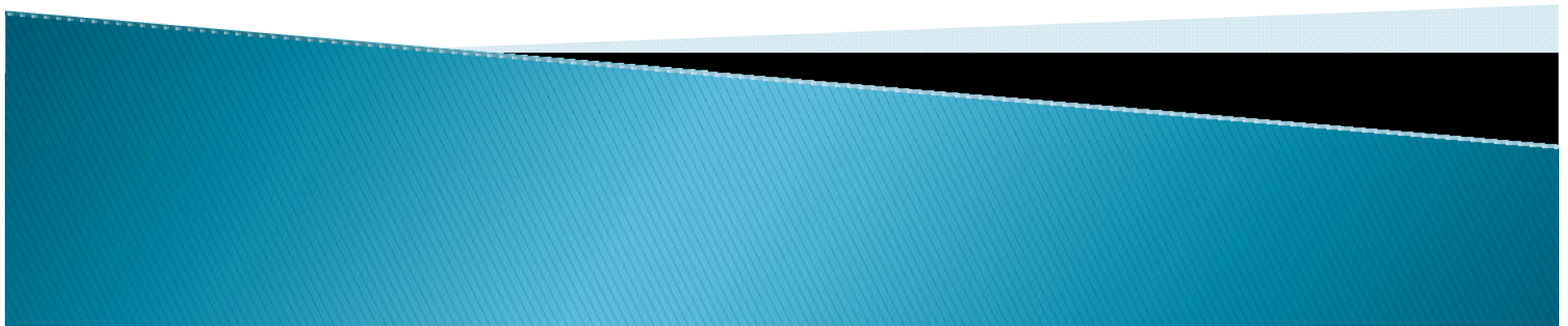


The Legal and Judicial Framework for Economic Growth

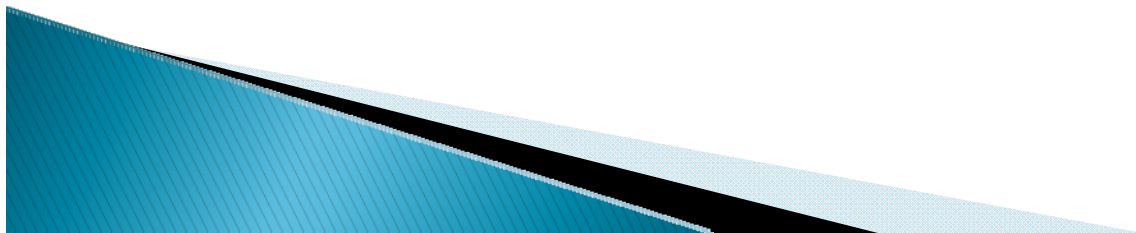
Eric A. Posner

University of Chicago Law School



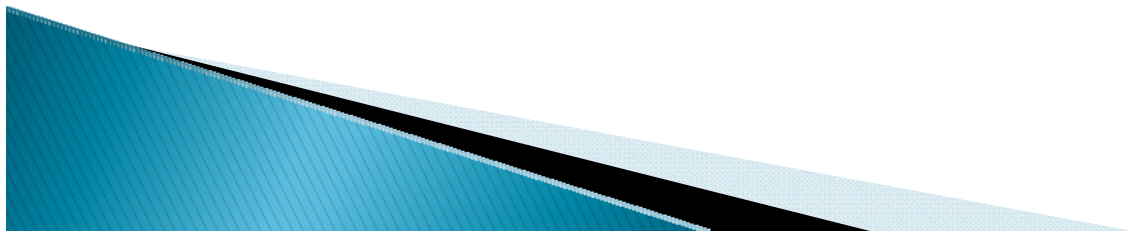
Outline

- ▶ What Explains Economic Development
- ▶ How the Law Helps
- ▶ The Importance of the Judiciary
- ▶ Alternatives to the Judiciary
- ▶ Reform



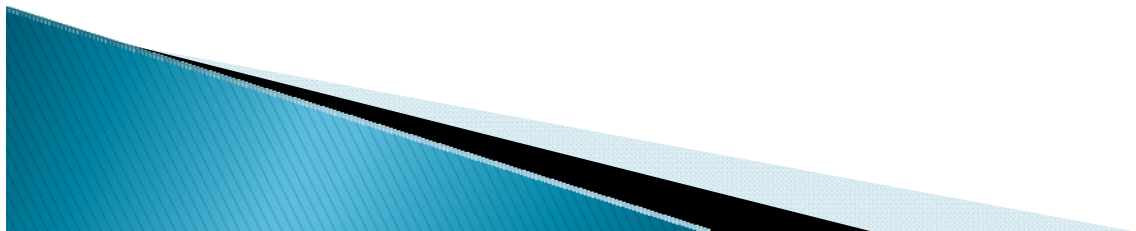
What Explains Economic Development?

