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Law Matters

John N. Drobak

Washington University School of Law

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LAW MATTERS

JOHN N. DROBAK*

Let us represent the human experience to date as a 24-hour clock in which the beginning consists of the time (apparently in Africa between four and five million years ago) when humans became distinct from other primates. Then the beginning of so-called civilization occurs with the development of agriculture and permanent settlement in about 8000 B.C. in the Fertile Crescent—in the last three or four minutes of the clock. For the other twenty-three hours and fifty-six or fifty-seven minutes, humans remain hunters and gatherers and while population grows it does so at a very slow pace.

Now if we make a new 24-hour clock for the time of civilization—the ten thousand years from the development of agriculture to the present—the pace of change appears to be very slow for the first twelve hours, although our archaeological knowledge is very limited The pace of change accelerates in the past five thousand years with the rise and then decline of economies and civilizations. . . . The last 250 years—just thirty-five minutes on our new 24-hour clock—are the era of modern economic growth accompanied by a population explosion that now puts the world population in excess of five billion.¹

This improvement in economic well-being is the greatest change in the history of human life. The drastic strides over the past 250 years are stunning. The average person today takes advantage of things that the wealth of kings and queens could not have purchased 250 years ago—much longer life expectancy, modern health care, automobile and air travel, household electricity, central heating and air conditioning, television and radio, and telecommunications, to name just a few. Why have things improved so much, especially in the last 250 years?

Neoclassical economic theory has attributed modern economic growth to a combination of factors: human capital (the amount and skill of labor), physical capital (machines, factories, agricultural improvements, etc.), natural resources, technology (human command over nature), and the stock of knowledge (the understanding of the natural environment).² Over the past

* Professor of Law and Professor of Economics, Washington University. B.S., Massachusetts Institute of Technology, 1970; J.D., Stanford University, 1973. Special thanks to Doug North of Washington University and Mary Shirley of the World Bank for their helpful ideas and comments.

1. Douglass C. North, *Economic Performance Through Time*, Acceptance Speech upon receiving the Alfred Nobel Memorial Prize in Economic Sciences (Dec. 9, 1993), in 84 AM. ECON. REV. 359 (1994).

2. See DOUGLASS C. NORTH, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* 4 (1981).

few decades, some economists have begun to emphasize the importance of one additional component: institutions. These are the “rules of the game” of a society.³ The “rules” structure human interaction and provide a framework of incentives that shape economic, political and social organization. Together with the technology employed, institutions affect economic performance by determining the transaction and transformation costs that make up the total costs of production.⁴ Institutions also affect economic performance by structuring the political process and the relationship between government and business. Institutions can be informal or formal. Informal institutions include such things as norms of behavior, cultural constraints, codes of conduct and business conventions. Some formal institutions are created by non-governmental organizations—religious laws, corporate rules of self-governance and use restrictions imposed by residential groups are some examples. The most important formal institutions, however, are legal, such as constitutions, statutes, regulations and decisions of courts and agencies.

The law will always have some impact on the costs of running a market system. Laws can raise these costs not only by making it more costly to use the law itself but also by creating incentives for inefficient and less productive activities. Even if many laws raise the costs only a little, economic growth will be constrained if the cumulative effect is large. Laws will be less costly to use if they are clear and transparent because those qualities lead to better understanding of legal requirements and help to make legal outcomes more predictable.⁵ Clarity and transparency may also diminish the likelihood of bureaucrats charging bribes or extracting other favors from those attempting to invoke the law. The appearance of broad bureaucratic discretion, in the application of complex and opaque laws, makes it easier for government officials to demand bribes.

There is a core set of laws that help markets become more efficient. Not only does this core include laws that directly govern private commercial transactions, it also contains laws that constrain the government’s power to extract wealth. The core must start with a criminal law that provides for

3. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990).

4. See Douglass C. North, *Prologue*, in THE FRONTIERS OF THE NEW INSTITUTIONAL ECONOMICS 3, 6 (John N. Drobak & John V.C. Nye eds., 1997).

