University of Southern California Law School
Law and Economics Working Paper Series

Year 2006 *Paper* 43

Legal Infrastructure, Judicial Independence, and Economic Development

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Economic theory generally supports the idea that judicial independence, and, more generally, high quality courts, facilitate economic growth. Good, independent courts enforce contracts and protect property, and by doing so encourage the investment which is crucial for economic development. Nevertheless, judicial independence and good courts are not necessary to investment, because there are other mechanisms which can enforce contracts and protect property, albeit perhaps not as well as courts. Contracts can be enforced by reputation, without recourse to the courts. Similarly, the government can protect property through executive restraint and policing, even if constitutional protections are weak and private litigation is ineffective. Thus, economic growth often starts without strong courts, and efforts to improve the quality of the judiciary are often the consequence, not the cause, of economic development.

The empirical literature, to the extent that it has investigated the relationship between courts and economic growth, has focused on judicial independence. Judicial independence is, of course, only one aspect of quality courts. Nevertheless, it is relatively easy to measure and probably correlated with other indices of court quality. It thus serves as a rough proxy for the quality of legal infrastructure. There is some evidence that judicial independence is associated with economic growth, but the evidence is mixed and causation is unclear.

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Judicial independence and effective courts are generally viewed as good for economic growth, but the theoretical underpinnings of this idea are surprisingly ambiguous, and it has proven very difficult to measure empirically the impact of quality courts. This essay will attempt three tasks:

1. To explore the theoretical relationship between courts, judicial independence, and economic growth

2. To review and critique the empirical literature on the relationship between courts, judicial independence, and economic growth, and

3. To suggest promising avenues for future research.

In summary, this essay will argue that economic theory generally supports the idea that judicial independence, and, more generally, high quality courts, facilitate economic growth. Good, independent courts enforce contracts and protect property, and by doing so encourage the investment which is crucial for economic development. Nevertheless, judicial independence and good courts are not necessary to investment, because there are other mechanisms which can enforce contracts and protect property, albeit perhaps not as well as courts. Contracts can be enforced by reputation, without recourse to the courts. Similarly, the government can protect property through executive restraint and policing, even if constitutional protections are weak and private litigation is ineffective. Thus, economic growth often starts without strong courts, and efforts to improve the quality of the judiciary are often the consequence, not the cause, of economic development.

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I. Theory

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Economic growth requires many kinds of investment. It requires time and effort, because growth is impossible if people are unwilling to work hard. Investments in human capital are also essential, because an educated, skilled population is a prerequisite to the production of all but the most basic goods and services.[1] Economic growth also requires investment in physical capital – tools, plants, and equipment. While much investment is general purpose, some is specific to particular relationships or contracts. For example, if a factory receives an order for a particular kind of steel, it may need to order particular supplies and to purchase or set up machine tools for that specific purpose. In the most general sense, investment means spending now for future gain. Economic growth requires sacrifice today for the sake of tomorrow. Without investment, there can be no growth. Most investment comes from within a country, although foreign investment sometimes plays an important role.

Investment will only occur if investors can be confident that they will reap the profits. Investment is undermined if the government or a private party expropriates the investment or the profits.[2] Relationship-specific investments are undermined if the purchaser doesn't pay.[3] In most developed countries, the risk of expropriation is reduced by constitutional guarantees and powerful courts. For example, in the United States, the Takings Clause[4] prevents the government from seizing property without compensation, and this protection is enforced by courts with the power to enjoin government action or award compensation. Similarly, the risk of purchaser non-payment is reduced by commercial law and reasonably impartial and efficient courts. If a purchaser breaches a contract and refuses to pay, the supplier can go to court, and courts can be relied upon to adjudicate fairly. Court judgments are generally respected and enforced. Of course, even in the most advanced countries, there are problems. Courts are expensive. Judges or juries may misinterpret the facts or the law. The losing party may be bankrupt or otherwise evade enforcement. Nevertheless, the courts are reasonably good, and the legal protection of property and contractual rights is sufficient to ensure large amounts of investment.