- ▶ Natural Resources?
- ▶ Culture?
- ▶ **Institutions**
 - Law
 - Property Rights
 - Enforcement of Contracts
 - Courts
 - Competent and Independent Judges
 - Rational Legal Procedures

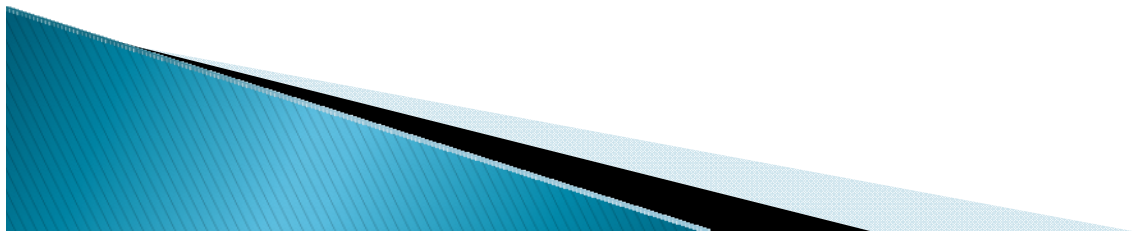


An Example

- ▶ An entrepreneur wants to open a factory to make cars
- ▶ Success is good for:
 - The entrepreneur
 - Consumers who buy cars
 - Suppliers (for example, sellers of leather for car seats)
 - Investors and creditors
 - Workers in the factory and affected firms
 - Government which obtains tax revenues



- ▶ Challenges for the entrepreneur
 - Acquiring a factory and protecting it from squatters and others who want to use it
 - Persuading creditors, suppliers, and investors that he will pay them back
 - Persuading buyers that the cars will be high-quality



How the Law Helps

▶ Property law

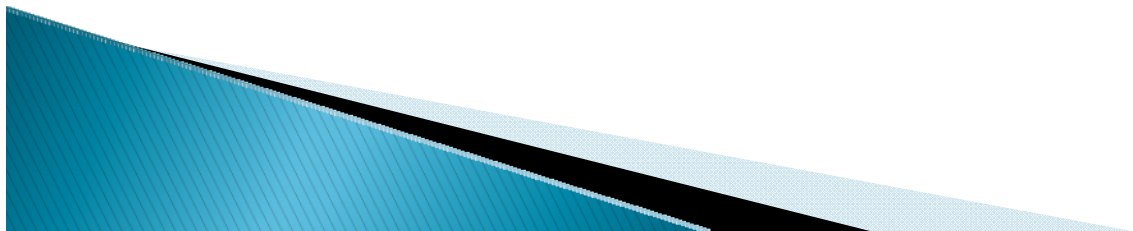
- The entrepreneur must believe that if he buys the factory (at great expense), he will earn revenues greater than the cost.
- Good property law prevents other people from taking, using, or encroaching on the factory.
- For example, trespass law. If someone trespasses, the entrepreneur has the right to have him removed by the police.
- For example, tort law. If someone damages the factory, the entrepreneur has the right to obtain compensation.



