THE LAW AND ECONOMICS OF DEVELOPMENT

Edited by

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PREFACE

This study of the law and economics of development comes at a critical time in Latin American history and makes available valuable commentaries by specialists and practitioners from throughout the Americas and Europe. It emphasizes the essential role of formal law in any effort to develop market economies in the Third World and thus raise the living conditions of most of the people in the world today.

Consider for a moment the matter of legally secured property rights as a critical component of market-oriented economic systems. The superiority of market-oriented economic systems over the alternatives hardly needs defending these days, for the alternatives have all failed miserably from continent to continent. And yet though most political leaders in most countries these days recognize that market economies are more productive, only twenty-five of 185 nations around the world have such an economy. Those nations that have succeeded in developing a market-oriented economy are not coincidentally those that have recognized the need for and secured widespread property rights protected by just laws. Looking into the future, we can say with much confidence that those countries that fail to acquire such laws will fail also in their efforts to develop the most productive of market systems. Macroeconomic policy alone simply will not do it.

It is essential to recognize that unlike developed countries, developing countries do not have enough secure property to allow markets to work. Markets themselves are an ancient and universal phenomenon but they will

not be truly productive until property rights are secured. But what are these property rights and why are they so important? Personal and real property rights are part of a trilogy of essentials for good law, the other two pillars of which are contracts and an extracontractual legal system. These rights confer inalienable and exclusive entitlement to holders, thus giving them the power to do what they like with the property.

If the majority of the world's countries want to operate like the United States—selling gold as futures on a Wall Street metal exchange, for example, instead of as nuggets on a Third World back street—their property rights must be "formalized." Property owners must be protected from uncertainty and fraud by indisputable proof of ownership formalized in standardized instruments of exchange that are universally obtainable and registered by a legally regulated central system. Simply put, formal law is the foundation of the market system, essential to the development of corporations, limited liability contracts and an adequate business environment. With these formal guarantees of ownership, modern market economies can emerge that make possible the massive and inexpensive exchange of resources to promote specialization and increasing productivity.

Up to now, few analysts have drawn the connection between formal property rights and market development. This is probably because the existing market economies in Europe, the United States and Japan in most respects developed over a prolonged period of time as responses to apparently unrelated historical events. But the security of property rights that emerged in such an unpremeditated way was of enormous and critical importance for several reasons. It encouraged owners to invest greater intelligence, effort and resources into developing and ecologically preserving their property, made it easier for them to get credit through the use of title as collateral, and encouraged general respect among rich and poor alike for the property of others. It converted potential capital into live capital and made possible the efficient and economical sale and purchase of property with all the stimulus to economic development that that implies. That is, it made possible the massive and inexpensive exchange of resources that promote specialization and increase productivity and thus make possible modern market economies.

The importance of formal title is evident if one realizes that all over the world property constitutes a very large portion of people's wealth, ranging from 40 percent of family assets in the United States to 70 percent in many developing countries. And yet in Peru, and evidently most other Third World countries, formalized land titles exist for less than 10 percent of rural and only about half of urban property. That is to say, ownership of most property is "informal" and thus outside the market economy. Indeed, over the past 50 years there has been a spontaneous and uncontrolled emergence of sprawling illegal cities and massive rural squatting throughout the Third

World. These developments have increased the importance of informal property that in its present form will never be able to play its potentially productive role in a modern market economy.

Some government leaders have recognized in some degree the importance of land ownership and even informality. Some have even conducted varying sorts of agrarian reforms intended to put land in the hands of the tillers. Still in most ways, even the most enlightened leaders do not grasp the scope and import of the problem and their policies have tended to lock their nations into Third World poverty.

In part this problem arises because the property phenomenon is disguised in most nations since national constitutions proclaim recognition of property rights and all governments are parties to international treaties that state the same. But these rights often are not enforced for many reasons, including the governments' failure to fully realize that the overwhelming majority of national savings and investment is tied up in informal assets, mainly real estate, that will never become live and productive capital until they are formalized. Other reasons range from deliberate obstruction of change by officials with vested interests in the old systems and relationships to often structural difficulties encountered even when changes are actively sought. For example, Latin American jurists generally do not know how to adapt the law to the people and even when they have the best of intentions, they know little about formalizing title. Traditional systems are expensive and slow because of excessive centralization, departmentalization and legalisms at all levels. What is more, most of the people themselves have never been integrated deeply into the legal system so they can recognize the rights they have, those they don't have or aren't enforced, or what rights they need to get in order to live more productive lives. That is to say, participation, accountability, transparency and common law practices are little known or unknown to most Third World peoples.

