may have low fixed costs (given the pre-existing social relationships among the parties and the avoidance of legal-judicial and public information and verification costs of rule-based systems), but high and rising marginal costs (particularly of private monitoring) as business expansion involves successively weaker relational links.⁷

Of course the transaction costs of legal-judicial systems are asymmetric in their incidence on the rich and the poor as they try to get legal remedies, and it is not surprising that the legally handicapped poor often feel that the law is just another ‘stick’ with which the resourceful rich can beat them. In small face-to-face communities what anthropologists call the ‘politics of reputation’ may provide some modest measure of protection for the weak against the strong; as long as all parties belong to what is perceived to be the same ‘moral community’ in terms of which reputation is defined, there are some accepted limits and symbolic sanctions against the kind of ruthless exercises of power that sometimes accompany the cut-throat impersonality of the legal system enforced by the gendarmerie of the state.

It also needs to be recognized that in a world of highly imperfect information and interlinked and multiplex nature of traditional informal contracts, the establishment of market relations enforced by the legal system in one market can crowd out implicit contracts in other related markets. Kranton and Swamy (1999) show in a study of the impact of the introduction of civil courts in British India on the agricultural credit

⁶ Some of the pros and cons of relational contracting are empirically studied in the case of Vietnam’s emerging private sector by McMillan and Woodruff (1999).

⁷ For a formal treatment of the subject see Dixit (2003).

markets of the Bombay Deccan that while it led to increased competition in the credit market, it reduced lenders' incentives to subsidize farmers' investments in times of crisis, leaving them more vulnerable in bad times, with insurance markets largely absent. In the context of environmental management of the village commons Seabright (1993) has pointed out that, as contracts are necessarily incomplete, attempts to enforce private property rights may weaken the mechanisms of cooperation that previously existed among the resource users, who may have shared implicit non-contractual rights in the common property resource.

The Law and Economics literature has inherited from mainstream economics the latter's behavioral postulate of rational self-interested individuals. This postulate is being increasingly questioned in the branch of economics that is now called 'behavioral economics', but there may be special reasons for questioning it in the context of poor countries. In traditional communities where your conformity to community norms is at a special premium, we may have to pay particular attention to social preferences ('other-regarding' as opposed to self-centered, or 'process-regarding' as opposed to simply outcome-oriented) which may go beyond the narrow interpretation of self-interested behavior. For example, social reciprocity (individuals going out of their way to reward helpful actions by other members of the community, or taking revenge for perceived unfair or nasty behavior on the part of others at some considerable cost to the revenge-taker-- 'honor-killings' in many traditional societies being the extreme but not uncommon case) is often a foundation stone of community norms, which define the informal institutional framework within which particular legal rules can be implemented.

It is also a questionable presumption of the Law and Economics literature that individuals always behave in their best interests. Common observations of myopic, weak-willed, procrastinating and time-inconsistent behavior fly in the face of the inexorably rational economic man of our textbooks.⁸ This may be a special problem in poor countries where

⁸ The standard argument that 'irrational' behavior is weeded out in the evolutionary process is much too limited. Other-regarding cooperative behavior may be more successful in many cases. Evolutionary success in replication and the economist's narrow conception of efficiency may not go together if payoffs to

public information media are weak, many people are uneducated and superstitious, and there is a surfeit of touts, middlemen and operators trying to manipulate you to make hasty uninformed decisions. The innate psychological characteristics of people may not be different in poor countries, but their circumstances and information sources are often quite different, and capacity for complex calculations is an acquired trait, honed only as transactions become more complex. Also, people often internalize their constraints and by all accounts the constraints are much more severe in the case of poor people. All this may sometimes call for more paternalistic regulations than are admitted in the rational-choice framework of Law and Economics. For example, consumer protection regulations in food labelling and health warnings, publicizing of information about often the exorbitant implicit interest rates charged in instalment purchase of durables from retailers and pawnbrokers, publicizing the odds of winning lotteries (which are very popular, as most people systematically overestimate their chance) are all instances of paternalistic regulations that are particularly important in poor countries. One, of course, has to be wary of the slippery slope here that may easily end up in heavy-handed regulations or regulatory capture, but one cannot deny that the sovereignty of the rational consumer is a particularly egregious myth in such contexts.

Furthermore, the Law and Economics literature, particularly through its Chicago origins, has inherited a presumption about voluntary contracts that one may have to be careful about. Milton Friedman and others have repeatedly asserted that if parties enter into a transaction voluntarily (without adverse effects on third parties), legal rules should not interfere; they should play only an enabling or facilitating role in that transaction. There are, however, many cases, particularly in poor countries, where it is possible to show that one party in this transaction would have been actually better off if the law intervened to take out certain options from the choice set. Take the case of ‘bonded labor’. Genicot (2002) in describing what she calls ‘the paradox of voluntary choice’ constructs a case where the strategic interaction between the landlord and the local credit institutions can constrain the poor peasant to ‘choose’ a bonded labor contract, whereas if bonded labour

adherence to particular behavioral rules depend on adherence by others, or if there are positive and negative interactions of different behavioral rules.

were banned it would have resulted in welfare-enhancing credit opportunities for the peasant. Basu (2000) models a somewhat similar case of a woman choosing a 'sexual harassment contract' where she would have otherwise been better off if such contracts were disallowed. Similar cases can be argued for legally taking out the option for a poor worker to work in unsafe or hazardous conditions. These are all cases for interventionist regulations in the context of extremely unequal but 'voluntary' contracts.

Let us end with a comment on a fashionable attitude to the rule of law in the context of development that is sometimes expressed at the opposite end of the political spectrum. We have indicated earlier in this section as well at the beginning of this essay that the rule of law is often an instrument in the hands of the propertied ruling over and restricting the activities of the propertyless. This undoubted fact sometimes leads commentators to dismiss the rule of law merely as an instrument of class oppression or as part of a modernizing elitist project that rides roughshod over the 'subaltern'. In the face of such tendentious simplifications we can do no better than to quote here from the far more nuanced historical analysis of E. P. Thompson. At the conclusion of his 1975 book, *Whigs and Hunters* (which shows how a political oligarchy in 18th century England invented callous and oppressive laws to serve its own interests) Thompson writes: "We reach, then, not a simple conclusion (law = class power) but a complex and contradictory one. On the one hand, it is true that the law did mediate existent class relations to the advantage of the rulers....On the other hand, the law mediated these class relations through legal forms, which imposed, again and again, inhibitions upon the actions of the rulers....In a context of gross class inequalities, the equity of the law must always be in some part sham...We ought to expose the shams and inequities which may be concealed beneath this law. But the rule of law itself, the imposing of effective inhibitions upon power and the defence of the citizen from power's all-intrusive claims, seems to me to be an unqualified human good. To deny or belittle this good is...a desperate error of intellectual abstraction." (pp.264-66)

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