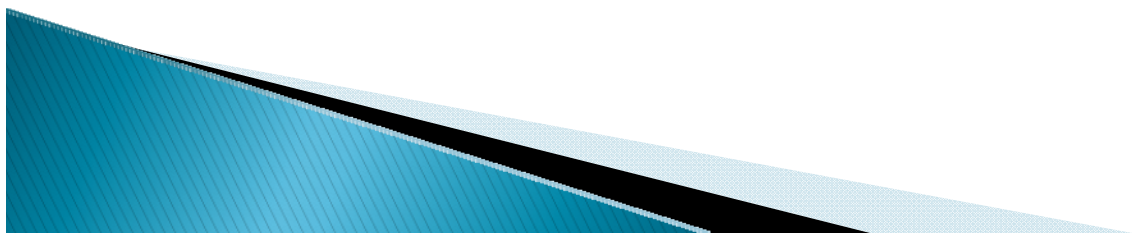
How the Law Helps

▶ Contract Law

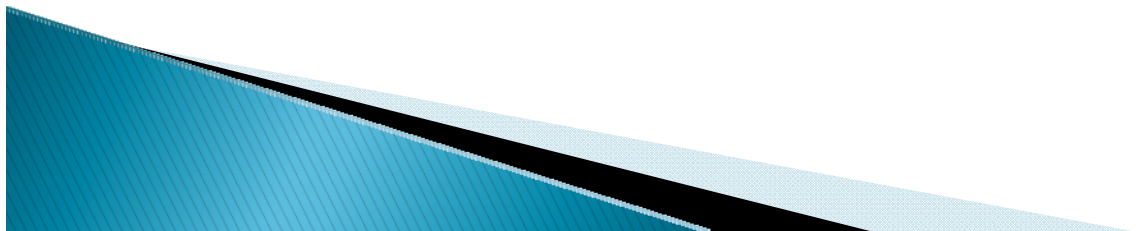
- The entrepreneur must enter numerous contracts
 - Suppliers: leather today in return for cash in a month
 - Creditors: cash today in return for principal plus interest in a month or a year or longer
 - Investors: cash today in return for a share of the profits
 - Customers: the car today (perhaps with a warranty) in return for cash in the future
 - Workers: cash for work



- The contracts must be enforceable. Various problems:
 - Suppose the entrepreneur makes a contract with the seller of leather:
 - The seller does not deliver the leather on time
 - The seller delivers the leather but it has defects
 - The entrepreneur fails to pay for the leather
 - The leather is destroyed by an accident in transit: who bears the loss?
 - The parties misunderstood each other when they negotiated the deal; how should the deal be unraveled?

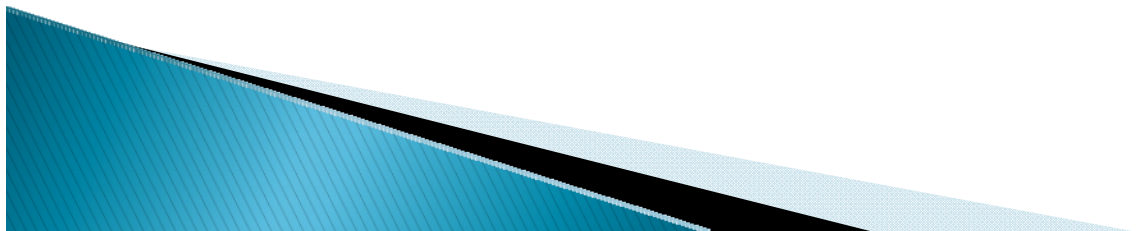


- Contract law solves these problems
 - The judge interprets the contract when it is ambiguous
 - The judge enforces the contract and requires breachers to pay damages
 - The judge applies “default rules” to address cases (like destruction of the goods in transit) that the contract does not address



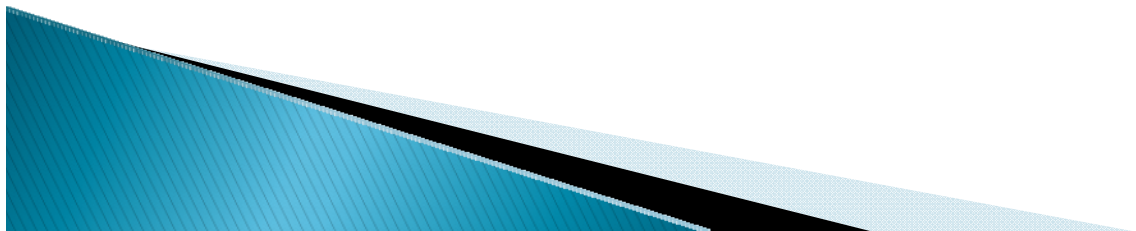
The Importance of a High-Quality Judiciary

- ▶ The problem of corruption
 - If judges accept bribes, then outcomes are biased or litigation becomes more expensive
 - The same problem exists if judges take orders from political superiors: judges need independence
- ▶ The problem of incompetence
 - If judges are not intelligent and highly educated, they cannot understand business. If they cannot understand business, they cannot enforce contracts properly.

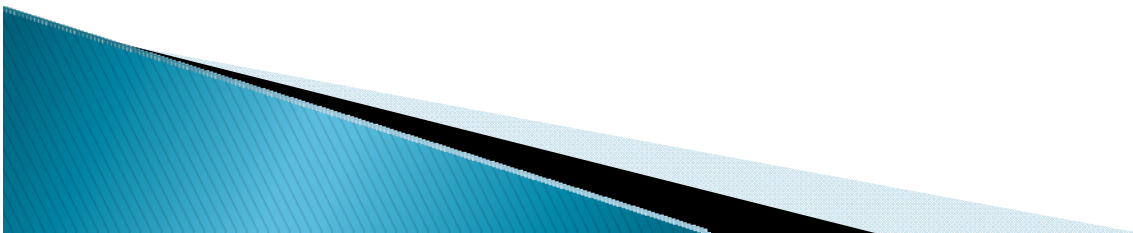


The Importance of High-Quality Judicial Procedures

- ▶ Judicial procedures are complex; they govern issues such as:
 - How much time parties have to submit papers
 - How many chances to appeal
 - What kind of evidence can be submitted
 - How property is seized and liquidated in order to satisfy judgments

