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Economics and the rule of law

Order in the jungle

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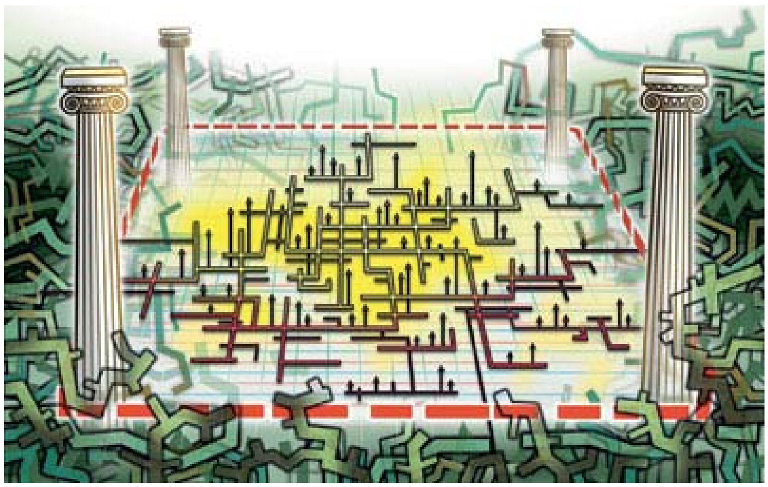


The rule of law has become a big idea in economics. But it has had its difficulties

"AM I the only economist guilty of using the term [rule of law] without having a good fix on what it really means?" asks Dani Rodrik of Harvard University. "Well, maybe the first one to confess to it."

The rule of law is usually thought of as a political or legal matter. The world's newest country, Kosovo, says its priority is to improve the rule of law in order to reduce corruption and build up the state. But in the past ten years the rule of law has become important in economics too. Indeed, it has become the motherhood and apple pie of development economics—which makes Mr Rodrik's confession the more striking. The rule of law is held to be not only good in itself, because it embodies and encourages a just society, but also a cause of other good things, notably growth. "No other single political ideal has ever achieved global endorsement," says Brian Tamanaha, a legal scholar at St John's University, New York.

But as an economic concept the rule of law has had a turbulent history. It emerged almost abruptly during the 1990s from the dual collapses of Asian currencies and former Soviet economies. For a short time, it seemed to provide the answer to problems of development from Azerbaijan to Zimbabwe, until some well-directed criticism dimmed its star. Since then it has re-established itself as a central concept in understanding how countries grow rich—but not as the panacea it once looked like.

Economists became fascinated by the rule of law after the crumbling of the "Washington consensus". This consensus, which was economic orthodoxy in the 1980s, held that the best way for countries to grow was to "get the policies right"—on, for example, budgets and exchange rates. But the Asian crisis of 1997-98 shook economists' confidence that they knew which policies were, in fact, right. This drove them to re-examine what had gone wrong. The answer, they concluded, was the institutional setting of policymaking, especially the rule of law. If the rules of the game were a mess, they reasoned, no amount of tinkering with macroeconomic policy would produce the desired results.

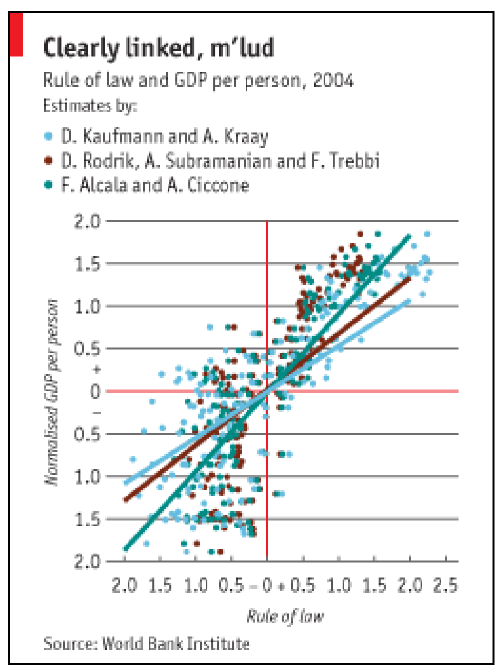
This conclusion was strengthened by events in the former Soviet empire. Many post-communist countries got their policies roughly right fairly quickly. But it soon became clear this was not enough. “I was a traditional trade and labour economist until 1992,” says Daniel Kaufmann, now head of the World Bank Institute's Global Governance group. “When I went to Ukraine, my outlook changed. Problems with governance and the rule of law were undermining all our efforts.”

