Legal academics study the law extensively, but the great bulk of this research dwells upon the analysis of particular laws or doctrines as judged by standards of justice or individual liberty or simple positive formalism. While such research is unquestionably valuable, law professors have fallen far short when it comes to the study of the effect of law and laws on the economic welfare of nations.\(^1\) The now-flourishing law and economics movement has stepped into this void, but even much of that movement’s research has focused on particularized doctrines and micro-level theoretical analyses of efficiency rather than empirical studies of the structural features that conduce to growth.\(^2\) There remains a relative paucity of academic legal research on the big picture – what particular laws and legal institutions are conducive to the overall economic welfare of society.\(^3\)

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1. See, e.g., Philip M. Nichols, *A Legal Theory of Emerging Economies*, 39 VA. J. INT’L L. 229, 236-239 (1999) (discussing how such research has focused on individual countries and failed to develop the necessary overarching theories). One suspects that law professors think that a focus on economics and wealth seems a bit tawdry, when compared to the great issues of justice, rights and fairness with which they commonly grapple. Such a view is quite shortsighted, however. Economic welfare is central to human wellbeing and relevant to human development and the exercise of freedom.


3. I must anticipate the threshold objection that economic growth is not the goal of the law, which might be characterized as freedom and justice. See, e.g., Ronald Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980) (criticizing theory that law should concern itself with increasing wealth); Jules Coleman, *Economics and the Law: A critical Review of the Foundations of the Economic Approach to the Law*, 94 ETHICS 649 (1980) (challenging philosophical basis of wealth maximization objective). While I would concede that economic growth is not the sole objective worth considering in the law, it would be odd to suggest that it should not be one of the central concerns of a legal system. Overall economic growth is instrumental to the more general well-being of a society, including the welfare of disadvantaged groups. Thus, “wealth maximization may be the most direct route to a variety of moral ends,” including political rights, liberty, dignity and contentedness. Richard A. Posner, *THE PROBLEMS OF JURISPRUDENCE* 382 (1990). Economic growth leads to more collective goods advanced by regulation and redistributive benefits such as health insurance and unemployment benefits. Carles Boix, *Democracy, Development, and the Public Sector*, 45 AM. J. POL. SCI. 1 (2001) (reporting empirical results to this effect). It is ironic that liberals may place less value on economics, because growth tends to drive public policies in a liberal direction, while economic difficulties cause such policies to shift to the right. Randolph T. Stevenson, *The Economy and Policy Mood: A Fundamental Dynamic of Democratic Politics*, 45 AM. J. POL. SCI. 620 (2001) (reporting this empirical result in study of developed nations). While economic growth may be demeaned on distributive grounds, the empirical evidence shows that such growth directly benefits the poor, in both developed and developing nations. See David Dollar & Aart Kraay, *Growth Is Good for the Poor*, World Bank Research Paper (March 2000) (reporting results from sample of eighty countries over four decades and finding that income of the poor raises proportionately with overall economic growth); Cass R. Sunstein, *FREE MARKETS AND SOCIAL JUSTICE* 210 (1997) (reporting that “[t]ime and again it has been shown that economic growth can do more than welfare and employment programs to benefit the
Economists have increasingly studied the importance of law to economic growth and made key contributions to our understanding of the issue. Most of these economists, though, are not trained in law and do not test many of the hypotheses that are most important to pragmatic legal and policy determinations. Indeed, much of the economic research appears to reflect a fundamental misunderstanding about what is meant by basic terms such as “law” or “rights” or “property rights.” The contribution of economists to this study is invaluable, but the field cannot be left to this discipline; law professors must themselves add their understanding to the conversation.

This article surveys the field of empirical research on law and economic growth and analyzes its findings. The article begins with a review of the theoretical and historical evidence associating good legal institutions with economic growth rates. The new institutional economics has used history and theory to make the case that legal institutions are crucial to economic development. While some may argue that such institutions are unnecessary for growth or ineffective in light of local cultures, these positions contain only a grain of truth. There is ample reason to believe that law and legal institutions are fundamental to a nation’s economic development.

Considerable empirical research now informs the economic and other theories about the relationship of law and economic growth. There is substantial evidence that some major legal rules and institutions (such as democracy, property rights, and certain government regulations) have a distinctly positive effect on growth. The findings, though, are too generalized and for the most part do not focus on the features of democracy, property rights, and regulations that are malleable policy positions. Moreover, much of the research has been conducted by economists who may fail to capture relevant legal variables.

The current issue “before policy makers therefore is no longer ‘do institutions matter?’ but ‘which institutions matter and how does one acquire them?’” These are precisely the questions for which input from legal academics is essential. They are trained in the pragmatic
operation of laws and legal institutions, unlike many economists. Legal academics should build upon and enhance the existing economic research and help discern the laws and legal institutions that facilitate the economic wellbeing of nations.

I. THE THEORETICAL IMPORTANCE OF LEGAL INSTITUTIONS FOR ECONOMIC GROWTH

Much research effort has been devoted to ascertaining the determinants of economic growth. Economic wellbeing cannot be ascribed to such fortuities as the natural resource endowments of nations. It is clear that factors such as investment and labor productivity are critical to economic growth, and the important research question is how these and other contributors to economic growth may be encouraged. It is now generally recognized that government institutions and the law are relevant to increasing economic growth. This section will review the current understanding of the theory of economic growth.

The review begins with the theoretical contribution of the new institutional economics, which formally recognized the significance of law for economic wellbeing. Under this economic theory, a good institutional structure is necessary to unleash effective capitalist growth. There are some who argue that voluntary arrangements can take the place of a legal structure or that different local cultures are more economically important than particular legal institutions. The remainder of the section examines those claims.

A. The New Institutional Economics

Under the standard neoclassical economic model, legal institutions should not matter. The model explains how, independent of law, levels of economic development should steadily converge among nations, ultimately equalizing wealth, at least roughly. Obviously, this has not occurred. Great and persistent disparities in wealth remain, and often countries have often

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7 See Institutions for High Quality Growth, supra note 000, at 4 (observing that “[I]nstitutions do not figure prominently in the training of economists”).

8 Ironically, natural resource endowments are generally a negative factor for economic growth. The immediately available wealth from natural resources was a readily available economic rent to be seized by the politically powerful. Historically, “the resource-poor countries’ economic performance tended to be much better, on average, than that of those with abundant natural resources.” Deepak Lal, UNINTENDED CONSEQUENCES: THE IMPACT OF FACTOR ENDOWMENTS, CULTURE, AND POLITICS ON LONG-RUN ECONOMIC PERFORMANCE 3 (1998).

9 See, e.g., Michael Trebilcock, What Makes Poor Countries Poor?, in THE LAW OF ECONOMICS AND DEVELOPMENT 16 (E. Buscaglia, W. Ratliff & R. Cooter eds. 1997) (reporting that according to “neoclassical theories of growth, countries that are capital intensive (developed economies) will have lower marginal products of capital and thus lower investment rates and economic growth, while countries that are labor intensive (developing countries) will grow faster” implying a “convergence in growth rates over time”).

10 See, e.g., Mancur Olson, Jr., Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor, 10 J. ECON. PERSP. 3, 14 (1996) (noting that “the dramatically uneven distribution of capital around the world contradicts the familiar assumption that all countries are on the frontiers of aggregate neoclassical production functions”); Leschke, supra note 000, at 266 (reporting that the predictions of neoclassical models “do not match reality”).

This finding is not a basis to disregard the theory behind the neoclassical models. In fact, there is empirical evidence that such models do capture some reality. See, e.g., Peter Howitt, Endogenous Growth
shown a divergence, rather than convergence, of economic welfare. The neoclassical theory’s predictions of convergence did not take account of the different national legal and institutional framework under which development occurred. The new institutional economics developed to address this failed predictions of the neoclassical model, by emphasizing the importance of government institutions and policies to economic growth and explaining divergence by the existence of varying qualities of national institutions across the globe. One cannot expect wise or efficient government institutions to evolve naturally. When such institutions do not arise, national growth suffers. Capitalism “is not a naturally occurring system” either.

The new institutional economics is closely associated with the research of Douglass North, who won a Nobel Prize for his efforts and insights in developing the theory. The fundamental theory of institutional economics is straightforward. It begins with the assumption that individuals will invest for economic growth when they can capture the returns from their investments. The ability to capture economic returns from one’s work or investment is not naturally automatic. To achieve optimality requires the existence of “[p]erfectly specified and

and Cross-Country Income Differences, AM. ECON. REV. 829 (2000) (discussing evidence of convergence under neoclassical model). However, the neoclassical models are clearly oversimple and require supplementation by consideration of legal institutions.

See Philip Keefer & Stephen Knack, Why Don’t Poor Countries Catch Up? A Cross-National Test of an Institutional Explanation, 35 ECON. INQUIRY 590, 590 (1997) (reviewing research on divergence and the institutional explanation); What Makes Poor Countries Poor?, supra note 000, at 16-17 (citing examples of dramatic divergence during this century). Nor does capital shift to poorer nations, as the theory projects. See Robert E. Lucas, Jr., Why Doesn’t Capital Flow from Rich to Poor Countries, 80 AM. ECON. REV. (1990). However, once one controls for institutional effects, convergence may occur. Why Don’t Poor Countries Catch Up?, supra note 000, at 597 (reporting findings that “[n]ot only is growth faster when institutions are better, so also is convergence”).

See, e.g., Gerald W. Scully, CONSTITUTIONAL ENVIRONMENTS AND ECONOMIC GROWTH 9 (1992) (reporting that “[n]othing in the neoclassical theory considers the institutional framework in which capital (physical and human) is accumulated, invention or innovation is made, or inputs are converted to output”).


See Douglass C. North, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 7 (1990) (reporting that “[r]ulers devised property rights in their own interests and transaction costs resulted in typically inefficient property rights prevailing”). See generally Thrainn Eggertsson, ECONOMIC BEHAVIOR AND INSTITUTIONS 250-280 (1990) (describing traditional “naïve theory” that property rights will arise whenever they contribute to efficiency and how it has been abandoned in favor of an interest group theory describing development of such rights). In fact, most governments “do not supply structures of property rights that are appropriate for placing the economy close to the technical production frontier.” Id. at 320.


See Douglass C. North, STRUCTURE AND CHANGE IN ECONOMIC HISTORY 5 (1981) (reporting that his “model assumes an incentive structure that will allow individuals to capture the returns to society of investment”).
costlessly enforced property rights.”

While such an optimal condition is unachievable, societies may be able “to raise the private return close enough to the social return to provide sufficient incentives to achieve economic growth.” Absent such property rights, though, incentives may be insufficient to promote growth. In the view of the new institutional economics, “institutional capital may be a more important determinant of economic development than financial capital, physical capital, human capital, or technological capital.”

North explored the importance of institutions historically. Throughout human history “growth has been more exceptional than stagnation or decline,” which demonstrated that the circumstances enabling growth were not inevitable or natural but required thought and effort. It is government that must be relied upon to create the conditions enabling growth. However, government does not automatically create these conditions but may in fact produce perverse policies, and the state has also been “the source of man-made economic decline.”

North’s tour de force through history begins in the ancient world but keys on the Industrial Revolution and associated great expansion of economic growth. This transpired, he finds, only because of the “prior development of a set of property rights, which raised the private rate of return on invention and innovation.” England and the Netherlands surpassed France and Spain during the seventeenth century, in large part because of the effective recognition of property rights. The “establishment of secure and stable property rights” was a “key element in the rise of the West and the onset of modern economic growth.”