Judicial independence is an important aspect of legal effectiveness in the developed world. It ensures that courts don't favor the government in expropriation disputes. After all, there's no point in having a Takings Clause if the courts always side with the government. Similarly, an independent judiciary provides assurance that courts won't favor politically powerful or connected parties in contractual disputes.

Nevertheless, good, independent courts are not the only mechanism for protecting property and enforcing contracts. Governments can adopt policies against expropriation which don't require courts. One example is the former Soviet Union, which even though it was ruled by the communist party, had a good reputation for protecting the property of foreign investors.[5] Those property rights were not protected by courts, and there certainly wasn't an independent judiciary. Nevertheless, because the ruling party had

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[1] Gary Becker, *Human Capital: A Theoretical and Empirical Analysis, With Special Reference to Education* (3rd ed. 1993).

[2] Douglass North, *Institutions, Institutional Change, and Economic Performance* (1990).

[3] Oliver E. Williamson, *The Economic Institutions of Capitalism* (1985).

[4] U.S. Constitution, Amend. V.

[5] Political Risk Services, *International Country Risk Guide*, (1986?); Glaeser, et al, "Do Institutions Cause Growth," 9 Journal of Economic Growth 271, 276 (2004).

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decided that foreign investment was necessary, investments were protected through government restraint and other non-judicial means.

Similarly, contract enforcement does not require courts. When parties deal with each other repeatedly, or when communities are tight-knit, contracts may be respected because people fear retaliation and value their good reputations. Fear of a bad reputation, and ensuing social or commercial ostracism, can motivate people to honor their contracts, even when courts are non-existent or corrupt.[6] Although reputational enforcement may sound alien to those living in modern economies, it is a familiar part of everyday life. Why did I honor my promise to prepare this keynote address? It certainly wasn't that I feared a lawsuit. Rather, it was because I valued my reputation among fellow academics and in the legal community at large. Why do friends honor their commitments to each other? Because an unreliable person is likely to lose her friends.

In addition, even courts which lack independence can enforce contracts. A judiciary which was subservient to the government in political cases, might still render impartial justice in ordinary commercial cases, especially when neither party was politically connected. As the articles in this issue by Susan Franck and Dan Kolkey point out, arbitration can also substitute for local adjudication, because it allows parties to select private judges known for their wisdom and impartiality.[7]

Finally, organizational form can substitute for contract. As Ronald Coase pointed out in his Nobel-prize winning article on the firm, business entities can choose between contract and command.[8] Large, vertically integrated firms don't need to rely as much on courts as small firms which need to "contract out" large parts of their business. Perhaps the weakness of the courts can help explain the emergence of large, family-controlled conglomerates in much of east Asia, most notably the South Korean *chaebol* and Japanese *koretsu*.

Although other mechanisms may substitute for courts in protecting investment, these substitutes (executive restraint, reputation, vertical integration) are likely to be less effective, more costly, or more limited in their applicability. Government policies against expropriation can change quickly if not backed up by strong institutions. Reputational enforcement of contracts restricts transactions to those with established track records, impedes new entry, and often fosters ethnic, religious, political or racial discrimination. More generally, reliance on reputation impedes large-scale, impersonal exchange.[9] Arbitration, especially international arbitration, is impractical for small contracts between domestic parties. In addition, the enforcement of arbitration agreements and awards ultimately depends on local courts.[10] Vertically integrated firms

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[6] See discussion of the Maghribi Traders Coalition in Chapter 3 of Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (2006). Note, however, that the Maghribi traders eventually lost ground to Italian merchants, who relied less on reputation and more on institutions, such as courts.

[7] Don Kolkey, "___" , _ *Transnational Lawyer* _(2006); Susan Franck, "Foreign Direct Investment, Investment Treaty Arbitration and the Rule of Law," _ *Transnational Lawyer* _(2006).