Pretty quickly, “governance”—political accountability and the quality of bureaucracy as well as the rule of law—became all the rage. Economists got busy calculating what it was, how well countries were doing it and what a difference it made. Mr Kaufmann and his colleague Aart Kraay worked out the “300% dividend”: in the long run, a country's income per head rises by roughly 300% if it improves its governance by one standard deviation. One standard deviation is roughly the gap between India's and Chile's rule-of-law scores, measured by the bank. As it happens, Chile is about 300% richer than India in purchasing-power terms. The same holds for South Africa and Spain, Morocco and Portugal, Botswana and Ireland. Economists have repeatedly found that the better the rule of law, the richer the nation. (The chart below shows the results of three studies, put on a comparable basis by Mr Kaufmann.) Every rich country with the arguable exceptions of Italy and Greece scores well on rule-of-law measures; most poor countries do not.

Mr Rodrik reviewed the contributions to growth of governance (“institutions”, he called it), geography and openness to trade. He concluded, to use the title of an article he published in 2002, that “Institutions Rule”. Writing from the perspective of a political scientist, Francis Fukuyama of Johns Hopkins University concurred: “I believe that the institutionalists have won this argument hands down.”

Partly because of this, and also because the rule of law is desirable for its own sake, governments and aid agencies began splurging money on rule-of-law reforms, such as training judges, reforming prisons and setting up prosecutors' offices. Such reforms had begun in Latin America in the mid-1980s. Now they became universal.

The European Union insists that all its members satisfy standards for the rule of law. It requires applicants to commit themselves to legal reforms to meet those standards and dispatches armies of lawyers to advise them how to bring their legal systems up to scratch. America's Millennium Challenge Corporation, set up in 2004 to improve the effectiveness of American official aid, confines its largesse to countries that have committed themselves to minimum rule-of-law standards (one of three basic requirements). Western donors have poured billions into rule-of-law projects over the past 20 years. The World Bank is now running such projects (narrowly defined) worth almost $450m; on a wider definition, almost half the bank's total lending of $24 billion in 2006 had some rule-of-law component (for example, advice on conflict resolution in village-development projects, or on bankruptcy law in privatisation programmes). In roughly a decade the rule of law has gone from a specialist political and legal topic into a staple of economic thinking and the subject of a vast aid-giving effort.



Clearly linked, m'lud

Rule of law and GDP per person, 2004

Estimates by:

- D. Kaufmann and A. Kraay
- D. Rodrik, A. Subramanian and F. Trebbi
- F. Alcala and A. Ciccone

Source: World Bank Institute

So it came as an unwelcome surprise when, in 2003, one of the world's acknowledged experts on governance wondered aloud whether the emperor had any clothes. Thomas Carothers of the Carnegie Endowment for International Peace, a think-tank in Washington, DC, wrote a paper politely entitled “Promoting the Rule of Law Abroad: The Problem of Knowledge”. According to Mr Carothers, the problem was, as William Goldman said of Hollywood, that nobody knows anything.

Mr Carothers argued that the intrinsic difficulty of defining the rule of law, combined with the problems of knowing how specific laws work in practice, meant that “the rapidly growing field of rule-of-law assistance is operating from a disturbingly thin base of knowledge at every level.” Many of the difficulties are inherent, he said. But not all: aid organisations always look forward to the next project, rather than back to the lessons of experience; lawyers who carry out the work are not much interested in development; university professors are not gripped by applied policy research. As a result, according to one rule-of-law promoter, “deep down, we don't really know what we are doing.”

The shock of Mr Carothers's argument was salutary. In response, there has been a flurry of rule-of-law studies. A new body of work has appeared, which could be called the economics of the rule of law. It shows the rule of law can indeed be improved. It has made clearer what economists and others mean when they talk about the rule of law. It has laid down some guidelines about reforms, helping show what works when, say, training judges or policemen. What it has not yet shown beyond doubt is that the rule of law is a precondition for economic growth everywhere. In the process, the subject of law as an economic matter has begun to grow up. It has passed from vigorous childhood into more troubled adolescence.