More recent history shows that strong economies have market-oriented economic systems and that such systems are found in nations “that have recognized the need for and secured widespread property rights protected by just laws.”

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17 Id. See also Timothy Besley, Property Rights and Investment Incentives: Theory and Evidence from Ghana, 103 J. POL. ECON. 903, 903 (1995) (reporting that the “evolution of property rights and their effect on investment are central issues in the political economy of investment” and that “the role of the state in codifying and protecting such rights is regarded, in many contemporary and historical discussions as important to providing the preconditions for economic growth”).

18 Id. See also Eggertson, supra note 000, at 341 (discussing how the failure to provide certainty of property rights, requires investors to make “various adjustments to minimize the risk of appropriation” which in turn “tend to lower the level of investment activity and change its nature”).

19 What Makes Poor Nations Poor?, supra note 000, at 19.

20 STRUCTURE AND CHANGE IN ECONOMIC HISTORY, supra note 000, at 6.

21 See id. at 17 (reporting that “[u]ltimately it is the state that is responsible for the efficiency of the property rights structure, which causes growth or stagnation or economic decline”).

22 Id. at 20.

23 STRUCTURE AND CHANGE IN ECONOMIC HISTORY, supra note 000, at 147.

24 Id. at 148-157.

25 Institutions for High Quality Growth, supra note 000, at 5.

26 Hernando de Soto, Preface, in THE LAW AND ECONOMICS OF DEVELOPMENT, supra note 000, at xiii.
economic difficulties of the privatizing, post-communist states of Eastern Europe are attributed to their poor legal systems.  

The importance of legal institutions is now widely recognized. A Nobel laureate, Mancur Olson, has identified “the conditions necessary for economic success” as including “secure and well-defined rights for all to private property and impartial enforcement of contracts.” Yet identifying the theoretical and historic importance of legal institutions does not answer the truly important practical questions. One cannot say that more or greater legal institutions are necessarily better. The same law and government that can provide the prerequisites for property right enforcement may also take them away. Research must focus upon the nature of institutions and legal rules that promote growth.

Hernando de Soto has recently written on the importance of full property rights to economic growth in poorer nations. He argues that squatters with untitled real estate in these countries have assets worth at least $9.3 trillion. Yet they cannot access these resources for investment because they lack the full rights of ownership associated with the formal property system. The wealth of the Western nations is attributed to the existence of such rights. The “legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential.” Enhancing economic growth and expanding its benefits “is principally a legal challenge,” in which “[a]ll other disciplines play only a supporting role.”

Simply emphasizing the significance of the existence of property rights is not sufficient. Some poor nations suffer not from the absence of formalized property rights but from legal barriers to the recognition of those rights. Property rights must be readily enforceable and credible to have the desired effect. The substantive nature of the property rights is also relevant.

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27 See, e.g., Alan B. Krueger, Economic Scene, N.Y. TIMES, March 29, 2001, at C2 (suggesting that the “overall experience suggests that rapid mass privatization, in the absence of a strong legal system, has negative effects on performance”).

28 See, e.g., Robert M. Sherwood, The Economic Importance of Judges, 9 FED. CIRCUIT B.J. 619, 620 (2000) (reporting that “North’s views have been warmly received and widely accepted”); Pierre Englebert, Pre-Colonial Institutions, Post-Colonial States, and Economic Development in Tropical Africa, 53 POL. RES. Q. 7, 8 (2000) (referring to “new consensus” that “it is the lack of state capacity and institutional quality which is responsible for economic stagnation in Africa”); Rafael La Porta et al., The Quality of Government 15 J. LAW ECON. & ORG. 222, 223 (1999) (reporting that the “importance of good government for growth thus appears to be a well-established empirical proposition”).

29 Charles Cadwell, Foreword, in Mancur Olson, POWER AND PROSPERITY viii (2000).


31 Id. at 35.

32 Id. at 46 (observing that it is “formal property that provides the process, the forms, and the rules that fix assets in a condition that allows us to realize them as active capital”).

33 Id. at 51.

34 Id. at 158.

35 Id. at 21 (observing that the time required to gain recognition of legal land rights in Haiti was nineteen years).
Moreover, many other legal rules and structures appear to have a material effect on economic welfare.

B. The Incompleteness of Substitutes for Law

While the potential value of legal institutions and property rights has been broadly recognized by institutional economists, the actual need for such institutions may be exaggerated. Individuals may voluntarily organize their transactions, without legal institutions, in a manner that generally enables their capture of the returns of investment. They may mutually agree upon informal property rights and contract, when they have informal assurances of performance by other parties. Perhaps law is not truly a necessary condition for development. North himself emphasized the importance of extralegal norms in protecting property rights, though only as a complement to legal enforcement of those rights. Some go much further and claim that private substitutes can take the place of legal arrangements and create the climate that enables economic growth. They argue that “the informal mechanisms which businesses use can be just as effective in supporting economic development as some formal systems.” In this view, the “case for state enforcement of contracts may be overplayed.”

While private arbitration may be a valuable alternative for state enforcement of private deals in some cases, it has not proved to be a full substitute. Russia created private arbitration commissions to take the place of judicial enforcement, but “traders were reluctant to use these [commissions] despite the very high rate of contract violations.” Perhaps this is because even a victory in arbitration may not be collectible. Private enforcement seems inferior to state enforcement of contracts, because private enforcement is typically more costly, creates a competition of violence, is more difficult to monitor, and often inhibits changes in economic institutions that may increase efficiency.

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36 See STRUCTURE AND CHANGE IN ECONOMIC HISTORY, supra note 000, at 18 (noting the importance of the “articulation of a set of moral and ethical behavioral norms to reduce enforcement costs”). He notes that “[t]o the extent that the participants believe the system fair, the costs of enforcing the rules and property rights are enormously reduced by the simple fact that the individuals will not disobey the rules or violate property rights even when a private cost/benefit calculus would make such action worthwhile.” Id. at 53.

37 See, e.g., Ginsburg, supra note 000, at 830 (observing that “some have claimed that the rule of law is dispensable in the pursuit of economic growth”); Richard A. Posner, Creating a Legal Framework for Economic Development, 13, WORLD BANK RESEARCH OBSERVER 1, 2 (1998) (reporting that there “are many informal substitutes for the legal enforcement and protection of property rights” including arbitration and reputation).


39 Timothy Frye, Contracting in the Shadow of the State: Private Arbitration Commissions in Russia, in THE RULE OF LAW AND ECONOMIC REFORM IN RUSSIA 123, 123 (J.D. Sachs & K Pistor eds. 1997).

40 Contracting in the Shadow of the State, supra note 000, at 128.

41 See Contracting in the Shadow of the State, supra note 000, at 133.
The classic study of extralegal private governance is Robert Ellickson’s study of the Shasta County, California cattle industry.\(^{42}\) He found that ranchers in the area effectively created their own informal rules for common disputes, such as cattle trespass, boundary fences, etc.\(^{43}\) He therefore critiqued the theory of “legal centralism,” which maintains that governments must be “the chief sources of rules and enforcement efforts.”\(^{44}\) Ellickson therefore suggested that formal law was not necessarily required for economic arrangements to be effective. There are other examples of functioning private contract enforcement today, such as that found in the diamond industry\(^{45}\) or cotton industry.\(^{46}\) These informal approaches may even be more efficient than formal legal structures of property and contract.\(^{47}\)

One may even argue that extralegal governance is an economically superior approach that has been undermined by the creation of law. The introduction of legal constraints may be counterproductive, by “undermining incentives to develop private cooperative arrangements and by creating incentives for entrepreneurs to engage in rent-seeking.”\(^{48}\) Larry Ribstein contends that trust is essential to efficient transactions and that the introduction of laws may be counterproductive.\(^{49}\) By providing for the enforcement of detailed contracts, the law, he maintains, may “crowd out” the trust that enhances efficient transactions\(^{50}\) or even breed distrust.\(^{51}\)

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\(^{43}\) The ranchers resolution of these matters was not conducted in the “shadow of the law” and driven by legal rules. Ellickson found that the parties were essentially oblivious to what the formal legal standards were. See id. at 141 (noting that ranchers were ignorant of substantive legal rights on boundary fences and badly misperceived legal requirements on highway collisions with livestock).

\(^{44}\) Id. at 138.


\(^{47}\) See, e.g., Robert Cooter, Structural Adjudication and the New Law Merchant: A Model of Decentralized Law, 14 INT’L REV. L. & ECON. 215 (1994) (discussing land tenure in Papua New Guinea and finding that shift from relationship-based economy to formal property ownership would be disruptive and counterproductive); Jonathan R. Macey, Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules, 82 CORNELL L. REV. 1123 (1997) (arguing that “private ordering generates substantive legal principles that are superior to those that the state produces”).


\(^{50}\) Id. at 570.

\(^{51}\) See id. at 576-584 (presenting “trust-based arguments against law”).
Matt Ridley, an evolutionary psychologist, maintained that trade predated law and thrived under the privately created and enforced rules that voluntarily arose.\textsuperscript{52} He observes that “[m]arkets, exchanges and rules can develop before government or any other monopolist has defined their rules,” because they “define their own rules.”\textsuperscript{53} Historically, merchant guilds created rules for transactions, with multilateral enforcement.\textsuperscript{54} For Ridley, modern commercial law was “invented and enforced” by merchants and “[o]nly later did governments try to take it over, and with mostly disastrous results.”\textsuperscript{55} In this story, law is the enemy of growth. The story is echoed today in the increasing calls to privatize the commercial law.\textsuperscript{56} It is too quickly assumed, though, that the extralegal private contract governance is necessarily efficient and effective.\textsuperscript{57} More significantly, the creation of formal legal rules may only enhance the private rules and not displace their benefits.

Under our relatively advanced legal system, contracts in any society may be considered formal (public legal) or informal (private extralegal). Parties clearly are able to transact, even absent formal legal institutions, through informal contracts, sometimes called relational contracts that depend upon mutual trust and fair dealing.\textsuperscript{58} Parties might even prefer relational contracts, which can employ a more subjective standard for judging performance.\textsuperscript{59} Creation of a legal institutional structure for formal contracting does not, however, necessarily preclude conducting relational transactions.\textsuperscript{60} It simply adds an additional level of contracting choice. There are “informal sectors within the geographic jurisdiction of a legal authority [that] often establish and enforce rules and resolve disputes.”\textsuperscript{61}

\textsuperscript{53} Id. at 204.
\textsuperscript{54} See generally A. Greif, P. Milgrom & B. Weingast, Coordination, Commitment and Enforcement: The Case of the Merchant Guild, 102 J. POL. ECON. 745 (1994).
\textsuperscript{55} Id. at 202.
\textsuperscript{56} See, e.g., Gillian K. Hadfield, Privatizing Commercial Law, REGULATION, Spring 2001, at 40.
\textsuperscript{57} See Avner Greif, Informal Contract Enforcement: Lessons from Medieval Trade, 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 294 (reporting that the private customary law that arose was not especially efficient).
\textsuperscript{58} Relational deals are sometimes captured in formal contracts but depend not on the parties’ enforcement of all legal entitlements but on flexible adjustments to maintain the ongoing business relationship. For discussion of relational contracts, see Richard E. Speidel, The Characteristics and Challenges of Relational Contracts, 94 NW. U. L. REV. 823 (2000); Charles J. Goetz & Robert E. Scott, Principles of Relational Contracts, 67 VA. L. REV. 1089 (1981).
\textsuperscript{59} See A Legal Theory of Emerging Economies, supra note 000, at 248-249 (discussing differences between formal and relational contracts).
\textsuperscript{60} There is, for example, the “right to contract around the rule” established by courts, enabling the parties to establish their own governance rules. See Bruce L. Benson, Evolution of Commercial Law, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 90-91 (1998).
\textsuperscript{61} Benson, supra note 000, at 91. Indeed private contractual governance has even overridden government regulatory schemes. See Thomas Palay, Informal Contracts and Regulatory Constraints, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 295-299 (reporting how private arrangements in the railroad industry altered the regulatory scheme of the Interstate Commerce Act).
among ranchers occurred in a state subject to formal legal rules. The government need not and generally has not prohibited private arrangements, such as arbitration agreements, and so formal law need not directly interfere with extralegal contracting. It may, however, considerably expand the scope of contracting. Parties may use clauses such as choice of law, choice of forum and arbitration provisions “to allocate certain aspects of their relationship to governance by associational norms or business custom, and others by state law.” Creation of formal law does not necessarily undermine norms but simply expands the horizon of contracting choices. Legal structures permit a party to structure a transactional relationship that was flexible and did not rely on strict legal requirements but maintain a structural legal “backstop” should the relationship fall apart and behavior become too opportunistic. To the extent that perfectly informal, extralegal deals are economically optimal, they should supplant formal contracts.