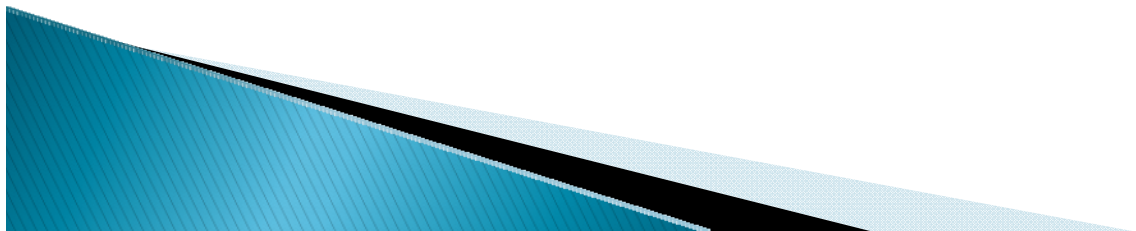


- ▶ A recurrent problem in developing countries is that judicial procedures are
 - Too slow
 - Too complex
 - Too favorable for defendants



Are There Alternatives to High-Quality Judicial Systems?

- ▶ Reputation
 - Only works for small-scale transactions
- ▶ Nonlegal enforcers
 - Creates crime and disorder
- ▶ Arbitration and mediation
 - Arbitration and mediation are highly effective;
 - They can be faster and take advantage of expertise;
 - BUT: they require the judicial system as a backup. Only courts can review and enforce arbitration awards.



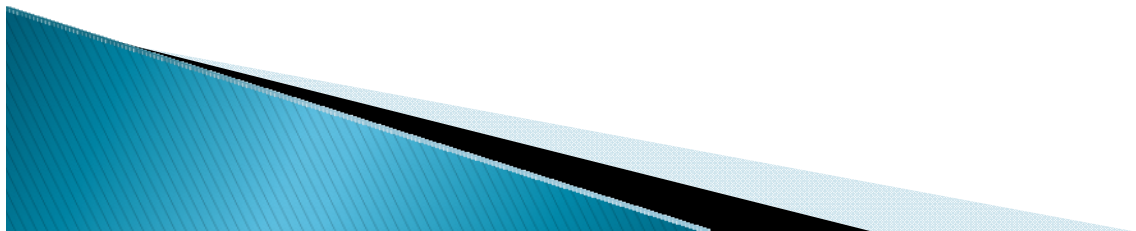
The Evidence

- ▶ Academic studies show that stronger “rule of law” is associated with:
 - More valuable stock markets
 - A larger number of listed firms
 - Larger listed firms
 - Higher dividend payments
 - Lower concentration of ownership and control
 - Lower private benefits of control
- ▶ In addition, very strong correlations between “rule of law” measures and economic growth but causality is uncertain



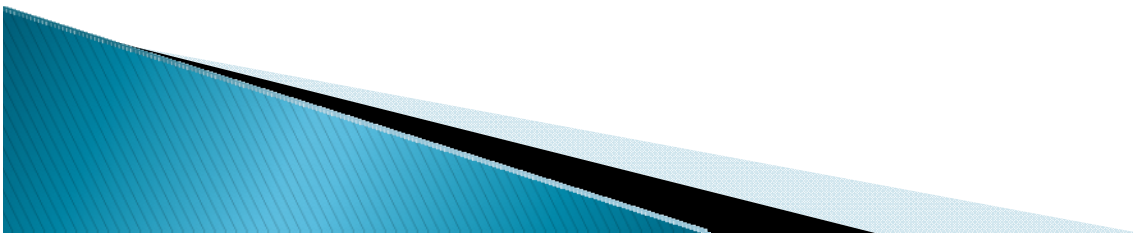
Legal Reform: Some Suggestions

- ▶ Property law should give strong protection to property owners
- ▶ Contract law should reflect freedom of contract: courts should enforce the deal
 - The problem with restrictions on freedom of contract
- ▶ Procedural laws should be simple. It is important that people who win lawsuits can liquidate their judgments by seizing assets of defendants



Institutional Reform: The Judiciary

- ▶ Judges should be well-paid and highly qualified
- ▶ Judges should be free of political interference
 - Strong rules against corruption
- ▶ Judges should be knowledgeable about economics and business; ideally, they will have some experience in these fields



A Final Lesson

- ▶ Economic growth include both “good law” and “good institutions”
- ▶ Good law without good institutions is ineffectual
- ▶ Good institutions without good law can only produce bad outcomes