Unruly law

In “The Rule of Law and Development” (to be published next month by Edward Elgar), Michael Trebilcock of the University of Toronto and Ron Daniels of the University of Pennsylvania tackle the question of what economists mean by the rule of law. A report by a new research group, the Hague Institute for the Internationalisation of Law, does the same thing. Both publications argue that people routinely use two quite different definitions, which they call “thick” and “thin”.

Thick definitions treat the rule of law as the core of a just society. In this version, the concept is inextricably linked to liberty and democracy. Its adherents say a country can be spoken of as being ruled by law only if the state's power is constrained and if basic freedoms, such as those of speech and association, are guaranteed. The “declaration of Delhi” drawn up by the International Commission of Jurists in that city in 1959 followed this line in saying that the rule of law “should be employed to safeguard and advance the civil and political rights of the individual” and create “conditions under which his legitimate aspirations and dignity may be realised.” Among other proponents of a thick definition are Friedrich Hayek, an Austrian economist, and Cass Sunstein of the University of Chicago. In their view, the rule of law includes elements of political morality.

Thin definitions are more formal. The important things, on this account, are not democracy and morality but property rights and the efficient administration of justice. Laws must provide stability. They do not necessarily have to be moral or promote human rights. America's southern states in the Jim Crow era were governed by the rule of law on thin definitions, but not on thick.

The existence of competing definitions of something may seem fatally to undermine its usefulness. If you argue that the rule of law is vital to growth, which version do you mean—the one that defends human rights or the one that guarantees property rights? But economists love competition. Their differing definitions of the rule of law reflect competing explanations of what drives economic growth.

One account of growth—associated with Douglass North of Washington University in St Louis, Missouri—is “institutional”. It focuses on the importance of property rights, transaction costs and economic organisation. On this view, stable, predictable laws encourage investment and growth. Thin definitions of the rule of law fit this well. The other—associated with Amartya Sen of Harvard—says that if you expand people's “capabilities” (Mr Sen's term), they will do things that help countries grow rich. Freeing people to take advantage of their capabilities usually means lifting the oppressive burden of the state and guaranteeing certain basic rights—a much thicker concept.

The distinction between thick and thin versions of the rule of law overlaps another distinction between legal traditions. Starting in 1997, a group of economists led by Andrei Shleifer of Harvard and Robert Vishny of Chicago started to compare the economic performance of common-law countries (such as America and Britain) with that of civil-law ones (France, Germany and Scandinavia). They argued that common-law countries have more secure property rights, better protection of shareholders and creditors, more diversified share ownership, and tougher disclosure and liability laws—to the benefit, they claimed, of stockmarket performance.

Like the initial claims for the rule of law, those on behalf of the common law were subject to harsh criticism at about the same time, mostly from continental economists. Some claimed the differences between common and civil law were not as sharp as they seemed, and were proxies for differences of politics, history and culture. Others pointed out that a country's legal origins do not seem to explain much about how it is faring economically or in terms of the rule of law. North and South Korea have the same legal origins.

But just as rule-of-law scholars have responded to criticism with more research, so have the legal-origins crowd. In a stream of papers they have found strong evidence that civil-law countries encourage government ownership of the media and banks, a higher burden of entry into business, more labour-market regulation and greater formalism of court procedures—to their detriment, they claim.

Perhaps such arguments can never be resolved. As Rainer Grote of the Max Planck Institute for Comparative Public Law and International Law in Heidelberg says, the rule of law "belongs to the category of open-ended concepts which are subject to permanent debate." This part of the new economics of the rule of law clarifies its role, but no more. Other findings, though, are more constructive.

Scales of justice

There have been huge improvements in monitoring and measuring the rule of law, even though people cannot agree exactly what it is. "Fifteen years ago, we didn't talk about this stuff," says Steve Radelet of the Centre for Global Development, a Washington think-tank. "Ten years ago, there was no data." Now, the Worldwide Governance Indicators project—"one of the best kept secrets at the World Bank", believes Gordon Johnson, a grand old man of aid-giving—is the state of the art. It gathers data on more than 60 indicators (the extent of crime, the quality of police, judicial independence and so on) to create rule-of-law and governance measures for virtually every country in the world. Aggregating like this (and being honest about the margin of error), says Mr Kaufmann, is far from perfect, but is a decent approximation.