[8] Ronald Coase, "The Nature of the Firm," 4 Economica 386 (1937).

[9] Paul Milgrom, Douglass North & Barry Weingast, "The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges, and the Champaign Fairs," 2 Econ. & Pol. 1 (1990); Francis Delaey, "Enforcing Contracts in Transition Countries," in European Bank for Reconstruction and Development, *Law in Transition: Contact Enforcement*, 17, 20-21 (Autumn 2001).

[10] Don Kolkey, "___" , _ *Transnational Lawyer* _(2006); Susan Franck, "Foreign Direct Investment, Investment Treaty Arbitration and the Rule of Law," _ *Transnational Lawyer* _(2006).

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may be less efficient than smaller, more nimble firms which must rely more on courts for contractual enforcement.

Although good courts are usually viewed as a cause of economic growth, causation may run the other way. Economic growth may start without good courts, relying on governmental restraint and reputational enforcement. Then, as economic growth proceeds, the problems described above may become more acute. With more at risk, the possibility of executive expropriation may become less acceptable to business owners. As businesses grow in size, reliance on small groups of trading partners becomes more problematic. Also, with economic growth, the political power of the commercial class may grow. In very poor societies, only military or religious elites may have the power to pressure the government. As wealth increases, private parties have more to offer the government and become more politically powerful. As a result, as growth proceeds, demand for good, independent courts may increase and such demands are more likely to be heeded. China today provides a good example of this process. Through the 1980s and '90s, its courts were of notoriously poor quality. Nevertheless, China enjoyed an unprecedented economic boom. More recently, as the economy has matured, demand for better courts has become louder, both among domestic businesses and foreign investors.[11]

The analogy between courts and roads implicit in the concept of judicial infrastructure itself points to the ambiguity of causation. Although a network of well-paved roads and highways would certainly facilitate growth, few countries possess such infrastructure at early stages of their economic development. Instead, growth begins with small vehicles on poorly paved roads and dirt paths. As growth takes off, the inadequacies of the transportation system become more apparent. Bigger businesses would like to use larger trucks, and the production of higher-value products makes transport delays more costly. Business thus demands better roads. Growth also provides the resources for better infrastructure. A poor country cannot afford high quality roads, but after some growth, they become affordable.

Causation is thus likely to be complex. Neither good courts nor good roads are necessary for economic growth, but economic growth is likely to increase demand for both. In turn, improvement in the quality of roads and courts is likely to facilitate increases in growth, which will further increase demand for high-quality legal and physical infrastructure.

II. Empirical Work on Courts, Judicial Independence, and Economic Growth

In recent years, there has been a flurry of research on the relationship between courts and economic growth.[12] Unfortunately, it is very difficult to measure judicial

[11] Jing Liu, "___"_ *Transnational Lawyer* _(2006); Wang Juan, "___"_ *Transnational Lawyer* _(2006); Conversation with Laura W. Young, Wang & Wang, LLP (October 28, 2005).

[12] This article focuses on the more recent, quantitative literature. There is also quite a bit of non-quantitative work on the subject. See, e.g., Edguardo Buscaglia, William Ratliff, and Robert Cooter, eds., *The Law and Economics of Development* (1997); Tom Ginsburg, "Does Law Matter for Economic Development? Evidence from East Asia," 34 Law & Society Rev. 829 (2000); Richard E. Messick, "Judicial Reform and Economic Development: A Survey of the Issues," 14 World Bank Research Observer 117 (1999); Amanda Perry, "Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence," 49 Int'l & Comp. L. Q 779 (2000).

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quality. Judicial independence is often used as a proxy for the quality of a court system, but it is obviously imperfect. Recent interest in this line of research has been sparked in large part by a series of papers by economists Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, joined in some papers by Edward Glaeser, Cristian Pop-Eleches, and Robert Vishny.