The creation of law can supplement and enhance the ability of parties to order their private investments. This can be illustrated by the Delaware law of business organizations. Delaware provides an elaborate set of legal rules for corporations, including fiduciary duties imposed on officers, directors and controlling shareholders. These rules do not necessarily apply to partnerships, however, because the partnership agreement may override the default rules. Yet many entities choose to organize as corporations, subject to the legal rules, and many partnerships do not fully opt out of the default rules. This is a market test of the value of binding legal rules.

The model of extralegal contracting is surely a bit utopian – one study in Russia testing the degree of success in commercial transactions found that the law-related variables were more important than those reflecting the parties’ possibilities for forming long-term relationships. At best, voluntary, extralegal cooperation may substitute for law “when individuals repeatedly interact, when they have a great deal of information about each other, and when small numbers

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62 Misgovernance or Misperception?, supra note 000, at 19.

63 Formal mechanisms may even strengthen the informal basis of contracting. See Christopher Clague, et al., Institutions and Economic Performance: Property Rights and Contract Enforcement, in INSTITUTIONS AND ECONOMIC DEVELOPMENT, supra note 000, at 69 (contending that the private arrangements for contract compliance may be dependent on “the political and judicial institutions of the society”) See also Misgovernance or Misperception?, supra note 000, at 161 (reporting survey findings that “formal and informal mechanisms are complements rather than substitutes”).

64 See Robert Scott, A Relational Theory of Default Rules for Commercial Contracts, 19 J. LEGAL STUD. 597, 615 (1990) (noting that parties may learn “to behave under two sets of rules: a strict set of rules for legal enforcement and a more flexible set of rules for social enforcement”); Stewart Macaulay, Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian Macneil and Lisa Bernstein, 94 NW. U. L. REV. 775, 792 (2000) (discussing Bernstein’s suggestion that parties might want to structure a relational deal but still “be able to turn to the written contract and enforce its formal provisions” when the “relationship was no longer valuable or had been damaged beyond repair”).

65 See Steven R. Salbu, The Decline of Contract as a Relationship Management Form, 47 RUTGERS L. REV. 1271, 1359 (1995) (reporting that if formal contracts are inappropriate to transactions “some variety or varieties of nonobligational relationship management form may be expected to evolve”).

66 See Kathryn Hendley, Peter Murrell & Randi Ryterman, Law Works in Russia: The Role of Law in Interenterprise Transactions, in ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES, supra note 000, at 82-85. Similarly, a study in the Kyrgyz Republic and Kazakhstan found that “[a]ll legalistic enforcement methods were found to be more effective than the options of stopping trade and reporting problems to other enterprises.” Young Lee & Patrick Meagher, Misgovernance or Misperception? Law and Finance in Central Asia, in id. at 158.
characterize the group." These circumstances are obviously limiting. Reliance on extralegal norms for contract performance requires business to forego “potentially mutually beneficial exchanges among a much larger network of trading partners for which these conditions do not hold.”

Efforts to expand the range of business partners involve considerable transaction costs associated with ensuring the reliability of those more distant entities and it is these “costs of transacting that are the key obstacles that prevent economies and societies from realizing well-being.”

The informal frameworks may limit transacting to members of one’s family or ethnicity. The consequent “shortage of new firms and new people can mean a dearth of new ideas and entrepreneurship, and an inability to enter into long-term contracts can inhibit the adoption and development of complex technologies.”

Limiting one’s business partners to a small number of individuals with whom one is familiar and has long transacted is not exactly a prescription for widespread competition or even specialization of functions and division of labor. Long-term contracts, where performance is not simultaneous for the parties, require an external enforcement mechanism.

Some of the contracts most critical for economic growth depend on

67 INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, supra note 000, at 12.

See Kevin Davis, Michael J. Trebilcock & Bradley Heys, Ethnically Homogenous Commercial Elites in Developing Countries, 32 LAW & POL’L INT’L BUS. 331, 333 (2001). See also POWER AND PROSPERITY, supra note 000, at 180 (noting how informal markets are constrained by factors such as the need to make “both parts of the transaction simultaneous, by making trades only within families or other close social groups where the aggrieved individual can bring social sanctions to bear, by restricting trades to those who have invested too much to obtain a reputation for honoring deals to profit from failing to do so, and so on”); A Legal Theory of Emerging Economies, supra note 000, at 273 (suggesting that “the number of contracts that can be created under traditional law is limited”); Ginsburg, supra note 000, at 834 (reporting that “[u]nder conditions of weak formal protections, business is conducted within extended family groups, and firms are typically family owned”).


See, e.g., BUILDING INSTITUTIONS FOR MARKETS, supra note 000, at 174-175 (describing how informal institutions may exclude parties because of linguistic or cultural barriers and how the results of such exclusion may be a growth of inequality, social unrest, and crime).

69 Cheryl W. Gray, Reforming Legal Systems in Developing and Transitional Countries, in MAKING DEVELOPMENT WORK, supra note 000, at 62. See also Why Don’t Poor Countries Catch Up?, supra note 000, at 591 (reporting that “[m]ore secure property rights and credible policy regimes increase the incentives of entrepreneurs to adopt those techniques that maximize long-run profits”). See also See Christopher Clague, et al., Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance, 4 J. ECON. GROWTH 185, 185-186 (1999) (reporting that “markets in which economic actors making exchanges requiring significant and irreversible commitments in the present” are “less likely to exist when institutions for the protection of property rights and contract enforcement are absent”); Edgardo Buscaglia, Obstacles to Judicial Reform in Latin America, in JUSTICE DELAYED: JUDICIAL REFORM IN LATIN AMERICA 15, 16 (E. Jarquin & F. Carrillo eds. 1998) (reporting that the need to rely on extralegal reputational cues in contracting “excludes many potential transactions, such as those involving new partners or start-up businesses”).

70 Ethnically Homogenous Commercial Elites, supra note 000, at 332-333. See also Ginsburg, supra note 000, at 835 (noting that reliance on informal mechanisms limits transactions to close-knit groups and “can prevent many potentially beneficial transactions with new businesses or persons with whom the firm is unfamiliar”); Thomas W. Walde & James L. Gunderson, Legislative Reform in Transition Economies: Western Transplants: A Short-Cut to Social Market Economy Status, in MAKING DEVELOPMENT
secure enforcement. For example, investing in a company is for the long run and requires assurance that the managers will not steal the investment,\textsuperscript{73} and even putting money into a bank to obtain interest requires similar assurances.\textsuperscript{74} A survey in the Kyrgyz Republic and Kazakhstan found that businesses relied heavily in informal arrangements, but that “growth-oriented financial transactions, such as borrowing for company expansions or investments in new product lines, are consistently linked with the use of formal legal arrangements.”\textsuperscript{75} Without law, business must forego profitable alternatives.\textsuperscript{76} Law is not essential for the mere existence of free markets but may be crucial for large scale national economic growth.

Complex societies thus appear to require government enforcement of economic transactions.\textsuperscript{77} The need for government enforcement is apparent from arbitration provisions in contracts. It is relatively common for contracting parties to choose not to use a legal forum for dispute resolution but agree to arbitrate their disputes privately. Superficially, this might seem to demonstrate that a governmental legal structure is unnecessary. However, it is also relatively common for a party to reject the results in arbitration, requiring a court to step in and interpret and enforce the arbitration provision. In this circumstance, the law is essential to preserve the parties’ right to choose an informal private forum for their disputes. The law also provides a benefit by providing default rules and monitoring for opportunism,\textsuperscript{78} which efficiently reduces the

\textsuperscript{73} See, e.g., Alsi Demirguc-Kunt & Vojislav Maksimovic, Law, Finance, and Firm Growth, 53 J. FIN. 2107, 2108 (1998) (suggesting that legal restraints are necessary for a firm that wishes to obtain long-term financing to commit credibly to controlling opportunistic behavior by corporate insiders).

\textsuperscript{74} See POWER AND PROSPERITY, supra note 000, at 184-186 (noting transactions that require legal enforcement, including capital contributions to corporations and depositing money in banks).

\textsuperscript{75} Young Lee & Patrick Meagher, Misgovernance or Misperception? Law and Finance in Central Asia (April 2, 2000), at 1. The authors also found that legal weakness explained the “extremely low level of commercial bank borrowing” in the republics, which “broadly suggests the linkage between weak legal institutions and slow growth, and hence the need for stronger institutions to promote growth”).

\textsuperscript{76} See Christopher Clague, et al., Institutions and Economic Performance: Property Rights and Contract Enforcement, in INSTITUTIONS AND ECONOMIC DEVELOPMENT, supra note 000, at 69 (reporting that in “societies without well-functioning contract enforcement institutions,” individuals and companies may have to produce their own food rather than relying on market exchange, manufacture their own products and maintain large stocks of inventories of replacement parts).

\textsuperscript{77} INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, supra note 000, at 35 (noting that we “cannot have the productivity of a modern high income society with political anarchy”).

\textsuperscript{78} See also Paul H. Rubin, Legal Reform in Eastern Europe, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 554 (1998) (reporting that “[e]fficient contract law would limit the possibility for private opportunism”).
ex ante precautions that have to be taken by contracting parties. Moreover, extralegal arrangements may ironically lack the sort of adaptability and flexibility required by markets, that law may offer.

Historically, the “removal of restrictions widening the gap between private and social returns frequently required positive action by government.” 

Government action can also provide other benefits for private transactions. By establishing the “basic rules of exchange,” the law may substantially reduce “negotiation and enforcement costs.” The law, rather than being antagonistic to informal norms and controls, may “invigorate” them. The experience of East Asia did not in fact demonstrate the private ordering could substitute for law. Moreover, the presence of informal networks of transacting parties may well have a “negative external effect on nonmembers” of the network. Contract law is still “an essential institution for an efficient market.”