These measures confirm what is clear anyway: some countries have been able to improve their legal framework even in a short time. In 2000 Mikhail Saakashvili, then Georgia's minister of justice, sacked two-thirds of his country's judges for failing to pass an exam. Four years later as president, he fired all the country's traffic police. Georgia's World Bank rule-of-law score rose from nine out of 100 in 2002 (in the bottom 10%) to 33 at the end of 2006—low, but better. Central European and Baltic countries are doing better still: the radical legal changes required by membership of the EU improved their economies as well as their judicial systems.

In general, the measures suggest, bold reforms work better than gradual ones. Latin America modernised its penal codes and made trials more transparent. Chile, for instance, established a new public-prosecution system beginning in 2003. But many of its officials lack experience and have met resistance from the police. Russia implemented some judicial reforms in the 1990s and raised spending on the courts in 2000—to no avail: its rule-of-law scores have fallen in five of the past seven years.

The difference between central Europe and Latin America may be one of political backing. Messrs Trebilcock and Daniels divide countries into three: those where politicians, legal professionals and the public all support reform (central Europe after the fall of communism, South Africa after apartheid); those where politicians support reform, but lawyers and police do not (Chile and Guatemala); and those where lawyers want change, but not politicians (Pakistan). Only in the first group, the professors say, does rule-of-law reform get far.

Consistent with that rather gloomy finding, some new research finds only a weak link between the rule of law and economic growth. The connection with wealth is well established (see chart again) but that is different: it has been forged over decades, even centuries. The link with shorter-term growth is harder to see. China appears to be a standing contradiction to the argument that the rule of law is needed for growth. It is growing fast and is the world's largest recipient of foreign investment, yet has lots of corruption and nothing that most Westerners would recognise as a rule-of-law tradition. (It does, though, guarantee some property rights and its government is good at formulating and implementing policies.)

On the other hand, there is surely a connection between the legal reforms carried out in central Europe and the Baltics and their fast growth rates, or between Spain's post-Franco legal opening and its long boom. And there are proxy indicators connecting legal reform with growth in other areas. The value of rural land in Brazil, Indonesia, the Philippines and Thailand increased sharply when people were given title deeds, because owners were more willing to invest. One independent study for the World Bank a decade ago found a surprising link between projects the bank financed and civil liberties: projects in countries with strong civil liberties had far higher rates of return than those in countries with weak traditions of liberty.

But such links do not tell you anything about causation. Perhaps growth helps the rule of law, not vice versa. Perhaps countries can afford the luxury of the rule of law only after they have grown rich. The persistence of "frontier justice" into the 1930s in America gives a colour of plausibility to that idea.

Yet it is not Mr Kaufmann's view. He argues that rule-of-law improvements tend to help growth; that few countries have sustained gains in growth without improving their rule of law; and that places that have grown without such improvement have subsequently lurched backwards (Argentina used to be one of the ten richest countries in the world). The real puzzle is to explain the exceptions: why crony capitalism has flourished in parts of fast-growing Asia or Kremlin banditry in Russia. The answer, he says, is that, without a rule of law, well-connected crooks can grab an unfair share of the spoils of growth, especially if these include windfall gains from oil and raw materials.

The existence of crony capitalism and "state capture" by robber barons is, of course, an argument for trying to strengthen the rule of law where you can, since it suggests growth will not necessarily create law automatically. There are other arguments, too: the rule of law is desirable for its own sake—to improve human rights or to increase citizens' chances of justice against predatory governments. As John Locke wrote in 1690, "wherever law ends, tyranny begins." Plainly, in some countries, such as Myanmar and Zimbabwe, legal abuses and over-mighty regimes are direct obstacles to growth. Reforms would help—if they could be implemented.

But as a generalisation, the efforts of the past few years have thrown up mixed messages. They suggest the rule of law can be improved sharply; that rule-of-law reform is at root a political not a technical undertaking; and that it is linked to growth, if weakly in the short term. But they do not really bear out the assertion that the rule of law is an underlying prerequisite for growth. Rather, the more economists find out about the rule of law, the more desirable it seems—and the more problematic as a universal economic guide.

Sources

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