In conclusion, legal reform in general and the formalization of property rights in particular are essential if Latin American countries are to develop national market economies that can participate in the world market economy. Though sometimes tempted to do so, Latin Americans must not despair at the difficulties they face and will face in making necessary changes. They must adopt a productive strategy of reform that takes the problems of the day into full consideration and finds ways to overcome them. It is clear to me that the widespread support we see today for macroeconomic stabilization programs does not signal truly revolutionary changes in the thinking and objectives of Latin American leaders. These changes are prompted mainly by the need to respond somehow to hyper-inflation and the chaos of the past.

The legal change we support must be more broadly based and will probably have to be inspired by legal mavericks or from outside the

established legal system. It must be supported at the highest levels of government, but it also must reach down into the depths of the legal system itself to traditional jurists and lawyers who are concerned mainly with legal stability or special interests and are thus predisposed to oppose change. Personal experience has taught me that these lawyers must be brought into play if for no other reason than because otherwise they can and undoubtedly will become the most vigorous opponents of reform. That is, if those in position to obstruct change are not brought into the reform process, they will at the least complicate and perhaps block the changes that must be made, a point the editors of this volume argue in some detail.

The reality is that "developing" economies will not really develop until the impoverished majority have access to secure and impartial legal rights and can thus participate in the development of and reap the benefits of a functioning market economy. And until the lot of this majority actually begins to improve, populists will continue to appear and peddle their inflationary "cures" that won't work any better now than they have in the past.

Latin America is at a critical turning point in its history, when basic reforms are more within reach than they have perhaps ever been before. Legal reform is an essential aspect of this reform and its many ramifications are discussed by the authors represented in this book. The way countries in the developing world respond to these issues will determine whether they break out of underdevelopment and move ahead with productive market economies or whether they lock themselves into permanent poverty and despair.

Hernando de Soto

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INTRODUCTION

Edgardo Buscaglia

During the past decade, a major paradigm shift has occurred in the thinking of social scientists concerned with theories of development. The process of economic transformation through deregulation, the privatization of the means of production, and intensified international trade of complex goods and services in transition developing countries, has demanded the creation of a new legal framework with clear rules for economic interaction. In this context, the economic analysis of private and public law has emerged as the most relevant paradigm in applied economics in the past few decades. Identifying the implicit price transmitted by institutions to firms and individuals, and specifying the institutional structure needed to achieve allocative and productive efficiency are two areas in which Law and Economics possesses a comparative advantage over other social sciences. Thus, the works presented in this book take a positive and a normative approach to the economic analysis of the law.

The magnitude of the economic transformation experienced by many developing countries in recent years involves complex contractual relationships among savers, producers, investors, and customers. This process of growth needs a system of rules focussed on enhancing risk management in a increasingly complex economy. Legal, judicial, and alternative dispute resolution systems present potential institutional improvements in how society deals with higher social complexity and increasing risks generated by human interactions. Clearly identifying and specifying these improved mechanisms is the first area of research addressed in this volume. Michael Trebilcock's contribution sets the scope of the field in the first chapter by

focusing on the set of institutions that is most conducive to economic development and identifying the factors and conditions that hamper efficient institutions. The extent to which legal institutions will be allowed to foster economic development is one of the frontiers of public policymaking in the nations of Africa, Asia, and Latin America that are currently implementing market reforms. The economic analysis of the law in developing countries represents an attempt to identify changes in laws, regulations, and enforcement mechanisms that, within the legal tradition of each country, can enhance economic efficiency and improve equity. The authors of the eleven chapters contained in this volume undertake a qualitative and quantitative analysis of the impact of the law on economic development.

The application of the economic analysis of law to development issues provides a means of clearly and consistently defining and enforcing the conditions of ownership in developing countries undergoing transformations. Paraphrasing Thomas Ulen's contribution to this volume, a government that credibly commits itself to enforcing rights of property and contract not only provides a basis whereby partners in economic transactions can trust each other, it also reinforces the hope that the government itself can be trusted to transact honorably and meet its contractual obligations. Yet, high costs for determining property rights are still common in most developing countries. Confiscations of property; multiple, high, and unanticipated taxation applied to the same bundle of property rights again and again; unclear definition of contractual obligations; inconsistent application of the laws coupled with corruption; and *ad hoc* regulations have increased transaction costs within the marketplace. As shown by Buscaglia (1994), that institutional instability increases the discount rate applied to social interactions in future periods, thereby hampering investments, savings, and the consumption of durable goods.

