

# Washington University Journal of Law & Policy

---

Volume 26 *Law & The New Institutional Economics*

---

2008

## Laws, Enforcement, Legality, and Economic Development

Frank H. Stephen

*The University of Manchester*

Stefan Van Hemmen

*Autonomous University of Barcelona*

Follow this and additional works at: [https://openscholarship.wustl.edu/law\\_journal\\_law\\_policy](https://openscholarship.wustl.edu/law_journal_law_policy)



Part of the [Law and Economics Commons](#)

---

### Recommended Citation

Frank H. Stephen and Stefan Van Hemmen, *Laws, Enforcement, Legality, and Economic Development*, 26 WASH. U. J. L. & POL'Y 37 (2008), [https://openscholarship.wustl.edu/law\\_journal\\_law\\_policy/vol26/iss1/4](https://openscholarship.wustl.edu/law_journal_law_policy/vol26/iss1/4)

This Essay is brought to you for free and open access by the Law School at Washington University Open Scholarship. It has been accepted for inclusion in Washington University Journal of Law & Policy by an authorized administrator of Washington University Open Scholarship. For more information, please contact [digital@wumail.wustl.edu](mailto:digital@wumail.wustl.edu).

# Laws, Enforcement, Legality, and Economic Development

Frank H. Stephen<sup>\*</sup>  
Stefan Van Hemmen<sup>\*\*</sup>

In recent years there has been an explosion in the number of papers published on the relationship between the legal system and the process of economic development. A distinctive feature of this current interest is that the major contributions to the literature come from an economic perspective, which differs from an earlier period of interest in law and development that was driven largely by legal scholars during the 1960s and 1970s.<sup>1</sup> This Article will examine the relationship between laws, enforcement, legality, and economic development by utilizing a framework developed within the *New Institutional Economics*.

A major development in economics over the last thirty or so years has been the increased attention given to issues of institutional design and economic organization. What economists labelled, somewhat loosely, “The Theory of the Firm” has been transformed from what was really “price theory” to the study of the nature of the firm, and what determines the boundary between firms and markets when the issue of incomplete contracting plays a central role. This development has its origins in Ronald Coase’s seminal paper, *The*

---

\* School of Law, The University of Manchester.

\*\* Department of Business Economics, Autonomous University of Barcelona.

1. For a discussion of why the initial law and development movement failed, see John H. Merryman, *Comparative Law and Social Change: On the Origins, Style, Decline and Revival of the Law and Development Movement*, 25 AM. J. COMP. L. 457–91 (1977); Richard E. Messick, *Judicial Reform and Economic Development: A Survey of the Issues*, 14 WORLD BANK RES. OBSERVER, 117–36 (1999); David M. Trubek & Marc Galanter, *Scholars in Self-Estrangement: Reflections on the Crisis in Law and Development Studies in the United States*, WIS. L. REV. 1062–1102 (1974). See generally David M. Trubek, *The “Rule of Law” in Development Assistance: Past, Present, and Future*, in THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL 74 (David M. Trubek & Alvaro Santos eds., 2006).

*Nature of the Firm*.<sup>2</sup> Coase's insights lay dormant in economic literature for many years until they were taken up by Oliver Williamson, who developed what he called "Transaction Cost Economics" ("TCE") through a series of papers and books.<sup>3</sup> Williamson has subsequently used the term "Governance" to cover the issues dealt with by this type of analysis.

Around the same time as Williamson was developing TCE, Douglass North was beginning his work on the role of the institutional environment in economic growth. *Institutional Change and American Economic Growth* was published in 1971.<sup>4</sup> Later, North also developed an analysis evaluating the importance of institutions for economic growth.<sup>5</sup> Prior to both Williamson and North, Armen Alchian and Harold Demsetz had begun writing on the economic importance of property rights.<sup>6</sup> By the early 1970s, the economics of property rights had developed sufficient literature to merit a review article in the *Journal of Economic Literature*.<sup>7</sup>

Since the early 1970s, work in these areas of economics has grown rapidly and the relationship between them has been developed to the extent that it has become reasonable to talk of the *New Institutional Economics*. According to Eirik Furubotn and Rudolf Richter<sup>8</sup> the term New Institutional Economics ("NIE") was first used by Williamson.<sup>9</sup> Exactly what is counted as part of the NIE varies

---

2. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

3. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (Free Press 1975); OLIVER E. WILLIAMSON, *ECONOMIC INSTITUTIONS OF CAPITALISM* (Free Press 1985); Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 *J. ECON. LITERATURE* 593 (2000).