While Ribstein, Ridley and others have presented arguments for how private arrangements may substitute for and be preferable to legal enforcement, they are just arguments and not proved. Weighing these arguments against the counter-arguments requires empirical evaluation. In addition to the evidence in Russia and Asia and North’s broader historical evidence, there is rigorous cross-country evidence demonstrating that strong legal institutions to enforce property and contract rights are correlated with economic growth. This evidence should be sufficient to demonstrate that private arrangements cannot successfully substitute for legal institutions. Moreover, such arrangements may impose external costs on society.

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80 See Richard A. Epstein, PRINCIPLES FOR A FREE SOCIETY 35 (1998) (reporting that custom finds it “difficult to adapt sensibly to rapid discontinuities in traditional business or legal environments”).

81 STRUCTURE AND CHANGE IN ECONOMIC HISTORY, supra note 000, at 167.

82 STRUCTURE AND CHANGE IN ECONOMIC HISTORY, supra note 000, at 37.

83 ORDER WITHOUT LAW, supra note 000, at 284.

84 See Ginsburg, supra note 000, at 841 (reporting that the “ADB study effectively undercuts that thesis by noting that the substitutes are themselves dependent on legal norms”).

85 Raja Kali, Business Networks in Transition Economies: Norms, Contracts, and Legal Institutions, in ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES, supra note 000, at 212. See also id. at 218 (reporting a number of theoretical papers that suggest that “the partial equilibrium result – of informal contract enforcement institutions enhancing economic efficiency – is not robust to a general equilibrium extension, one that takes into account the effect of network structures on the economy as a whole”).

86 Mattei, supra note 000, at 538. See also Chang Ju Choi et al., A Note on Countertrade, Contractual Uncertainty and Transaction Governance in Emerging Economies, 30 J. INT’L’L. BUS. STUD. 189 (1999) (reporting that the “gains from trade require legal and governmental institutions that guarantee individual rights to impartial enforcement of contract and property”).

87 See infra at ___. 
Ellickson emphasized the importance of extralegal agreement and dispute resolution for “close-knit” groups, but a modern economy requires transactions that go beyond such groups. Reliance on family alliances alone may be “dysfunctional” and will create a “bias against new firms” established by other families. There is also a risk that the extralegal norms created by the close-knit groups may not be in the more general interest. As Ellickson observed, a “norm of ‘honor among thieves’ may well be welfare maximizing for thieves, but welfare diminishing for society at large.” He likewise cautioned that the “communitarian’s dream of numerous small autonomous communities might end up as a nightmare of constant strife between neighboring groups.”

Even within groups, reliance on extralegal controls is more likely to result in violent self-help measures. In addition to the incompleteness of substitutes for the law, there is also a darker side to the absence of law and property rights. Trust alone has proved inadequate to support private markets. Free markets will arise, to some degree, under any set of conditions. Transactions will occur between friends and when simultaneous performance ensures compliance. Members of such communities will inevitably seek the greater efficiency and profit of expanding the range of available transactions, however. Those circumstances do not ensure perfect contract compliance, however. In the absence of government enforcement, these parties will seek out private enforcement mechanisms for breached contracts. These private enforcement mechanisms are likely to take the form of organized crime syndicates.

When law is unavailable for the enforcement of private transactions, parties will seek out “alternative enforcers of property rights.” These alternatives frequently employ “the threat and sometimes the actuality of violence.” When state action is unavailable, “the enforcers might be thugs, mafia, or even the police.” In Russia, the underground economy “ultimately led to the creation of the mafia as an alternative to government.” As a result, the “contract killing of private businessmen has sadly become commonplace.” The use of criminals to enforce economic arrangements is not only violent, it is an unproductive and inefficient approach to

88 The “more close-knit a group, the more successful it will be at generating and enforcing utilitarian norms to govern internal disputes.” ORDER WITHOUT LAW, supra note 000, at 250.

89 Creating a Legal Framework for Economic Development, supra note 000, at 3.

90 ORDER WITHOUT LAW, supra note 000, at 249.

91 Id. at 250.

92 Id. at 253.


95 Opportunism Knocks?, supra note 000, at 11.

96 Civilizing the Russian Underground Economy, supra note 000, at 74.

97 Contracting in the Shadow of the State, supra note 000, at 133.
Competition is stifled, and a “market economy dominated by illegal market activity is inefficient at best, and likely to foster inequality and exploitation.” In Bulgaria a study found that informal enforcement deployed “informal ‘mutual hostage’ situations and mafia-influenced enforcement.” In Latin America, shortcomings in the judicial system have led to “private justice” enforced by “justicieros or gunmen.”

Even in a more economically developed nation like Japan, these “alternative enforcers” of “private ordering: also include mobsters known as yakuza. History demonstrates that “when the law has no way of enforcing contract, the underworld provides it.” Reliance on organized crime “closely track[s] inefficiencies in formal legal structures, including both inefficient substantive laws and a state-induced shortage of legal professionals and other rights-enforcement agents.” A careful empirical analysis found that the presence of organized crime could be attributed to the weakness of legal institutions. Japanese victims of traffic accidents have retained organized crime syndicates in order to recover “damages” from other parties. Japanese companies make extortion payments to sokaiya, to ensure that shareholder meetings go smoothly, because of weaknesses in the nation’s law of corporate governance. There is a “clear statistical correlation between yakuza activity and gaps in the legal infrastructure.”

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98 See, e.g., Legal Reform in Eastern Europe, supra note 000, at 556-557. Rubin notes that organized crime may also be invoked to intimidate creditors and prevent the enforcement of agreements. The need to resist organized crime has forced Russian banks to protect themselves, so that “one-third of bank employees are security guards.” Id. at 556. Moreover, the short time horizon of Mafiosi makes them unreliable agents – they may simply recover due payments on a contract and just keep the money for themselves. Such criminalization may be “destroying the Russian economy.” Id. at 557.

99 Civilizing the Russian Underground Economy, supra note 000, at 77. Mafia-like enforcers may intimidate competitors from entering markets, create the functional equivalent of fixed prices, and discourage outside investors. Id. at 76.

100 See Opportunism Knocks?, supra note 000, at 19.

101 Luis Pasara, Judicial Reform and Civil Society, in JUSTICE DELAYED, supra note 000, at 83, 85.

102 See Gilliam Tett, Gangsters who hold Japan’s future to ransom, FIN. TIMES, Oct 15, 2001, at 21 (reporting that because the “Japanese state has not been very effective at creating clear-cut rules for business,” the country has relied on the yakuza to fill the vacuum). She observed that Japan has four times as many yakuza as licensed attorneys. Id.


104 The Dark Side of Private Ordering, supra note 000, at 41.

105 Id. at 84.


108 Tett, supra note ___.

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reliance on organized crime is not unique to Japan but has occurred in many other nations when legal institutions have broken down.\textsuperscript{109} Other countries have their own version of corporate sokaiya, when institutions protecting minority shareholder rights are absent.\textsuperscript{110} In addition to the economic limitations of purely private transactional arrangements, they may produce private enforcement arrangements that are unnecessarily violent.

C. The Exaggeration of Culture’s Importance

A second challenge to the importance of legal institutions emphasizes the role of local cultures. Some have questioned the value of attempting to export so-called “Western” notions of law and property rights to the nations of other parts of the world. They emphasize the cultural differences between nations and argue that a national’s fundamental cultural attributes, rather than its laws, is the key determinant of its society and economy. Much of the legal research on development has focused on this cultural aspect to growth. Some argued that the legal institutions that enabled the development of the West could not be transferred effectively to emerging nations in other parts of the world.\textsuperscript{111} The recent success of East Asian nations has been ascribed, not to legal institutions, but to features associated with a Confucian culture.\textsuperscript{112} Thus, the universalist vision of wise legal institutions could be criticized as either ineffectual or hegemonic.

Law and development research first thrived in the 1960s and 1970s with the work of authors such as David Trubek and Marc Galanter.\textsuperscript{113} At this time, scholars discussed the “legal liberalism” associated with the new institutional economics but questioned its application to developing nations. Although at first the researchers seemed to embrace the growth of liberal legalism, they increasingly questioned whether law was anything more than a beard for authoritarian interests and whether the legal liberalism model could be effectively extended to other cultures.\textsuperscript{114} The general view of this strain of research was that the “law is not of primary importance” and that the fate of each particular country “rests upon its unique historical, cultural, economic, political and material (population, natural resources, technology base, and so forth) mix.”\textsuperscript{115} Attempting to extend Western institutions to developing nations was at best futile and at worst imperialist.\textsuperscript{116} These sociologists, sometimes called “legal peripheralists” dismissed “the

\textsuperscript{109} See The Dark Side of Private Ordering, supra note 000, at 45.

\textsuperscript{110} See Information, Institutions and Extortion in Japan and the United States, supra note 000, at 796-797 (describing practice in Italy and South Korea).

\textsuperscript{111} See, e.g., Ginsburg, supra note 000, at 834 (reporting that “some have asserted that theories based on the experience of Western countries may be inapplicable to societies with very different cultural traditions”).


\textsuperscript{115} Bilder & Tramanaha, supra note 000, at 484.

\textsuperscript{116} See, e.g., James A. Gardner, LEGAL IMPERIALISM: AMERICAN LAWYERS AND FOREIGN AID IN LATIN AMERICA 6 (1980) (associating “American legal models” with “authoritarian
legal system as ineffectual.”  The research didn’t proceed to offer much of a positive vision, though, and the field soon died.

More recently, legal academics such as Amy Chua have tried to explore the intersection of culture and development with somewhat more nuance. While not declaring hopeless the use of legal institutions to prod economic development, Professor Chua argued that “free market democracy” succeeded in the West because of particular societal features that are “largely absent from the developing world, and there is no reason to assume that they will be spontaneously generated by market and democratic reforms.”

She suggests that attempts to deploy markets and democracies in underdeveloped countries will produce an anti-market backlash, a retreat from democracy, or even genocidal attacks on ethnic minorities. The success of democratic capitalism in the West, thus, could not be replicated in foreign cultures. Others criticize “shock therapy” privatization and in the process suggests that legal reform efforts that impress Western legal concepts on other countries will fail.

Evaluating the cultural argument also requires factual investigation. Capitalist marketplace transactions are ubiquitous and irrepresible and spontaneously arise, even in what might be called noncapitalist countries. Absent the appropriate legal institutions, such transactions may be referred to as part of an “informal economy.” These informal markets do not depend upon the existence of a particular culture or even upon market participants sharing a culture. Such markets are “commonplace even in the poorest countries,” though “long-term, abuse”); Lan Cao, Law and Economic Development: A New Beginning?, 32 TEX. INT’L L.J. 545, 550 (1997) (noting that the movement was criticized for “ethnocentrism, myopia and naivete”); Jane Kaufman Winn, How to Make Poor Countries Rich and How to Enrich Our Poor, 77 IOWA L. REV. 899, 922 (1992) (suggesting that past law and development efforts failed because the U.S. institutions were resisted by local cultures).

ORDER WITHOUT LAW, supra note 000, at 147.

See Markets, Democracy, and Ethnocentricity, supra note 000 at 13 (describing the death of the movement); Law and Economic Development: A New Beginning?, supra note 000, at 545 (noting that law and development was “declared dead by its proponents in the late 1970s”); Tom Ginsburg, Does Law Matter for Economic Development? Evidence from East Asia, 34 LAW & SOC’Y REV. 829, 829 (2000) (observing that the “Law and Development Movement ultimately fizzled”).


Id. at 345-347.