Recent work showing the links between the enforcement of contractual arrangements and economic growth is provided by Ulen (1996). Ulen argues that Law and Economics constitutes the most useful and effective paradigm to understand the key forces explaining economic growth. Ulen's chapter establishes how predictability and consistency in the enforcement of legal rules will affect the decision to invest in a developing country. For example, rules allocating risks and responsibility in cases of accidents have a powerful effect on economic behavior and the structure of the firm. In his pioneering study, Guido Calabresi (1961) uses normative rules to deal with torts. We can observe a similar analytical approach applied to developing countries by Mauro Bussani and Ugo Mattei in this volume. They develop a descriptive and normative framework of analysis and then apply it to the African and Latin American tort systems. Their chapter ends with a series of policy prescriptions that can be used by policymakers in developing

countries pursuing tort reform. The contributions by Gabriel Martinez and Ricardo Paredes-Molina apply a normative analysis to competition laws in Mexico and Chile, respectively. Their work demonstrates how competition doctrines are inconsistently applied in both countries.

Relatively few empirical studies have been advanced in Law and Economics and even fewer within the economic analysis of development. Observations and logical truths are abundant, yet the empirical verification of these logical truths seems to be scarce. The works by Buscaglia and Guerrero-Cusumano (1995), Cooter (1996), Buscaglia and Ulen (forthcoming), and Paredes-Molina's chapter in this volume, show the great advantages of applying statistical techniques to the economic analysis of the law. The potential to rationalize public policy with the aid of jurimetric techniques represents an improvement in the analysis of the economic impact of legal reforms in the Law and Economics of policymaking in developing countries. The remainder of this introduction will present the main topics explored by each of the authors in this volume.

SOCIAL NORMS, LEGAL CHANGE, AND ECONOMIC EFFICIENCY

A modern market economy requires laws that are able to adapt to novel ownership and market relationships when new forms of corporate structure emerge; to provide flexible determinations of contractual obligations, and extend them to new forms of financial instruments, tangible, and intangible property; and to redefine and enforce the rights of victims of new technologies and activities while protecting the environment from newly emerging risks. These are only some examples of the tremendous flexibility that the legal and judicial systems require in order to adapt laws to a dynamic economic system. In his legal and economic analysis of constitutional rules appearing in this volume, J.G. Backhaus interprets the dynamics of constitutional changes in order to address the legal flexibility required by market economies. Cooter's chapter also focuses on the relationship between legal flexibility and economic efficiency. As Cooter states in his contribution, "if economic law is poorly adapted to the economy, expectations conflict, cooperating is difficult, and disputes consume resources. Conversely, if economic law is adapted to the economy, people cooperate with each other, harmonize their expectations, and use resources efficiently and creatively." Cooter argues that efficiency is enhanced by a "bottom up" process of capturing existing social norms that are "informally" relevant in human interactions. Norms are understood here as mechanisms coordinating social interaction. This decentralized approach to lawmaking stands in sharp contrast with the centralization proposed by

the law and development movement that during the 1960s and 1970s proposed "modernization" of the law through transplants. The most important works in this movement are ascribed to Trubek (1972), Galanter (1974), and Seidman (1978), who inspired a comprehensive and centralized legislative reform modernizing the public and private dimensions of the law.

There are three main legal traditions in this century: civil law, common law, and socialist law. Eastern Europe has shifted from a socialist legal system with the production of centralized public rules to a prerevolutionary private civil system. Civil law systems are currently presented with a choice between legalizing and enforcing social norms in a bottom-up approach by avoiding the informational constraints mentioned by Hayek (1973), and simply generating law in a centralized top-down manner. As Cooter (1996, p. 148) points out, "efficiency requires the enforcement of customs in business communities to become more important relative to the regulation of business." As discussed in Buscaglia (1993, 1994), the irrelevance of the laws enacted by parliaments in many countries must be understood as a reflection of the lack of compatibility between the essence of what the law stipulates and the social norms followed by people and businesses in their daily life. When formal rules (regulations or laws) are incompatible with norms, the costs of complying and enforcing the law become higher. In this scenario, a lack of compatibility would produce the "bad news" mentioned by de Soto (1989) in *The Other Path*, where he identifies a deficient rule by comparing the transaction cost of complying with the law against the transaction cost of following the social norm within an informal market. In short, if legal institutions do not meet this compatibility requirement, private contractual arrangements will also become riskier and negatively affect private investment. Therefore, the formation of larger markets and the possibility of longer-term contracts, both of which are necessary conditions for economic growth, are hampered by the existence of legal rules that are divorced from the true rules of social interaction followed by people and businesses.