4. LANCE E. DAVIS & DOUGLAS C. NORTH, *INSTITUTIONAL CHANGE AND AMERICAN ECONOMIC GROWTH* (1971).

5. DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990); DOUGLASS C. NORTH, *UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE* (2005).

6. Armen A. Alchian, *Some Economics of Property Rights*, 30 *IL POLITICO* 816 (1965); Harold Demsetz, *The Exchange and Enforcement of Property Rights*, 7 *J.L. & ECON.* 11 (1964); Harold Demsetz, *Towards A Theory of Property Rights*, 57 *AM. ECON. REV.* 347 (1967).

7. Eirik G. Furubotn & Svetozar Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 *J. ECON. LITERATURE* 1137 n.4 (1972).

8. EIRIK G. FURUBOTN & RUDOLF RICHTER, *INSTITUTIONS AND ECONOMIC THEORY* (University of Michigan Press 1997).

9. OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (Free Press 1975).

from author to author. Furubotn and Richter suggest that the NIE can be defined to cover transaction cost economics, economics of property rights, the positive theory of agency, relational and incomplete contract theory, new institutional economic history, new institutional political economy, constitutional economics, public choice, and economic analysis of the law.<sup>10</sup> These authors suggest that the last two areas are sufficiently distinctive to be excluded from their coverage in NIE.<sup>11</sup> However, for present purposes, the former consideration is perhaps more important. The phenomena they focus upon are certainly relevant to the concerns of new institutionalists. The boundaries between such sub-disciplines are purely arbitrary, and how we aggregate sub-disciplines may be more related to the discourse to which a particular researcher contributes than anything more fundamental. However, each discourse has its own internal dynamic that shapes the development of its literature and the foci of concern in a path-dependent manner.

Although the law-and-economics movement (“L&E”) has developed over the same time period as the NIE, the connections between them have been fairly limited. L&E has, to a large extent, looked at the internal logic of the law, seeking to discern within its evolution an efficiency enhancing dynamic. This approach has been described as positive law-and-economics. There has also been the development of so-called normative L&E, which argues that efficiency should be the goal of the law. Many contributions to this literature can be seen more properly as *prescriptive*: if the objective is economic efficiency, what set of legal rules will achieve it? For scholars of the NIE, L&E, or more generally the economic analysis of the law, may be seen as contributing to a deeper understanding of the institutional environment.

#### LEVELS OF SOCIAL ANALYSIS

The concerns of NIE and its interface with L&E can be seen by adapting a figure from Williamson as shown in Figure 1.<sup>12</sup> The first

---

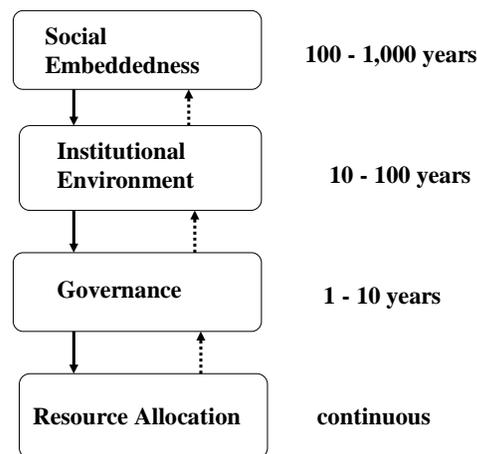
10. FURUBOTN, *supra* note 8, at 31–33.

11. *Id.* at 33.

12. Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking*

level from Williamson's analysis depicted in Figure 1 is what he calls *Embeddedness*.<sup>13</sup> We might think of this as the "cultural level." Located within this level are "norms, customs, mores, traditions . . ." of a society.<sup>14</sup> We think of culture, religion, and informal institutions developing at this level. Williamson sees activity at this level as being spontaneous and without the calculation that exists at other levels.<sup>15</sup> It is characterized as the level of embeddedness because its content for a particular society changes very slowly. Williamson suggests it may take as long as centuries or even millennia.<sup>16</sup>

FIGURE 1



Adapted from Williamson (2000)

---

*Ahead*, 38 J. ECON. LITERATURE 593, 597 (2000).