See, e.g., Spencer Weber Waller & Lan Cao, Law Reform in Vietnam: The Uneven Legacy of Doi Moi, 29 N.Y.U. J. INT’L L. & POL. 555, 558-559 (1997) (reporting that an “additional risk associated with the law reform business is that Western-style business law may be inappropriate for the receiving country”).

See, e.g, POWER AND PROSPERITY, supra note 000, at 173 (noting the ubiquity of markets in poor nations); 174 (noting how such markets spontaneously arise); and 180 (noting that markets arise even when “trade is illegal”); Contract-Intensive Money, supra note 000, at 185 (observing that markets are “commonplace in all types of societies, including the poorest, and they exist even in remarkably unfavorable conditions”).

See POWER AND PROSPERITY, supra note 000, at 174 (observing that “some types of markets regularly emerge whether or not the participants have anything in common, and sometimes even when participants have antipathy toward one another”).
simultaneous contacting is much less common.” 124 It is difficult to say that capitalist transactions intrinsically contradict particular cultural fundamentals.

These informal transactions that arise outside the law are sometimes referred to as the “underground economy” or the “informal economy.” 125 In some nations, this economy is huge. It “accounts for 50 percent of the GDP in Russia and Ukraine and a whopping 62 percent in Georgia.” 126 According to the International Labor Organization, “85 percent of all new jobs in Latin America and the Caribbean have been created in the extralegal sector.” 127 It is difficult to claim that there are many world cultures that reject marketplace transactions. Indeed, the notions of property rights underlying Western culture may not be local but reflect a concept that is “deeply ingrained in the human evolutionary past.” 128 At least rudimentary concepts of property rights, contract enforcement, and capitalism are found even in the absence of the associated legal structures.

The presence of an enormous underground economy in a country does not demonstrate that legal structures are unnecessary, however. There is considerable waste associated with operating a business extralegally, as Hernando de Soto observed:

We found that operating outside the world of legal work and business was surprisingly expensive. In Peru, for example, the cost of operating a business extralegally includes paying 10 to 15 percent of its annual income in bribes and commissions to authorities. Add to such payoffs the costs of avoiding penalties, making transfers outside legal channels, and operating from dispersed locations and without credit, and the life of the extralegal entrepreneur turns out to be far more costly and full of daily hassles than that of the legal businessman.

Perhaps the most significant cost was caused by the absence of institutions that create incentives for people to seize economic and social opportunities to specialize within the marketplace. . . . Being unable to raise money for investment, they could not achieve economies of scale or protect their innovations through royalties and patents. 129

It may be “bad law” that “discourages the entry of the informal economy into the official economy.” 130 It would seem difficult to suggest that a nation’s culture somehow dictate that transactions must be conducted illegally and underground. 131

124 What Makes Poor Countries Poor?, supra note 000, at 42.

125 See, e.g., Daniel McGrory, Civilizing the Russian Underground Economy: Requirements and Prospects for Establishing a Civil Economy in Russia, 5 TRANSNAT. LAW & CONTEMP. PROBS. 65, 66-70 (discussing concepts of underground and informal economies in context of Russia).

126 THE MYSTERY OF CAPITAL, supra note 000, at 69.

127 Id.


129 THE MYSTERY OF CAPITAL, supra note 000, at 83.

130 Civilizing the Russian Underground Economy, supra note 000, at 69.

131 Actually, some have sought to argue that what we call corruption is a cultural artifact, explained by gift-giving cultural conventions. See Nii Lante Wallace-Bruce, Corruption and Competitiveness in Global Business – The Dawn of a New Era, 24 MELB. U. L. REV. 349, 351 (2000) (reporting the “view in
It remains common to attribute great importance to culture as a determinant of economic growth and a barrier to the development and operation of legal institutions to facilitate development. Studies of immigrants by Thomas Sowell and others have urged that the relative success of ethnic groups can be deterministically explained by "culture." Some ascribe the economic failings of various population groups to a lack of competitiveness, lack of trust, or taste for conspicuous consumption. Assessing the validity of these claims, though, is frustrated by the fact that their notion of "culture" is "suspiciously flexible, maddeningly ambiguous, and ultimately elusive.

More seriously, the deterministic view treats culture as if it were an immutable and exogenous genetic fact of certain populations. In reality, "culture" is a more complicated phenomenon and what passes for culture is seldom truly innate to a region’s people. Culture may instead represent a response to external conditions and change as those conditions change. The very nature and institutions of the law may themselves influence or even redirect culture.

certain quarters that corruption has its roots deeply embedded in cultures”). However, this view has been “dismissed as a myth,” as every major religion or school of thought condemns the practice. Id. at 352. See also Padideh Ala’l, The Legacy of Geographical Morality and Colonialism: A Historical Assessment of the Current Crusade Against Corruption, 33 VAND J. TRANSNAT’L L. 877, 904-905 (2000) (discrediting claims that gift-giving or other cultural attributes validate corruption). In addition, it appears that corruption is explained by traditional economic factors See J.S. Nye, Corruption and Political Development: A Cost-Benefit Analysis, 61 AM. POL. SCI. REV. 417 (1967) (explaining how corruption was a response to economic circumstances and could be beneficial); Steven R. Salbu, Information Technology in the War Against International Bribery and Corruption: The Next Frontier of Institutional Reform, 38 HARV. J. LEGIS. 67, 86 (2001) (reporting that in “many places and in many instances, corruption represents a successful adaptation to the world in which people find themselves”).


See Kevin Davis, et al., Ethnically Homogenous Commercial Elites in Developing Countries, 32 LAW & POL’Y INT’L BUS. 331, 340 (2001) noting reports that native Fijians “are accustomed to a subsistence lifestyle” and that Sub-Saharan Africans suffer from an absence of trust and “predilection for engaging in conspicuous consumption rather than reinvesting profits in their businesses”).


See ORDER WITHOUT LAW, supra note 000, at 154 (reporting tendency among sociologists to treat social norms as if they were “exogenous givens”).

See, e.g., Amartya Sen, DEVELOPMENT AS FREEDOM 243 (1999) (addressing how the “image of regional self-sufficiency in cultural matters is deeply misleading” and how many “national traditions” in fact bear the imprint of past outside influences).

Sowell, for example, suggests that a group’s culture may be a rational response to their geographic circumstances. See Schuck, supra note 000, at 1747.

Certain ethnic immigrant minorities may succeed in countries with poor legal institutions, because of their ethnically-based trading networks, that require little legal enforcement and thus causes them to “incur lower contracting costs” than do other groups. Ethnically Homogenous Commercial Elites, supra note 000, at 347. If this is the case, improving legal institutions would simply extend those benefits to other groups and have a positive economic effect.
Many cultural features suggest the presence of underlying self-interest, and a historic review of cultural features suggests that they are “quite often shaped by politics.” Fuller suggests that it was the law that made murder culturally taboo, rather than vice versa. The same is true of other behaviors, such as tax compliance. The American South clearly had a cultural norm of racism and segregation that for a time was reinforced by the law but later largely overcome due in significant part to legal change.

A society’s culture may be an endogenous product of societal institutions, or even a state of poverty itself, rather than an exogenous constraint that controls the effect of institutions.

Fareed Zakaria observed:

Cultural explanations persist because intellectuals like them. They make valuable the detailed knowledge of countries’ histories, which intellectuals have in great supply. They add an air of mystery and complexity to the study of societies. But culture itself can be shaped and changed. Behind so many cultural attitudes, tastes, and preferences lie the political and economic forces that shaped them.

Much of what passes for culture “is not the inevitable result of people’s ethnic or idiosyncratic traits but of their rational evaluation of the relative costs and benefits of entering the legal property system.” As the rules of that system change, so will rational behavior. An anthropological investigation of sixty pre-industrial societies found that their cultures of production and distribution could largely be explained by standard economic variables. Another study of marriage and family systems found that “the economic determinants of these social customs are statistically significant.”

Economists may regard culture as a factor that determines an individual’s “tastes” or “preferences.” While such tastes are often treated as exogenous to a system, they may in fact be altered by different legal regimes. Robert Cooter has explained several ways in which this may

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139 The Quality of Government, supra note 000, at 230.
144 See, e.g., Daniel S. Landes, Why Are We So Rich and They So Poor?, 80 AM ECON. REV. PAPERS AND PROCEEDINGS 1 (1990) (observing that “values” are a problem for developers, because they “tend to be reinforced by economic failure”).
145 Quoted in THE MYSTERY OF CAPITAL, supra note 000, at 225.
146 Id. at 226.
147 See UNINTENDED CONSEQUENCES, supra note 000, at 14 (discussing research in Fredric L. Pryor, THE ORIGINS OF THE ECONOMY: A COMPARATIVE STUDY OF DISTRIBUTION IN PRIMITIVE AND PEASANT ECONOMIES (1977)).
148 See UNINTENDED CONSEQUENCES, supra note 000, at 14
occur, albeit in a slightly different context. He describes how the law can influence a party’s tastes for civic participation and other values, for example, through expressions of intent by a “credible state.” It is of course faithful legal practice that lends credibility, so that legal rules and procedures may be central to the modification of cultural practices. Cooter notes that for “bad men” the import of the law may only be its deterrent effect but that society also contains “good people” who ethically adhere to the law. Although he suggests that the law may be especially effective when aligning itself with preexisting cultural attributes, when those attributes are perverse he also observes that such values “are sufficiently malleable for law and policy to influence them in ways affecting the working of the state.” “Culture” is not necessarily exogenous and immutable. Neither is it necessarily worthy of respect, as local cultures have historically engaged in various despicable practices.

Economic difficulties in the nations of Africa may be attributed to cultural factors. In the African continent, land ownership has historically been considered “communal” rather than the individualistic approach associated with property rights. Yet despite this culture and the lack of legal institutions that guarantee individualistic property rights, parties have acted so as to create individual ownership of land. Moreover, the legal institutions in Africa have steadily but slowly evolved in the direction of individualism. Africa’s economic difficulties may be centrally attributed to weaknesses in their legal institutions.

While some may ascribe East Asia’s economic success to its culture (called “East Asian exceptionalism”), the historic record in Asia is also contrary to such explanations. As Professor Chua notes, Confucianism was “touted as wealth promoting . . . until the recent Asian financial crisis.” It was actually “deviations from Japan’s Confucian past [that] in large part explain its extraordinary economic success.” Culture was not the basis of the East Asian “miracle economies” – they shared the same culture in the decades before their economic successes, and

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150 *Id.* at 11.

151 *Id.* at 18.

152 *Id.* at 20.

153 *Id.* at 23.

154 Besley, *supra* note 000, at 904.

155 *Id.* at 906 (reporting that Africans have planted additional trees on their land in an effort to lay individual claim to the land itself).

156 *Id.* at 904 (observing that the communal land tenure systems in Ghana “have gradually been supplanted by individualistic property rights”).

157 See Adebayo Adedeji, *An Alternative for Africa*, in *ECONOMIC REFORM AND DEMOCRACY* (Larry Diamond & Marc F. Plattner, eds. 1995) at 129 (urging that a “legal system that fully and fairly enforces such standards is obviously essential”).

158 *The Paradox of Free Market Democracy, supra* note 000, at 342,

159 *UNINTENDED CONSEQUENCES, supra* note 000, at 139.
their relative levels economic success varied considerably. In Korea, the rate of economic growth clearly varied with government policies. An in-depth study of the recent record of six East Asian economies over thirty-five years set out to test whether law was important or irrelevant and whether different cultures should rely upon different legal structures. The authors found that the nations had undergone legal change, primarily associated with the importation of Western legal concepts. They further found that this change had apparently contributed to rapid economic growth among these countries. In Asia, as in the West, legal institutions are key to economic growth.