The first two papers by this set of researchers – "Legal Determinants of External Finance" and "Law and Finance"– examine the impact of investor protection and legal origin on the strength of capital markets in forty-nine countries.[13] They find that countries with strong investor protection and common-law legal origin have stronger equity markets. These articles do not, however, contain any analysis of judicial independence or other measures of court quality (aside from common-law origin), nor do they investigate effects on economic growth. Of course, there is presumably some relationship between strong capital markets and economic growth, but these articles never use economic growth as a dependent variable.

A later paper, "Judicial Checks and Balances," examines the impact of judicial independence and other institutions on the protection of rights in seventy-one countries.[14] Countries with independent judiciaries are more likely to have strong protection of property, political, and human rights. Again, there is no direct analysis of economic growth or economic performance more generally, although it is plausible to think that rights would encourage growth. In addition, causation is unclear. The evidence presented is consistent with the view that rights cause judicial independence, as well as the idea that some other factor (perhaps education) leads to both rights and judicial independence.[15] Finally, as discussed below, the measurement of judicial independence is very problematic.[16]

In "Do Institutions Cause Growth," Glaeser, La Porta, Lopez-Silanes and Shleifer directly address the causation question.[17] They find that there is no connection between judicial independence and economic growth. More generally, there is no connection between institutions (such as constraints on the executive) and economic growth. Instead, education is the most important determinant of economic growth. Most countries which emerged from poverty started as dictatorships with few institutional protections. Good economic policies, such as protection of private property, resulted from ruler choice rather than institutional constraints. As countries got richer, they improved their institutions— e.g. granted independence to their judiciaries and imposed constitutional restraints on the executive. This, they argue was the history of most of Western Europe and can be seen most recently in the Pacific Rim, especially Taiwan and South Korea.

Although this last paper is the best so far, it has several problems. First, the paper analyzes judicial independence data from 1995 only. The most powerful test in the paper

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[13] 52 Journal of Finance 1131 (1997); 106 J. Political Economy 1113 (1998).

[14] 112 J. Pol. Econ. 445 (2004).

[15] The authors recognize this problem and argue that "judicial independence is to a significant extent a feature of colonial transplantation, and as such is likely to be causal." Id at 465. This is plausible, but without detailed investigation into the history of judicial independence (whether it is, in fact, a feature of transplantation rather than choice), it remains just a conjecture.

[16] See *infra* _.

[17] 9 Journal of Economic Growth 271 (2004). For a critique of this article, see Doron Acemoglu, Simon Johnson, James A. Robinson and Pierre Yared, "From Education to Democracy?" 95 American Economic Review 44 (2005).

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is the relationship between constraints on the executive in 1960 and 2000, and economic growth in the period 1960-2000. Because they find a positive relationship between growth and constraints on the executive in 2000, but not in 1960, they conclude that constraints on the executive do not cause economic growth, but that, in fact, the reverse may be true. But they did not perform equivalent tests for judicial independence, because they did not have data for judicial independence in 1960. So they don't really have a good test of the causal relationship between judicial independence and economic growth.

In addition, the authors use a crude, idiosyncratic measure of judicial independence based on two factors: (1) whether judges of the highest courts have life tenure, and (2) whether "judicial decisions are a source of law."[18] The first factor is very simplistic, as it ignores the tenure of lower court judges and the numerous other factors (such as salaries and promotion practices) which affect judicial independence. The second factor, whether "judicial decisions are a source of law," is irrelevant to judicial independence. The authors justify this factor by arguing that "the binding power of precedent checks the ability of the sovereign to influence judges in specific instances,"[19] but one could easily argue that judiciaries in countries without a strong doctrine of precedent are equally constrained by detailed codes.