13. *Id.* at 596–98.

14. *Id.* at 596.

15. *Id.* at 597.

16. Based on the World Values Survey data on eighty societies, RONALD INGLEHART & CHRISTIAN WELZEL, *MODERNIZATION, CULTURAL CHANGE, AND DEMOCRACY* (2005) describe how, even when socioeconomic development has produced fundamental changes in belief systems over the last three decades, both religion and colonial past have a long lasting impact on cultural values in contemporary societies.

The institutions in this first level of social embeddedness are assumed in the second level, the *Institutional Environment*. According to Williamson, this level contains the formal rules of society, such as constitutions, laws, property rights, and the activities of the “executive, legislative, judicial and bureaucratic functions of government.”<sup>17</sup> It is the venue for what Williamson calls “first order economizing”: the design of institutions to achieve specific ends.<sup>18</sup> However, this economization may take place over many years and be subject to the shocks of various political, economic, and other crises. It may be thought of as an evolutionary process. Williamson suggests that it occurs over periods of decades.<sup>19</sup>

Although systematic efforts to codify legal characteristics and to measure levels of enforcement are relatively recent, existing evidence supports his insight. With the exception of major reform programs experienced by former socialist countries, an analysis of financial and legal institutions suggests that relevant changes have been rather infrequent over the past two or three decades.<sup>20</sup> Similarly, when the rule of law is considered, few countries show significant changes over the last decade.<sup>21</sup>

---

17. Williamson, *supra* note 12, at 598.

18. *Id.*

19. *Id.*

20. This can be illustrated by the examination of bankruptcy codes. Simeon Djankov et al., *Private Credit in 129 Countries*, 84 J. FIN. ECON. 299 (2007). According to Djankov et al., since 1978, up to ninety-nine countries undertook one or more reforms in their bankruptcy laws. *Id.* at 305. This represents more than seventy-five percent of their sample of 129 countries. *Id.* However, these reforms only affected substantial aspects of the law in twenty-five countries. *Id.* This means that over the last three decades, only one in five countries have introduced significant reforms in bankruptcy legislation.

21. See Daniel Kaufman et al., *Governance Matters VI: Aggregate and Individual Governance Indicators 1996–2003*, 34 (World Bank Research Policy Working Paper, Working Paper No. 4280, 2007). Figure 2, p. 29, which illustrates that, for the period from 1998 until 2006, only seven countries experienced large improvements in rule of law (Algeria, Georgia, Kiribati, Liberia, Tajikistan, Serbia, and Rwanda), whereas six countries suffered significant deterioration (Zimbabwe, Venezuela, Argentina, Trinidad and Tobago, Cote d’Ivoire, and Eritrea). *Id.* The proportion of countries in the sample for which a significant change is observed between these two dates is extremely low: less than seven percent. Fig.2, at 29. Note that most of the countries identified as experiencing large changes have suffered severe political or economic crisis around or throughout this period (i.e. large improvements are likely to show a return to the previous situation). Fig.2, at 29.

Significant change in financial legal institutions or the rule of law is constrained by the first level of embeddedness. Nevertheless, there is a feedback loop to the first level. Experiences of the institutional environment may, over long time periods, lead to modification of informal institutions and culture which may in time lead to further changes of the institutional environment.

The third level of institutional analysis is described by Williamson as the level of *Governance*.<sup>22</sup> He associates this with the “play of the game.”<sup>23</sup> Within the context set by the *Institutional Environment*, economic activity is shaped by the use of contract and the design of organizations. For Williamson, this is the domain of transaction cost economics (“TCE”). Transactions differ in characteristics, such as frequency and the need for transaction-specific investment, which, when combined with the human characteristics of bounded rationality and opportunism, leads to a discriminating alignment of transactions and means of governing them.<sup>24</sup> In particular, Williamson considers the choice between market and hierarchy (the choice between contracts and organizations) as the means of mediating a transaction.<sup>25</sup> The TCE theory is usually interpreted as arguing that transaction costs are the major determinant of mode of governance. However, a close reading of the literature makes it clear that it is the sum of transaction costs and production costs that is relevant.