One of the common cultural characteristics that supposedly interferes with legal institutions and capitalist markets is ethnic division, and research has found an effect of such divisions on economic growth. It would be unsurprising that such ethnic division would have some adverse effect on a country, if only because it surely complicates governance to have populations deeply divided by background and language. This division may be captured by a variable called ethno-linguistic fractionalization, which “estimates the probability that two persons, randomly selected among a country’s population, will belong to two different ethnic groups.” A recent study of African nations found that, once institutional variables were accounted for, ethno-linguistic fractionalization had no statistically significant effect on growth. Indeed, the only equation in which ethno-linguistic fractionalization was significant found that it had a positive effect on growth. The study’s rule of law variable, by contrast, had a significant impact on growth. While there may be an apparent negative association between ethno-linguistic fractionalization and economic growth, it has disappeared when control variables are introduced.

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160 See Minxin Pei, The Puzzle of East Asian Exceptionalism, in ECONOMIC REFORM AND DEMOCRACY, supra note 000, at 116 (noting that the “pace, depth, and viability of economic reform vary enormously across the region”).

161 See UNINTENDED CONSEQUENCES, supra note 000, at 138 (observing that “social rates of return improved in the early part of the period, when Korean policy moved toward openness, and fell (from 31% to 19%) in the second half (1974-1979) when dirigiste policies were adopted”).

162 See Pistor & Wellons, supra note 000, at 21 (discussing these hypotheses).

163 See id. at 278 Figure 8.1 (showing that the legal systems generally had moved from traditional state-based discretionary structures to Western-style rule-based market systems during the time period). Though some differences remain, “Asia’s growth experience largely resembles the different paths of economic and institutional change taken historically in the West.” Id. at 286.

164 See id. at 1 (reporting that “[l]aw played an important role in “Asia’s remarkable economic growth during the second half of the twentieth century”).


166 Englebert, supra note 000, at 9.

167 See id. at 21 (Table 2).

168 See id. at 24 (Table 3).

169 Id. at 18.

170 See, e.g., The Quality of Government, supra note 000, at 245 (finding that negative effect became insignificant once authors controlled for per capita income and latitude).
There should be little doubt that cultural variables will have an effect on economic growth. For example, some cultures deny education and equality of opportunity to women. Those restrictions are the economic equivalent of a fighter tying one of his hands behind his back. Abandoning a vast pool of human resources must inevitably harm economic growth.\textsuperscript{171} But this cultural feature, like others, is not immutable. The extension of legal rights to women will alter such a culture and, coincidentally, enhance its economic welfare.\textsuperscript{172}

There is relatively little persuasive evidence that culture has a predominant economic effect that overrides the importance of legal institutions. The effects of culture might readily be distinguished from the effects of institutions, simply by examining the behavior of immigrants. It is established that some immigrant groups have had greater success.\textsuperscript{173} However, that may only prove that the group is more quickly adaptable to a different set of circumstances, not that cultures are impervious to such circumstances. Some have asserted that cultural factors are crucial to individual savings, but a more rigorous study of immigrants had found no cultural effect on savings behavior.\textsuperscript{174} Many immigrants from other cultures have thrived under the legal institutions and free market system in the United States.\textsuperscript{175} This fact suggests that such institutions and markets may well have a positive effect in other countries.

Rather than undermining the effect of legal institutions, cultural issues may simply make them all the more important. Thus, “good institutions are most necessary and beneficial where there are ethnolinguistic divisions.”\textsuperscript{176} Legal institutions may provide the “social glue” for transactions that is necessary when society is so divided.\textsuperscript{177} A World Bank study found that high quality institutions, such as rule of law and property rights, mitigated the adverse economic consequences that have been associated with ethnolinguistic fractionalization.\textsuperscript{178} A very

\textsuperscript{171} See, e.g., The World Bank, ENHANCING WOMEN’S PARTICIPATION IN ECONOMIC DEVELOPMENT 25 (1994) (discussing substantial economic benefits to educating women and how their labor market participation “increases economic efficiency”).

\textsuperscript{172} See Nicholas D. Kristof, The Veiled Resources, N.Y. Times, December 11, 2001, at A27 (reporting that “[h]istory has repeatedly shown the economic advantages of education and autonomy for women, and indeed the West pulled ahead of the rest of the world beginning in the 1400’s partly because it was educating more girls”).

\textsuperscript{173} See supra note 000.


\textsuperscript{175} See THE MYSTERY OF CAPITAL, supra note 000, at 226 (reporting that “Vietnamese, Cuban and Indian migrants have clearly had few problems adapting to U.S. property law”).


\textsuperscript{177} Id.

\textsuperscript{178} See William Easterly, Can Institutions Resolve Ethnic Conflict?, World Bank Policy Research Working Paper 2482 (November 2000). The lessened trust among different ethnic groups undermines the social cohesion necessary for informal legal substitutes. Id. at 6. Moreover, “[g]ood institutions may mitigate ethnically-based social conflict that lowers growth. Id. at 8. Using measures of ethnolinguistic fractionalization and ICRG scores for rule of law and related variables, the study concluded that “sound
comprehensive study found that legal systems transcended ethnolinguistic divisions and had a powerful effect on growth even with the fractionalization controlled. Yet another recent study found that ethnic fractionalization showed no effect on growth, once policy variables were considered.

A recent more rigorous cross-country study that found some effect of culture on economic growth. It employed sociological survey research that provided scores for various countries on features such as relative individualism, a “masculinity index,” a measure of inequality, and uncertainty avoidance. Of the cultural factors, the author found a significant negative effect for uncertainty avoidance. This result is certainly consistent with economic theory, as such cultures would be less likely to embark on the entrepreneurial risk-taking associated with growth. This finding of relevance for culture does not mute the significance of traditional legal institutions – it enhances that significance. By providing better assurances of property rights and contract enforcement, the law reduces the uncertainty that may be associated with investment and may help overcome cultural barriers to economic development.

Another cross-country study found an effect for “social capital.” Social capital was defined as the level of trust in a society, measured both in terms of trusting family members and trusting people in general. The author found that higher levels of trust correlated with higher economic growth rates. However, many other cultural factors such as Confucianism, corporatism, and values generally had no effect.

While some attribute economic consequences to faith, such as Islam, researchers have suggested that “given the protean nature of Islamic economic precepts, Muslims have been able to pick and choose among them, and so Islam is irrelevant in explaining the fluctuating economic fortunes of Muslim
This research also found that the level of financial investment was much more significant than even the cultural social capital for economic growth. Other research has found some economic effect of a country’s race and religion but a significant independent positive effect of liberty and democracy after controlling for race and religion. Thus, cultural factors should be conceived of as more of a complement to traditional legal and economic explanations, rather than as a barrier to or substitute for such explanations.

It would be foolish to say that a society’s culture was irrelevant to any aspect of that society, especially a significant one like economic growth. But the ultimate significance of these cultural factors has not been demonstrated. North has emphasized the importance of “culturally derived norms of behavior” and their interaction with the formal legal rules. However, culture is not destiny. The critical institutional legal rules and institutions for growth need not be precluded or obstructed by cultural barriers, as the empirical evidence shows. The implementation of certain basic principles of law and economics may have to be adapted to local situations. While it is undoubtedly true that transplanting legal institutions in new cultures will work imperfectly, the transplantation procedure may still be the most pragmatic and effective approach to development. Joel Trachtman suggests that those engaged in law and development

societies.” UNINTENDED CONSEQUENCES, supra note 000, at 56. Economic successes in a number of Islamic nations “show that it is not Islamic beliefs in themselves that have hindered development but dysfunctional etatism and dirigisme.” Id. at 66.


See Joel P. Trachtman, The Applicability of Law and Economics to Law and Development: the Case of Financial Law, in MAKING DEVELOPMENT WORK, supra note 000, at 204 (suggesting that principles of law and economics succeed “not by ignoring local differences, but by evaluating local rules against potential substitutes so as to determine which structure is more efficient to achieve local preferences”).

A middle ground is suggested by A Legal Theory of Emerging Economies, supra note 000. Phil Nichols suggests that formal contracting institutions need to be introduced into poorer nations but that this introduction will be affected by local cultural factors and not result in institutional practices that are “coincident with that of the West.” Id. at 296.

See, e.g., The Paradox of Free Market Democracy, supra note 000, at 301 (conceding that cultural explanation often suffers from “ad hoc residualism and non-falsifiability”).

INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, supra note 000, at 140. See also Andrzej Rapaczynski, The Roles of the State and the Market in Establishing Property Rights, 10 J. ECON. PERSP. 87 88-89 (1996) (discussing how a legal system cannot enforce all property rights disputes and requires self-enforcing mechanisms as well).

See Knieper and Boguslavski, supra note 000, at 123 (reporting that a nation’s historic features should be taken into account but that universal principles of commercial law are not altered by that history). The necessary adaptation may have less to do with “culture” as it is commonly conceived than with the legacy of political and economic structures of the nation in question. See, e.g., id. at 118-120 (reporting that efforts to reform post-communist nations suffered for the failure to take into account their historic political and judicial structures)

See Brian Tamanaha, A Pragmatic Approach to Legislative Theory for Developing Countries, in MAKING DEVELOPMENT WORK, supra note 000, at 156 (reporting on Micronesian experience that
unfortunately “oscillate between arrogance and modesty,” when the best answer is to rely on the “confidence earned by methodologically sound and contextually sensitive analysis that will be used not to dictate solutions but to inform politics in the emerging market country.”\textsuperscript{197}

The theoretical debate over the relevance of culture cannot ultimately answer the question. The ability of culture to render legal reform ineffectual should appear in the empirical evidence. If a change in legal institutions has a significant societal impact in different cultures, that is evidence that culture is not a barrier to the positive economic effects of law. The empirical data is also a test for whether legal substitutes can be effective in facilitating societal economic growth.

II. **Empirical Research on Law and Economic Growth**

Empirical research on law and economic growth has burgeoned of late, with much of the work done by international economic organizations, such as the World Bank and International Monetary Fund. Before reviewing this research, some context is required. The law may be a necessary but not a sufficient condition for growth or it might be neither strictly necessary nor sufficient but just a contributing factor. Certainly, many other variables have an effect on growth, such as social capital (the relative level of interpersonal trust in a society), human capital (the relative level of a population’s education and skills), resources, and even climate. The existence of these factors will tend to obscure the true effect of law, so that it can be difficult to empirically extract even an authentic association between law and economic growth, amidst the noise of other influential factors. Hence, it will be difficult to identify even a true association, and one might expect to find results only for the most substantial legal and institutional variables, though other rules might still have some meaningful economic effect.

While it is unlikely that we can find general economic growth effects from a particular antitrust doctrine, for example, an effect might be found for major legal variables, such as the presence of democracy, property rights, judicial independence, and the extent of government regulation. Such findings may also guide us on more specific legal questions. A finding that recognition of individual freedom is generally wealth-enhancing, for example, would suggest if not prove that positive economic benefits may result from particularized expansions of such freedom, even if those expansions are not in themselves so significant as to produce empirically identifiable benefits.