A study by Feld and Voigt tries to develop more sophisticated measures of judicial independence.[20] They distinguish between *de jure* and *de facto* independence. The former comprises twelve variables, including life tenure and appointment by professionals, while the latter is composed of eight factors, including the average length of actual judicial service, whether salaries have been eroded by inflation, and how often laws relating to courts have been changed. The authors examine the relationship between judicial independence and economic growth in fifty-seven countries. They find that *de jure* independence is not related to economic growth, but that *de facto* independence is. Unfortunately, because the measurement periods for the independent and dependent variables overlap -- *de facto* judicial independence was measured for 1960-2000 and economic growth was measured for 1990-98 -- the study cannot fully distinguish between causation and correlation.

An article that Paul Mahoney and I published last year takes a different approach, looking at change over time in a single country – England in the eighteenth century.[21] Unlike other papers, we did not look at dozens of countries with a variety of confounding cultures and political systems. We did not take snapshots of counties at one time, but instead looked at change over time. As a result of the Glorious Revolution in 1688, England began to grant its judiciary more independence. We tried to examine the impact of these changes on the economy. Unfortunately, we could not examine the impact on

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[18] Id at 300.

[19] "Judicial Checks and Balances" at 451. The data on judicial independence used in "Do Institutions Cause Growth" is the same as that used in "Judicial Checks and Balances," and is described more fully in "Judicial Checks and Balances." Because the two articles use the same measures of judicial independence, the critique in the text applies also to "Judicial Checks and Balances."

[20] Lars P. Feld & Stefan Voigt, "Economic Growth and Judicial Independence: Cross-Country Evidence Using a New Set of Indicators," 19 European Journal of Political Economy 497 (2003). See also Lars P. Feld & Stefan Voigt, "Making Judges Independent – Some Proposals Regarding the Judiciary," CESifo Working Paper Series No. 1260 (2004).

[21] Daniel Klerman & Paul Mahoney, "The Value of Judicial Independence," 7 American Law & Economics Review 1 (2005).

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economic growth directly, because there are no good high-frequency data on growth from this period, and because, even if such data existed, it would be difficult to disentangle the effect of judicial independence from the effect of the many other institutional changes enacted around the same time. Instead, we looked at effects on equity prices. England had a flourishing stock market from the 1690s, and surviving contemporary newspapers recorded daily prices. Because this market (like modern ones) responded quickly to news, we could isolate the effect of judicial independence from the effect of other institutional changes by looking at price movements the day before, day of, and day after important legislative actions (introduction of legislation, amendment of legislation, votes on legislation, etc.) relating to judicial independence. We found that improvements in judicial independence were associated with increases in equity values. In particular, legislation granting life tenure was associated with a ten percent increase in stock prices, while other changes, including increases in judicial salaries, were associated with smaller increases. Of course, there are problems with this approach. The stock market measures contemporary perceptions and predictions of economic impact, not actual impact. In addition, the eighteenth century was a long time ago, and England's economic development may have differed from that of other countries. The relationship between judicial independence and economic growth may be different today than three hundred years ago.

III. Future Research

There is obviously much potential for future work. For example, one could improve upon the analysis in Glaeser, La Porta, Lopez-Silanes, and Shleifer's most recent article by collecting data on judicial independence in 1960 and analyzing its impact on economic growth in the period 1960-2000. One could also build upon Feld and Voigt's analysis by using different data on *de facto* judicial independence. Reports compiled by the American Bar Association Central European and Eurasian Law Initiative (ABA-CEELI) might provide a rich vein of data for this purpose, albeit one which is restricted, at least at present, to only sixteen countries.[22] Finally, the analysis that Paul Mahoney and I performed could be extended to other countries and perhaps even to individual American states. With a larger sample of countries, it might also be possible to use economic growth as a dependent variable in addition to equity returns.

In conclusion, theory suggests that effective, independent courts promote investment and economic growth. Nevertheless, courts may not be necessary to growth, because executive constraint and reputational contract enforcement may be adequate substitutes. If growth starts without good judicial infrastructure, economic growth may cause demand for quality courts. The empirical literature provides some support for the idea that independent courts encourage economic growth, but causation remains unclear and much work remains to be done.

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[22] The author thanks Bruce Janigian for bringing this source to his attention.

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