Another approach to governance has become known as Positive Agency Theory. Here, the emphasis is on controlling agency costs. Ultimately this approach may be seen as identifying different forms of organization as responses to differences in agency costs and the means of controlling them over different contexts.<sup>26</sup> Williamson refers to activity at this level as second order economizing and suggests that the time scale for such behaviour is anything from a year to a decade.<sup>27</sup> Second order economizing is constrained by the

---

22. Williamson, *supra* note 12, at 599.

23. *Id.* at 597 fig.1.

24. *Id.* at 605.

25. *Id.* at 602–03.

26. A more detailed comparison of these two approaches is provided by Gérard Charreaux. Gérard Charreaux, *Positive Agency Theory: Place and Contributions*, in *THE ECONOMICS OF CONTRACTS* 251, 259 (Eric Brousseau & Jean-Michel Glachant eds., 2002).

27. Williamson, *supra* note 12, at 599.

institutional environment, particularly the distribution of property rights and contract laws.<sup>28</sup>

The fourth and final level of social analysis identified by Williamson is *Resource Allocation*.<sup>29</sup> It is here that economic decisions are made within the constraint of a fixed Institutional Environment and also of fixed modes of Governance. This is the arena of neoclassical economic analysis. Here, economic agents allocate resources in response to price signals generated by markets for factors of production, governments, and bureaucracies.<sup>30</sup> Williamson describes adjustment at this level as third order economizing and taking place “more or less continuously.”<sup>31</sup>

This Article is largely concerned with the Institutional Environment, which sets the context within which economic agents can design governance structures that allocates resources. The Institutional Environment is taken to be exogenous to issues of governance in the short run. This is indicated in Figure 1 by the solid arrows.<sup>32</sup> The choice of governance arrangements by participants in a particular activity are constrained by the institutional environment.<sup>33</sup> A given institutional environment may preclude the emergence of a particular governance structure or may not provide appropriate incentives for it to be chosen by agents in the system. This can be thought of as a short-run phenomenon, but the short run may be quite long in terms of chronological time, perhaps even decades according to Williamson.<sup>34</sup> In the long run, there may be feedback from the realm of Governance to the Institutional Environment, which leads to changes in the latter. As a result, the Institutional Environment may evolve in response to the feedback to widen the choice of feasible governance structures. This may be the case when some aspects of the institutional environment cannot be contracted around to fashion

---

28. *Id.* at 598–99.

29. *Id.* at 597.

30. *Id.* at 600.

31. However, this instantaneous adjustment presumably incorporates, *ceteris paribus*, what economists designate as the long run, i.e., the period necessary for adjustment in capital and technology to take place. *Id.* at 600.

32. *Id.* at 597 fig.1.

33. Williamson, *supra* note 12, at 596.

34. *Id.* at 597 fig.1.

a “desirable” governance structure in some area of economic activity. According to Williamson’s scheme, this combination of short-run constraints and long-run feedback loops is replicated at each level in the hierarchy.<sup>35</sup> However, as we move down the levels of analysis, the time needed for this feedback loop to occur is apparently reduced.

#### LAWS AND ECONOMIC DEVELOPMENT

The issue of growth and institutions has come to prominence in academic discourse in recent years. It has also been central to the concerns of the World Bank. Recently there have been a number of strands in economic research that have related economic growth and development to aspects of the institutional environment, both directly and indirectly.<sup>36</sup> At the most general level Acemoglu, Johnson, and Robinson have examined the influence of colonial origins and early institutions on the level of development in a sample of former colonies.<sup>37</sup> They argue that colonial origins and the nature of colonization are the key determinants of development because they heavily influence current institutions.<sup>38</sup> In their analysis, current institutions are proxied by an index of the risk of appropriation of assets by government. Rodrick, Subramanian, and Trebbi test competing explanations of development in an extensive econometric exercise.<sup>39</sup> The competing explanations are those that give the pre-eminent role of determinants of development to institutions, geography, or integration into world trade.<sup>40</sup> Their proxy for institutions is a “Rule of Law” index.<sup>41</sup> They argue that both rule of law and trade integration are not independent determinants of growth but are, themselves, determined within the system they seek to

---

35. *Id.* at 596.