Many may argue that civil law systems cannot be studied by applying the tools provided by law and economics. Yet, quoting Cooter (1996, p. 145) "Judges allegedly make law in civil systems by interpreting codes, not finding social norms. Compared to common law countries, the codifiers in civil law countries apparently have more influence and the judges allegedly have less influence. Interpreting some codes, however, looks a lot like finding social norms. Comparative lawyers, consequently, debate whether the apparent differences in the two systems are real or illusory." From this perspective, one could argue that civil law systems have the same capacity to react to efficiency forces as common law systems do. Moreover, Alan Watson (1983) shows that the civil law originally evolved as a common law system, whereas before the nineteenth century, the European *ius commune* was based on

judicial interpretation of Roman law within local norms and practices. Yet, there is a perception that civil law countries make rules through legislatures aimed at replacing laws based on social norms, with rational rules designed to engineer a better way of life for society. Under this system, the judge is only allowed to interpret laws generated by legislatures. The interpretation of laws, however, can be subject to an implicit and subtle application of social norms as inputs in the opinions of judges.

By following the studies by Cooter (1994, 1996) and Buscaglia (1994), we can argue that the laws generating obedience are the ones truly compatible with the ethical code prevailing in society. In this scenario, civil society's norms need to be reflected by public institutions and transformed into legal rights and obligations. In short, one could extend Cooter's analysis and state that, in order to enhance efficiency, politics must follow not just the market social norms but also the nonmarket social norms. In a more comprehensive fashion, civil society's market and nonmarket rules for social interaction provide a law-making guide for the legislature and the judiciary. By making laws familiar to the individual, the transaction costs of human interactions decrease and allow society to move toward efficiency.

LEGAL TRANSPLANTS AND ECONOMIC EFFICIENCY

A developing country selecting the source of its laws has two choices: it can adopt a law from within its own institutional mechanisms and social norms, or it can transplant the rule from outside its political-legal zone of dominance. The economic analysis of the law has a comparative advantage in the determination of a framework within which we can predict which of the two options is the most efficiency-enhancing alternative. Alan Watson (1983) has shown that most legal reforms are due to transplants. Therefore, we should also explain why, from an international pool of laws available for transplant, certain rules and institutions are commonly used while others are rejected. For example, why is it that some countries adopt the same rules to protect intellectual property? In more general terms, we should also explain why some countries adopt civil law as opposed to common law, separation of powers as opposed to parliamentary systems. As Mattei (1994) has pointed out, one reason could be simply "prestige." Yet he also points out that prestige is not a measurable variable and, thus, it is difficult to verify the claim in a scientific manner. Microeconomic theory, on the other hand, can provide a justification for the transplant by testing if the legal rules transplanted are also the most efficient ones. In other words, an intertemporal cost-benefit analysis may explain why some legal rules and systems are adopted and others rejected. Within this scenario, Ulen (1996) highlights the economic efficiency hypothesis under which different legal

systems may compute the costs and benefits of legal rules for the same situation differently because real economic factors (such as resource endowments and tastes) are different across regions and nations.

The recent approval of the intellectual property framework within the World Trade Organization umbrella provides a clear example of how some developing countries have incorporated a common set of rules into their national legislation. The reasons for, and consequences related to, these transplants are analyzed in this volume by John Barton. Barton also provides a clear account of the key areas where intellectual property can produce the largest multiplier effect on economic growth in developing countries.

Of central interest is why governments choose some strategies over others in pursuing legal/economic integration. In this volume, Clarisa Long and Edgardo Buscaglia propose that a successful legal/economic integration is a function of the convergence of three broad conditions: (1) the compatibility of political systems; (2) the public sector's expectation of gains from liberalizing international trade; and (3) the private sector organized constituencies' expectation of gains from regionalizing production, transferring capital and technology, and harmonizing trade-related laws. This chapter shows that some or all of these factors are key driving forces behind the main trade agreements within Latin America: The Andean Pact involving Bolivia, Colombia, Ecuador, Peru, and Venezuela, and the Common Market of the South ("MERCOSUR") covering Argentina, Brazil, Chile, Paraguay, and Uruguay.

THE IMPACT OF LAWS ON ORGANIZATIONAL STRUCTURES

Ronald Coase (1960) has shown that transaction costs determine the nature and organization of economic activity and the distribution of income. One interesting issue to be addressed in developing country studies is the type of legal rules and enforcement mechanisms that are needed to promote the existence of public and private organizations whose members' increase in wealth position is compatible with attaining the goals of the organization and improving the overall wealth of society. In this scenario, behavioral patterns such as low factor productivity incentives and corruption (i.e., a transfer of wealth caused by the use of public office for private benefit) can be understood as symptoms of organizational defects. These defects arise when individuals perceive that their well-being does not go hand in hand with the well-being of the organization in particular and society in general. In this scenario, a pattern of defective organizational structures hampers the creation of wealth and economic growth.