Perhaps the most significant topic of ongoing empirical research is the effect of democracy on economic growth. While democracy is not readily quantifiable, it has been operationalized by measures of free electoral process, freedom of opposition parties, and the presence of more than one significant party.\textsuperscript{198} Democracy might be expected to contribute to legal transplants “seldom work in precisely the same way in the transplanted milieu as in their place of origin,” but that “does not mean they do not work at all,” so that transplantation may be the “most efficient” source of legal development).

\textsuperscript{197} The Applicability of Law and Economics to Law and Development, supra note 000, at 196. Like so many debates, the significance of law and economics is too often cast as a Manichean debate between those who view it as a cure-all and those who dismiss it as worthless.

\textsuperscript{198} A common tool used for quantitative measures of democracy is that of Freedom House, which considers such variables. See Raymond D. Gastil, FREEDOM IN THE WORLD: POLITICAL RIGHTS AND CIVIL LIBERTIES (1978 and ensuing years). These are sometimes referred to as the Gastil estimates, after their author. An alternative is known as the Polity data set. See Keith Jaggers and Ted Robert Gurr, Polity III: Regime Type and Political Authority, 1800-1994, Inter-University Consortium for Political Research, Study number 6695.
growth because authoritarian regimes may be predatory expropriators of wealth and because accountability and competitive political markets create an incentive for democratic leaders to increase the welfare of their constituents. Some, however, argue that democracy itself is predatory and redistributive and that democratic regimes lack the ability to make the long-term commitments necessary for true economic reform.

Empirical evidence is needed to resolve the dispute over the economic effects of democracy. This evidence, though, does not produce consistent results. Przeworski & Limongi reviewed eighteen studies, eight of which found that democracies developed faster, eight of which found that authoritarian regimes grew faster, and two of which found no difference. It is intuitively difficult to believe, though, that such a central and important feature of governance as democracy has no economic effect. The inconsistent research may fail to account for complicating factors, or it may be that democracy may enhance economic welfare under some background circumstances but may be counterproductive under other circumstances. There is also a simultaneity or reverse causation difficulty in the empirical evidence – in the studies showing a positive effect, it may be that democracy produces growth but could be that growth produces democracy.

A recent study by Jenny Minier appears to provide the best evidence for understanding democracy and economic growth. Her study focused on significant changes in a country’s level of democracy, rather than its absolute level, which enables a check on the reverse causation problem. Any time a regime changes, there is instability and a need to establish new institutions, which are generally bad for economic growth. However, she found that new democracies did

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199 See Jack Donnelly, Human Rights, Democracy, and Development, 21 HUM. RIGHTS Q. 608 (1999) (suggesting that democracy can restrict predatory misrule)

200 See POWER AND PROSPERITY, supra note 000, at 18-19 (suggesting that democratic governance provides a greater incentive to expand the overall economic pie); David A. Lake & Matthew A. Baum, The Invisible Hand of Democracy, 34 COMPARATIVE POL. STUDIES 587 (2001) (reporting evidence that competitive political markets promote efficiency in the provision of public goods and services).

201 See, e.g., Pranab Bardhan, Symposium on Democracy and Development, 7 J. ECON. PERSP. 45, 45 (1993) (noting that democracies “may actually be more susceptible to pressures for immediate consumption and other particularistic demands that may hamper long-run investment”). J. Benson Durham, Economic Growth and Political Regimes, 4 J. ECON. GROWTH 81, 82 (1999) (noting argument that dictatorship may “more effectively stimulate growth and investment by suppressing labor unions, wages, and consumer demand – very unpopular measures”).

202 Przeworski & Limongi, supra note 000, at 61 (summarizing results in Table 1).

203 One study has suggested that democracy and economic growth may be positively related at low levels of democracy but negatively related at higher levels. Robert J. Barrow, Democracy and Growth, 1 J. ECON. GROWTH 1 (1996).

204 See Ross E. Burkhart, Economic Freedom and Democracy: Post-Cold War Tests, 37 EUROP. J. POL. RES. 237 (2000) (reviewing literature that suggests that capitalism promotes economic development); Law and Economic Development: A New Beginning, supra note 000, at 558 (noting that experience indicates that “political liberalization may indeed follow upon the heels (though not always immediately) of economic development”).

205 Minier, supra note 000.

206 Id. at 247. In addition, the upheaval associated with a shift to democracy may cause a “temporary worsening of property rights.” Christopher Clague et al., Democracy, Autocracy, and the Institutions
not suffer the expected slowing of growth but in fact did well economically.207 She also broke the countries of the world down into groups in a regression tree analysis, differentiating between poor and rich countries and varying levels of literacy, finding that democracies tended to have better education and more investment.208 In addition to finding that countries becoming democratic grew faster than expected, countries that saw a drop in their level of democracy grew more slowly in both the short run and long run.209

No study provides the final word on social scientific questions, but Minier’s well designed study does provide persuasive evidence that democratization of government enhances growth. Its persuasiveness is enhanced by other research finding that democracies tend to have greater property rights than do autocracies.210 Democracy appears to be a legal structure that contributes to a society’s economic welfare. While this macro-level finding does not directly inform us about the merits of more detailed democratic rules (such as particular laws governing elections and recounting), it could suggest that the more democratic among a choice of rules may likewise contribute to economic growth. However, one can imagine that there is some optimally democratic point, beyond which additional democracy (e.g., direct democracy and the elimination of representatives as intermediaries) would be contrary to economic wellbeing.

Another well-studied legal determinant of growth is economic freedom. This concept is generally operationalized as the establishment of secure property rights and the freedom to engage in voluntary transactions and their enforcement by government.211 There are various scales that have been used to measure relative international levels of economic freedom.212 These indices, though, have a number of components that would not be considered legal rights, or even legal matters at all.213 An alternative measure uses investor guides, based on the expert opinions

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207 See id. at 253 (observing that the “countries that democratized were predicted to grow more slowly than their control groups; in fact they tended to grow faster”).

208 See id. at 260-261 (Tables 7 & 8).

209 See id. at 261-262.

210 See Christopher Clague, et al., Property and Contract Rights in Autocracies and Democracies, 1 J. ECON. GROWTH 243 (1996). Rather than testing the indirect association between democracy and growth, this study tested the relationship between democracy and the intermediate variable of property rights and contract enforcement. It found that democracies consistently outperformed autocracies in protecting these rights. Id. at 258.


213 For example, they may include factors such as total government spending and national price stability. See ECONOMIC FREEDOM OF THE WORLD, supra note 000, at 7. The Heritage Foundation
of private professional consultants that assess the legal institutions of nations. Still another measure is “contract-intensive money” (CIM). This measures the extent of money held in banks or invested in other financial institutions or instruments and may be directly explained by the relative availability of government enforcement of contracts in a nation.

All of the above measures have been used for empirical research on the effect of economic freedom on economic growth. Research by the Fraser Institute and Heritage Foundation authors have found that their indices are significantly correlated with growth. One study broke down the Fraser Institute index and found that property rights were especially important for growth, more important than limited government. Empirical research using the investor guides has likewise found that economic liberty was a significant determinant of growth. The same is true for CIM-based research. While this research has the same potential simultaneity problem as the democracy research, there is empirical evidence to suggest that it is economic freedom that produces growth. The research has not yet established, though that the relationship is a linear one and that more economic freedom will always contribute to greater growth.

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See, e.g., Why Don’t Poor Countries Catch Up?, supra note 000, at 592 (noting the two main services, the International Country Risk Guide (ICRG) and Business Environmental Risk Intelligence (BERI)). These measures have the merit of passing the market test – businesses pay to subscribe to the services and obtain the information. See Daniel Kaufmann, Aart Kraay & Pablo Zoido-Lobaton, Governance Matters, World Bank Policy Research Working Paper 2196 (October 1999) at 5 (noting that these organizations “are able to consistently sell their assessments to commercial subscribers for considerable fees”).


See ECONOMIC FREEDOM OF THE WORLD 1975-1995, supra note 000, at xvii. See also id. at 89-110 (comparing the levels of economic freedom and economic growth with descriptive general statistics); See Kim R. Holmes & Melanie Kirkpatrick, Freedom and Growth, WALL ST. J., December 16, 1996, at A16 (summarizing results of study).

Leschke, supra note 000, at 277.


See Contract Intensive Money, supra note 000, at 200-203.

See Why Don’t Poor Countries Catch Up?, supra note 000 at 599-600 (analyzing the possibility that reverse causality explained their results and rejecting it, because of the timing of the independent and dependent variables); Institutions and Economic Performance, supra note 000, at 79-80 (noting that the relationship is strong when the independent variable economic freedom numbers predate the dependent variable growth results).
Another important factor that has seen some legal research is the rule of law. This factor is a procedural one, independent of the substantive content of the law.\textsuperscript{221} It is also very difficult to operationalize for empirical research, though it is estimated in some of the investor guides. The World Bank has embarked upon a major research program on the importance of the rule of law, including a private sector survey of over 3800 enterprises in 73 countries.\textsuperscript{222} They produced a general government credibility indicator for variables such as political instability, the security of persons and property, the predictability of judicial enforcement, and corruption. When the credibility indicator was disaggregated into its components, the most robust predictor of growth was the predictability of judicial enforcement, which was significant in every regression.\textsuperscript{223} The rule of law appears to be particularly important to entrepreneurial enterprises.\textsuperscript{224}

The structure of the judiciary may be critical to preserving the rule of law, but the precise structural requisites are not clearly established. Some suggest that an independent judiciary is an institution central to the preservation of the rule of law.\textsuperscript{225} The theory supporting this position is somewhat obscure, though. If democratic institutions further growth, why would a relatively nondemocratic independent judiciary be a positive? Truly independent judges may become arbitrary or corrupt and thereby undermine the rule of law. The functioning of the rule of law may also be dependent on the resources provided to the judicial branch, or the nature of the bar, or the structuring of the legal system as common or civil law.\textsuperscript{226}

Researchers increasingly have studied the effect of government regulation on economic development. The new institutional economics may be caricatured as propounding a laissez faire ideology, where the primary role of government is to create property rights and enforce contracts and then get out of the way of the market. While some subscribe to this position, it is not a necessary one. Coasean theory calls for “government intervention wherever such intervention reduces transaction costs below those that would exist absent government intervention: it is a rationalization of regulation not a condemnation.”\textsuperscript{227} Free markets may not promote developmental efficiency for a variety of reasons, including information asymmetries. Empirical analysis is necessary to understand the effects of government regulation.

\textsuperscript{221} This institutional setting may be much more important than the substantive component of the laws themselves, which may be ineffective absent a functioning rule of law. Private parties may be able to contract around inefficient rules, but it is “much harder to compensate for the systemic failures of the legal system.” Law, Finance and Firm Growth, supra note 000, at 2114.


\textsuperscript{223} See Credibility of Rules and Economic Growth, supra, note 000, at 367.

\textsuperscript{224} BUILDING INSTITUTIONS FOR MARKETS, supra note 000, at 119 (reporting international study finding that “newly created enterprises, which do not have established supplier and customer networks or significant market power, are most likely to resort to the use of commercial courts”).

\textsuperscript{225} See Whitford, supra note 000, at 738 (declaring that judicial independence was “widely seen as critically necessary to the effective implementation” of a rule of law).

\textsuperscript{226} See infra at ___.