36. This article only provides indicative references from the rapidly growing literatures.

37. Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001).

38. *Id.* at 1395–96. The nature of colonization and institutions was, in turn, determined by settler mortality rates during the colonization period.

39. Dani Rodrik, Arvind Subramanian & Francesco Trebbi, *Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development*, J. ECON. GROWTH, June 2004, at 131.

40. *Id.*

41. *Id.* at 132.

model.<sup>42</sup> To deal with this, they use the colonial origin variables used by Acemoglu<sup>43</sup> as the fundamental determinant of institutions.<sup>44</sup> They conclude that their results show that the main determinant of development is institutions.<sup>45</sup>

A second strand in the literature relates growth or development to the existence of a healthy financial sector, which is in turn a function of legal institutions.<sup>46</sup> They demonstrate the relationship between growth and various measures of the financial sector. Levine extends this to show that the measures of financial sector development are themselves functions of creditor protection laws, risk of government contract modification, and accounting regulations.<sup>47</sup> The latter, however, are seen primarily as instrumental variables to overcome the endogeneity of the financial sector variables. Levine extends this to an analysis of stock market development and shareholders' rights.<sup>48</sup> Azfar and Matheson, as part of a program on market augmenting government, develop the concept of "market-mobilized capital," which they claim plays a central role in economic growth.<sup>49</sup> Market-mobilized capital "is the sum of outstanding debt and equity relative to GDP."<sup>50</sup> Market mobilized capital is seen as a measure of private financial market development which may have a causal relationship with a country's economic performance.<sup>51</sup> Again, in dealing with issues of endogeneity and causality, Azfar and Matheson

---

42. *Id.* at 133. "The extent to which an economy is integrated with the rest of the world and the quality of its institutions are both endogenous, shaped potentially not just by each other and by geography, but also by income levels." *Id.*

43. Acemoglu, *supra* note 37.

44. Rodrick et al., *supra* note 39, at 134–35.

45. *Id.* at 146.

46. See Ross Levine, *Napoleon, Bourses, and Growth, with a Focus on Latin America*, in MARKET-AUGMENTING GOVERNMENT: THE INSTITUTIONAL FOUNDATIONS OF PROSPERITY 49 (Omar Azfar & Charles A. Cadwell eds., 2003) [hereinafter Levine, *Napoleon*]; Robert G. King & Ross Levine, *Finance Entrepreneurship and Growth: Theory and Evidence*, 32 J. MONETARY ECON. 513 (1993); Ross Levine, *Law, Finance and Economic Growth*, 8 J. FIN. INTERMEDIATION 8 (1999) [hereinafter Levine, *Law*]; Ross Levine & Sara Zervos, *Stock Markets, Banks and Economic Growth*, 88 AM. ECON. REV. 537 (1998).

47. Levine, *Law*, *supra* note 46.

48. Levine, *Napoleon*, *supra* note 46.

49. Omar Azfar & Thornton Matheson, *Market-Mobilized Capital*, 117 PUB. CHOICE 357, 358 (2003).

50. *Id.*

51. *Id.* at 365.

use measures of investor protection, creditor protection and enforcement of laws as instrumental variables.<sup>52</sup>

A third approach is taken by La Porta, Lopez-de-Silanes, Shleifer and Vishny (“LLSV”),<sup>53</sup> who in a series of papers develop measures of creditor protection laws, investor protection laws, and law enforcement to investigate a variety of issues. In their literature these measures are seen as key determinants of the phenomena under investigation.<sup>54</sup> A major theme of their work is the consistent influence of legal families, such as common law, French civil code, German civil code, and Scandinavian law, on aspects of the financial and corporate systems of countries.<sup>55</sup> The investor and creditor protection variables developed in this work allow the influence of differences in such laws on various aspects of the financial and corporate sectors to be analyzed. These papers and subsequent work with, *inter alia*, World Bank staff has had a profound influence on policymaking by both multilateral aid agencies and governments in developing countries.

Explicit attention to the operation of the legal system is essential to development and poverty reduction through liberalization and the market economy. Economic literature increasingly recognizes the importance of the rule of law and legal systems in the promotion of market-based economic growth and poverty reduction. . . . There is also an emerging literature on general differences between the economic growth of countries from the common law tradition, emanating from England, as opposed to the civil law tradition, emanating from France. Studies suggest that the countries from the civil law tradition may have more difficulties conforming to the market based models and standards for economic development. Common law systems historically put more faith in the autonomy of the judiciary and the law, while civil law states

---

52. *Id.* at 361.

53. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131–50 (1997).

54. Rather than a means of overcoming statistical problems.

55. See La Porta et al., *supra* note 53, at 1131–50; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113–54 (1998).

invested more in state control and circumscription of the courts and judiciary. It has been argued that it was more difficult to create entrepreneurial businesses in civil law countries where the state was so involved in the economy. In many countries to which civil law was exported, the relatively strong model of the state led to a government (and judiciary) dominated by leading families who could translate their elite status into control of both the state and economy. The greater autonomy and role of legal systems in common law countries helped produce rules that fostered new entry and investment.<sup>56</sup>

The second and third strands of the empirical literature relating growth and legal institutions are often grouped together under the heading of “Law and Finance.” Elsewhere, we review a large number of studies which have used this approach.<sup>57</sup>

Literature critical of the legal origin hypothesis has emerged more recently. The criticisms encompass the technical issues of variable construction and precision,<sup>58</sup> the role of statutory law in common law countries with respect to investor and creditor protection,<sup>59</sup> the extent to which the variables are used to measure aspects of the legal system rather than the interaction of the legal system with non-legal aspects of a particular society,<sup>60</sup> and the relationship between legal and political systems.

---

56. WORLD BANK, LEGAL AND JUDICIAL REFORM: OBSERVATIONS, EXPERIENCES AND APPROACH OF THE LEGAL VICE PRESIDENCY 20 (2002).

57. Stefan Van Hemmen & Frank H. Stephen, *Rule of Law, Finance and Economic Development: Cross-country Evidence*, in LAW AND THE STATE: A POLITICAL ECONOMY APPROACH 185 (Alain Marciano & Jean-Michael Josselin eds., 2003).

58. H. Spamann, On the Insignificance and/or Endogeneity of La Porta et al.’s “Anti-Director Rights Index” under Consistent Coding, Harvard Law School John M. Olin Center Discussion paper No. 7, Mar. 2006, available at [http://www.law.harvard.edu/programs/olin\\_center/fellows\\_papers/pdf/Spamann\\_7.pdf](http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf).

59. Mark J. Roe, Keynote Lecture at the European Association of Law and Economics Annual Conference: *Institutional Foundations for Securities Markets in the West* (Sept. 19, 2003), available at <http://www.econ.nyu.edu/user/frydmanr/Roe-AER2003.doc>.

60. Kevin E. Davis, *What Can the Rule of Law Variable Tell Us About Rule of Law Reforms?*, 26 MICH. J. INT’L L. 141 (2005).

## ENFORCEMENT AND “LEGALITY”

An aspect of the institutional environment that was undervalued in the early Law and Finance literature is how effectively legal rights are enforced. Although the statistical analysis linking development to legal rules frequently include “enforcement” as an explanatory variable, most of the discussion focuses on the rules rather than whether they are enforced or not. Indeed, LLSV argues that the degree of “enforcement” is determined by legal origin.<sup>61</sup> Others dispute this link.<sup>62</sup> More importantly, we would argue that regardless of statutes’ existence, if they are not enforced or enforced unpredictably, they are ultimately ineffective. Effort expended in improving the content of the statutory laws of a country may be totally wasted if they are not enforced or if their enforcement is too costly in terms of time and delay. The impact of legal rules on economic development in general and financial development in particular may not be independent of how they are enforced. Our own statistical analysis<sup>63</sup> shows that the impact of investor protection rules on the ratio of stock market capitalization to GDP is not independent from a measure of enforcement of statutes in a country. Using data on forty-nine developed and developing countries<sup>64</sup> previously analyzed by Azfar and Matheson,<sup>65</sup> we find that there are nineteen developed and middle income countries where the level of enforcement is high enough such that stock market capitalization could only be improved by improving investor protection laws. There are fourteen countries, including developed, developing, and middle income countries, where improvements in enforcement as well as investor protection rules would increase stock market capitalization. However, for five developing countries, from a sample of fourteen countries, increasing investor protection would not improve stock market capitalization.

---

61. La Porta, *supra* note 53, at 1139–46.

62. Berkowitz et al., *infra* note 78, at 174–75.

63. Frank H. Stephen & Stefan Van Hemmen, *Market Mobilized Capital, Legal Rules and Enforcement*, Discussion Paper in Economics No. 04-03, University of Strathclyde, Glasgow (2004), available at [http://www.economics.strath.ac.uk/Research/Discussion\\_papers/discussion\\_papers.html](http://www.economics.strath.ac.uk/Research/Discussion_papers/discussion_papers.html).

64. Data does not include transition countries.

65. Azfar & Matheson, *supra* note 49, at 362–69.

An increase in stock market capitalization in those five countries could only be achieved through improving the enforcement of laws.<sup>66</sup>

The process of identifying economic development with the reform of legal systems has continued through, *inter alia*, the World Bank's *Doing Business* project.<sup>67</sup> However, the *Doing Business* project is specifically concerned with the costs in the time and effort of enforcing legal rights rather than the content of the legal rights. When combined with the enumeration of the rights themselves, this work can be interpreted from a NIE perspective as an attempt to map across a large number of countries<sup>68</sup> major elements of their institutional environment. The *Doing Business* project does this with the intention of encouraging reform and adaptation in a way that will increase the effectiveness of the legal system in promoting economic growth and development.

The high costs of enforcement are clearly a transaction cost from a NIE perspective.<sup>69</sup> What creates them? At one level it is tempting to say that enforcement, as we measure it, is higher in developed countries than in developing countries. There is indeed a high and statistically significant correlation between measures of enforcement and income *per capita*.<sup>70</sup> However, since the institutional approach seeks to explain the level of development in terms of the institutional environment, this does not significantly further the analysis. A more fundamental explanation of differences in the effectiveness of legal systems is required.

In discussing the mixed record of countries in Central and Eastern Europe in making the transition from socialism to capitalism, Pejovich argues that differences in culture provide the explanation.<sup>71</sup> It should be noted that most transition countries have adopted laws from other jurisdictions to provide the legal protection normally

---

66. The forty-ninth country (Hong Kong) had the maximum score on the investor protection variable and a sufficiently high level of enforcement that no improvement in enforcement would increase stock market capitalization.

67. *Doing Business*, <http://www.doingbusiness.org> (last visited Oct. 28, 2007).

68. In the 2007 version of the *Doing Business* data base, there are 175 countries.

69. Svetozar (Steve) Pejovich, *Understanding the Transaction Costs of Transition: It's the Culture, Stupid*, 16 REV. AUSTRIAN ECON. 347, 348 (2003).

70. See La Porta et al., *supra* note 53; Berkowitz et al., *infra* note 78, at 174–75.

71. Pejovich, *supra* note 69, at 348.

associated with market economies.<sup>72</sup> However, the effectiveness of transition country legal systems, in many cases, is relatively poor.<sup>73</sup> The transplanted legal rules may be seen as being incompatible with the culture and social norms of these transition countries. Consequently, the transaction costs of using the legal system rise dramatically. Pejovich posits the view that the cultures of most Central and East European countries embody norms of collectivism, egalitarianism, extended family, and shared values.<sup>74</sup> He contrasts this with the culture of capitalism, which he suggests embraces individualism, self-interest, self-determination, self-responsibility, risk-taking, and open market competition.<sup>75</sup> The transition process in his view requires a cultural transformation rather than a legal one.<sup>76</sup> This, as Williamson's characterization of embeddedness suggests, is a much longer process than that of changing legal codes. As Pejovich puts it, formal rules are policy variables while informal rules are not.<sup>77</sup> In NIE terminology, the institutional environment imposed by the transition process is incompatible with the norms and informal rules that are embedded in these societies.

From a legal perspective, the transition process in Central and Eastern Europe is an example of the more general process of legal transplantation. Legal rules and codes have been transplanted from one society to another since antiquity. The transplantation may arise from conquest and colonization, through emulation and adaptation, or as a condition of development aid by an international donor agency. Some authors have sought to link the poor performance of a country's legal systems to the process by which it was acquired. Berkowitz, Pistor, and Richard classify countries as being receptive or unreceptive to legal transplants.<sup>78</sup> In receptive countries, laws are being transplanted because there is a perceived need by legal actors in that country for new laws. These new laws have been adapted to

---

72. Pistor et al., *infra* note 83, at 346.

73. See Pistor et al., *infra* note 83.

74. Pejovich, *supra* note 69, at 351.

75. *Id.* at 350.