\textsuperscript{227} Trachtman, supra note 000, at 204.
The best-studied area of public regulation is securities law. A larger and more liquid securities market demonstrably contributes to economic growth. Some have argued, as a theoretical matter, that the U.S. securities laws, such as prohibitions on insider trading, interfere with a free market in securities and thereby hamper economic growth. However, there is considerable empirical evidence that the regulation of information found in federal securities law fosters economic growth. Research particular to insider trading laws have found that they also tend to support stronger equity markets. It seems clear that government regulation of securities fraud is conducive to the development of stock markets and the associated benefit of economic growth.

Other forms of regulation have not been so well studied for their economic effects but there is evidence of value. A study of banking regulation in more than 100 countries found that “regulations that encourage and facilitate the private monitoring of banks tend to boost bank performance, reduce nonperforming loans, and enhance bank stability.” Antitrust and other competition laws may benefit economic development. Insofar as environmental laws protect against the externalization of costs and protect public goods, they too might be expected to provide economic benefits.

Just as every successful world economy recognizes property rights and enforces contracts, “every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods services, labor, asset, and financial markets.” It would be closed-minded to blindly attribute economic growth to the former (property rights) but not the latter.

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232 BUILDING INSTITUTIONS FOR MARKETS, supra note 000, at 80. The study included such requirements as an audit by certified external auditors. Id.

233 Id. at 141 (describing benefits of such competition laws).

234 Institutions for High Quality Growth, supra note 000, at 7.
(regulation). There is reason, both theoretical and empirical, to think that some forms of
government regulation of markets may contribute to economic development. Of course,
government regulation also may seriously interfere with growth. Empirical analysis is needed to
distinguish between beneficial and counterproductive regulatory approaches.

III. THE NEED FOR ADDITIONAL LEGAL RESEARCH

While law and governance institutions, broadly defined, clearly are relevant to economic
growth, that finding by itself is not very helpful. For practical purposes, governance requires an
understanding of precisely what laws and implementing organizations are most effective at
enhancing growth and what actions might affirmatively interfere with such growth. While the
role of law may be important in promoting growth, it is clear that more law is not always better
than less law. One cannot even generally say that “more” or “stronger” property rights are better
than fewer or weaker property rights. Lon Fuller stressed that while property and contract rights
were vital to growth, a legal system must restrain the “rigidities of property and contracts” so that
the society could “direct its resources toward their most effective use.”235 Interest groups may
demand the creation of inefficient property rights that amount to rights to a monopoly status. The
creation of property rights in, say, continued employment at a private company could be
economically counterproductive and increase unemployment levels.236 So the questions are
regarding what property rights are beneficial and how they best should be enforced.

Property rights may be viewed merely as protection of private owners against state
expropriation. Even in the absence of such a threat form the state, though, property rights may be
seriously limited by legal constraints on alienability or collateralization.237 There are different
bundles of legal entitlements associated with property rights and the composition of those bundles
may be critical to the economic consequences of those rights. Such rights may be of limited
utility absent effective judicial systems, and they may also require some sort of credible
commitment to future preservation of effective property rights.

In some circumstances, even the most traditional property rights, widely recognized as
economically valuable, may affirmatively interfere with growth. De Soto ascribes the great
economic expansion of the United States to the fact that it abandoned conventional British
common law and violated the property rights of large landowners in order to grant titles to
squatters and spread property rights to a larger number.238 Experience in Peru shows that
programs to provide property to the poor “have failed over the past 150 years whether they
followed the bias of the right (protecting property through mandatory law) or of the left
(protecting poor people’s land in government-run collectives).”239 There is no obvious simple
recipe for success. Studies around the globe have found that titling ownership in real property


236 This is the classical economic wisdom. See, e.g., Daniel S. Hamermish LABOR DEMAND 273
(1993) (noting that common explanation for slow employment growth in Japan and Western Europe is
difficulty in firing workers). There is some empirical research supporting this position. See Edward P.

237 See, e.g., Besley, supra note 000, at 906-907 (noting that in Ghana there was relatively little threat
of expropriation but that the value of recognition of property rights was reduced by restrictions on the rights
of transfer, bequeath, and collateralization).

238 See THE MYSTERY OF CAPITAL, supra note 000, at 110-127.

239 Id. at 168.
has sometimes, but not always, been economically beneficial.\textsuperscript{240} While the protection of some property rights is now recognized as invaluable to economic expansion, the issue is not really a binary one. Key questions are the scope of the rights and the circumstances in which they may be enforced, or compromised.

Even the “rule of law” cannot simplistically be regarded as beneficial. The rigid application of laws may be an economic problem. Latin American courts have been criticized for their “strict adherence to legal form and the letter of the law.”\textsuperscript{241} While a stable legal system has benefits, a “modern market economy requires laws that are able to adapt” and there is a “tremendous flexibility that the legal and judicial systems require in order to adapt laws to a dynamic economic system.”\textsuperscript{242} The stabilizing benefits of precedent may become stifling in effect.

While new institutional economists have often focused on private law, public law may also play a substantial role in economic growth. Interventionist state policies may in fact contribute to economic success, at least within a generally capitalist framework. The East Asian miracle could be attributed to an activist, even mercantilist, state that created cartels, channeled capital investments, and subsidized research.\textsuperscript{243} After their initial takeoffs, however, these nations have migrated in the direction of more traditional economically liberal policies.\textsuperscript{244} The optimal legal rules may depend upon the underlying economic situation of a nation.

One legal question of some importance is the extent to which constitutionalization of law matters. William Riker has declared that “everytime I convince myself that I have found an instance in which constitutional forms do make a difference for liberty, my discovery comes apart in my hands.”\textsuperscript{245} Constitutional protections may represent nothing more than parchment declarations without real world effect. Some empirical research suggests that constitutional recognition of rights is not significant.\textsuperscript{246} Other research suggests that such provisions may sometimes have an effect, depending on the circumstances of other institutions.\textsuperscript{247}

\begin{thebibliography}{99}

\bibitem{240} \textit{Building Institutions for Markets, supra} note 000, at 36 (discussing evidence of positive effects in Thailand and Brazil but lesser success in other very poor regions of the world).

\bibitem{241} \textit{Judicial Reform and Civil Society, supra} note 000, at 87.

\bibitem{242} Edgardo Buscaglia, \textit{Introduction}, in \textit{The Law and Economics of Development, supra} note 000, at 3.

\bibitem{243} \textit{See}, e.g., Katharina Pistor & Philip A. Wellons, \textit{The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995} 10 (1999) (reporting that a “relatively high level of state involvement was compatible with, and perhaps even conducive to, economic growth”).

\bibitem{244} \textit{See} Ginsburg, \textit{supra} note 000, at 839 (reporting that by the mid-1980s, these nations “shifted to more market-oriented solutions” and had an “increased recourse to formal law” and associated increase in litigation in all the East Asian nations other than Japan).


\bibitem{246} \textit{See} Xavier de Vanssay & Z.A. Spindler, \textit{Freedom and Growth: Do Constitutions Matter?}, 78 \textit{Pub. Choice} 359 (1994) (reporting that the constitutional entrenchment of rights had no apparent effect on growth); Joel S. Hellman, \textit{Constitutions and Economic Reform in the Post-Communist Transitions}, in \textit{The Rule of Law and Economic Reform in Russia, supra} note 000, at 55 (reporting that the establishment of a constitution had at best marginal value in promoting economic reform in Eastern European nations).

\bibitem{247} \textit{See}

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constitutionalization, there is a question whether the substantive content of any law genuinely matters, or whether all is politics and results are contingent on institutional arrangements rather than legal text. One study has, intriguingly, found that constitutional protection of religious freedom seems to be a significant factor in the protection of economic freedom. Legal academics are positioned to make a substantial contribution to the investigation of law and economic growth and help answer questions such as the importance of constitutionalization and legal text. The participation of law professors would undoubtedly enhance the accuracy of the measures of factors such as property rights and rule of law. Those who are familiar with the law may also identify other variables that might appropriately be employed in the empirical investigations, variables that economists or political scientists may overlook. Legal academics may also broaden the scope of the research and address relatively unexplored areas of the law.

The study of tort law offers much promise. Legal academics are in the best position to assess differences, both substantive and procedural, in comparative laws of tort liability and design research to test for the effects of such differences. One might expect such standards to have material economic impact. To the extent that such law internalizes the costs of production, it should contribute to economic efficiency and growth, but commentators have conversely lamented that tort litigation can be oppressively redistributive and inefficient. Some limited research on data from eleven nations found no significant effect of tort litigation on economic wellbeing.

Law professors may also contribute to study of the practical functioning of legal institutions. While considerable attention has been paid to judges and court systems, the role of lawyers should be examined. Attorneys are agents and producers of the law, who may serve as transaction cost engineers that facilitate the development of business enterprises. Yet the same legal profession that may be “necessary for growth” is also the group best-positioned “to sabotage capitalist expansion.”

The raw number of lawyers may affect its growth rate, as “developing countries face serious shortages of lawyers with the training and skills to play these roles in a market economy.” Some economists have argued that the U.S. and other nations have too many lawyers with a negative economic effect, though these studies are disputed.

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248 Zane A. Spindler & Xavier de Vanssay, Constitutional Design and Economic Freedom (September 16, 2000).

249 Critics have claimed that “current legal arrangements led to major detrimental effects on the U.S. economy,” such as “limitations on the availability of products, increases in product prices, and discouragement of innovation.” Steven Garber, Tort Liability and Economic Performance: Research Challenges, in JUDICIAL REFORM IN LATIN AMERICA AND THE CARIBBEAN, supra note 000, at 27.


251 For a review of some of the valuable services that lawyers provide business, see Charles Silver & Frank B. Cross, What’s Not To Like About Being a Lawyer?, 109 YALE L.J. 1468-69 (2000).

252 THE MYSTERY OF CAPITAL, supra note 000, at 197-198.

253 Webb, supra note 000, at 38.

254 See, e.g., Stephen P. Magee, et al., BLACK HOLE TARIFFS AND ENDOGENOUS POLICY THEORY 119 (1989) (reporting empirical test indicating negative effect of lawyer numbers); Kevin M. Murphy et al., The Allocation of Talent: Implications for Growth, 106 Q. J. ECON. 503 (1991) (reporting that ten percent increase in law school enrollment caused 0.3% decline in economic growth).
important than raw numbers may be the local legal culture\textsuperscript{256} or the self-regulation practices of the bar.

**CONCLUSION**

The advancement of economic wellbeing is an important societal objective. The law may play an important role in achieving that objective. Yet law professors have not attended to this relationship as much as they should. The importance of legal institutions and governance for economic growth is now relatively well accepted in the economics profession. The association has been well demonstrated, both theoretically and empirically. But this generalized finding of economists leaves many of the most important questions unanswered.

Those of a “law and economics” bent have certainly helped explicate some aspects of the association between legal rules and economic development. Within law schools, though, this research has been produced by a small segment of the professoriate and has not been particularly comparative or even commonly empirical. Nor has it been especially evenhanded. Broader research is needed on the economic effects of law. This need not take the form of large cross-country studies such as most of those I have described. Individual country studies of legal change are informative. Within the United States, comparisons of state laws may inform. At whatever level, it would behoove legal academics to conduct additional research on the practical consequences of the law, including economic growth.


\textsuperscript{256} See Walde & Gunderson, *supra* note 000, at 80 n.80 (reporting that the “emphasis on legal culture – the specific habits, procedures, attitudes, induction and community rituals and communication media of the professional community of the lawyers – seems to be a condition for the emergence of at least a Western system of market economy law”).}