76. *Id.* at 348, 358.

77. *Id.* at 348.

78. Daniel Berkowitz et al., *Economic Development, Legality and the Transplant Effect*, 47 EUROPEAN ECON. REV. 165, 174 (2003).

suit local conditions or legal actors are sufficiently familiar with the basic principles of the legal system from which they are being transplanted to facilitate easy adoption.<sup>79</sup> In other words, receptive transplant countries are those where there is an effective demand for the transplant. Unreceptive countries are those where, in effect, transplanted laws are supply driven. Therefore, a legal system imposed on colonies by a conquering colonial power may not be suited to local conditions or be adapted appropriately over time. However, where colonization has taken place through settlement, rather than conquest, the settling population will bring with them a familiar legal system that they are likely to adapt over time to suit their needs.

Berkowitz, Pistor, and Richard tested their theory with data from the forty-nine countries analyzed by LLSV.<sup>80</sup> These include ten legal origin countries and thirty-seven recipients of legal transplants. The authors allocated the thirty-seven countries into receptive and unreceptive categories on the basis of their legal histories and developed an index of “legality” that measures enforcement and effectiveness of a legal system.<sup>81</sup> They found that “legality” is lower for unreceptive transplants and for French civil law countries, and that the influence of the legal system on income per person is through “legality.”<sup>82</sup> In other words, the effectiveness of the legal system’s operation is more important for economic development than the content of the law itself.

Further research on transition countries confirms the importance of the transplant effect. Pistor, Raiser, and Gelfer analyzed data on investor and creditor protection for a number of transition countries in 1992 and 1998 and showed that on average, the countries had improved over the six year period.<sup>83</sup> Indeed the average rating for creditor protection in 1998 was higher than the average for any of the comparator groups of countries, including common law countries, while the rating for investor protection was higher than all

---

79. *Id.* at 174–80.

80. Berkowitz et al., *supra* note 78; La Porta et al., *supra* note 53.

81. Berkowitz et al., *supra* note 78.

82. *Id.* at 183–85.

83. Katharina M. Pistor et al., *Law and Finance in Transition Economies*, 8 *ECON. OF TRANSITION* 325 (2000).

comparator groups other than common law countries.<sup>84</sup> However, these transition countries did not perform well on a range of measures evaluating the effectiveness of the legal system and the rule of law.<sup>85</sup> The authors demonstrate that for these countries, there is a strong correlation between legal effectiveness and the transplant status of the countries. Unreceptive transplants have lower legal effectiveness.<sup>86</sup> They then show that, statistically, legal effectiveness has a stronger influence in determining the size of financial markets than the content of the law with respect to creditor and investor protection.<sup>87</sup>

Among the recent efforts to link cultural and legal institutions, Licht, Goldsmith, and Schwartz find that cultural values, such as uncertainty, avoidance, or harmony are negatively associated with statutory laws that encourage the resolution of corporate governance disputes through confrontational litigation processes.<sup>88</sup> They conclude that, “in the long term, formal institutions should be consistent with the informal cultural environment.”<sup>89</sup> One implication of this data is that policymakers should consider cultural contexts before designing reforms or transplanting legal rules.

### CONCLUSIONS

This Article has analyzed the role of law and the legal system in the process of economic development. We have used a model of four levels of social analysis developed by Oliver Williamson to organize our analysis. The effectiveness of the legal system in enforcing rights, we have argued, is equally if not more important, than the fine detail of the law itself for many developing countries, and transplanting legal rules from one legal system to another requires legal actors in

---

84. *Id.* at tbl.4, p. 340 and tbl.2, p. 337.

85. *Id.* at 341–48.

86. *Id.* at 348.

87. *Id.* at 356.

88. Amir N. Licht et al., *Culture, Law, and Corporate Governance*, 25 INT’L REV. L. & ECON. 229 (2005).

89. *Id.* at 250.

the recipient jurisdictions to have an effective demand for the transplant.