5. The market can sometimes adjust to nontransparent and complex laws and minimize the costs imposed by those laws. For example, the cumbersome licensing regulations for opening small businesses in Brazil led to the birth of brokers who handled the licensing requirements, in effect making licensing a one-stop process for the new business. See Andrew Stone et al., *Public Institutions and Private Transactions: A Comparative Analysis of the Legal and Regulatory Environment for Business Transactions in Brazil and Chile*, in EMPIRICAL STUDIES IN INSTITUTIONAL CHANGE (Lee J. Alston et al. eds., 1996).

security of both people and property. It is extremely difficult, perhaps impossible, for sustained economic growth to occur in countries where extortion, theft and other violent crimes undermine market transactions. The warlord economies of some African countries and the disruption of market activities in Russia by the mafia are blatant examples. The breaking of kneecaps by a competitor is an effective "barrier to entry," but firms need not worry about that if they operate in countries with effective criminal justice systems.

A market system depends on some type of commercial law to provide the framework for transactions. Some rules for exchange are important even in primitive economies. Therefore, as economies became more complex, with increased specialization and division of labor, begetting more and complex transactions, commercial law had to become more specialized. Consequently, a modern market-based economy depends on various bodies of law. For example, property, contract, negotiable instrument and debtor-creditor laws establish property rights and the rules for exchange. Bankruptcy laws smooth the movement of failing firms out of and back into the market. Partnership and corporate laws provide ways to create useful forms of business entities. The recent experiences of the formerly Communist countries in Central Europe, in their attempts to move to a market system, reinforce the importance of some type of securities law governing emerging capital markets. Antitrust laws provide the rules for competition in these markets.

Many of these laws governing market transactions allow for flexibility by the participants in tailoring the rules for their own particular needs. The law does provide a baseline by establishing a default rule, applicable unless the parties specify otherwise.⁶ This is important because it enables the parties to know *ex ante* their relative rights and obligations. With rights and obligations established, the parties are now in a position to contract around the default rule if they believe some other rule better suits their needs. In a similar fashion, many of the differences in commercial laws one sees from country to country do not matter significantly because the market participants in each country adjust their activities to accommodate the particular terms of the governing law. For example, firms in the United States and in Europe do just as well under different types of antitrust laws.⁷ Thus, in some instances, it does not matter so much what the law is, only that there is a law.

When parties cannot contract around a legal rule as a result of

6. See, e.g., Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

7. Compare Sherman Act, 15 U.S.C. §§ 1, 2 (1997) with Treaty Establishing European Economic Community, *opened for signature* Nov. 23, 1957, arts. 85-86, 298 U.N.T.S. 11.

impediments to bargaining,⁸ the terms of the rule become even more important. *Bass v. Gregory*,⁹ one of the series of nuisance cases discussed by Ronald Coase in *The Problem of Social Cost*,¹⁰ illustrates this well. That case involved a suit by the owner of the Jolly Angler pub to establish the legal right to use a ventilating shaft on a neighbor's land.¹¹ For over 40 years, the pub had operated a brewery in its cellar, venting the production process through a shaft that connected into an old well located in the neighbor's yard.¹² When the neighbor blocked the ventilation through the well, the pub owner sued.¹³ The outcome of the lawsuit established a legal rule with both short-term and long-term consequences. As Coase saw it, "[t]he economic problem was to decide which to choose: a lower cost of beer and worsened amenities in adjoining houses or a higher cost of beer and improved amenities."¹⁴ Coase's criteria for making the choice was to maximize the value of production from both parcels. In *Bass* the court ruled that the pub had the right to vent its brewing operations through the well.¹⁵ Assuming the brewery's established ventilating system added more to productive output than the neighbor lost, the value of production would have been maximized.¹⁶ This short-term consequence of the *Bass* decision was a good economic result in terms of Coase's criteria. Of course, if the court had reached the poorer economic outcome by ruling for the neighbor, the parties could have still reached a desirable result through the neighbor's sale of the right to the pub owner, assuming no impediments to bargaining. Thus the short-term goal of maximizing productivity can be reached either way.

The long-term consequences of the *Bass* decision—the downstream economic effect—can have an even bigger impact on economic growth. For example, consider the incentives for future conduct resulting from the *Bass* decision. If the defendant had been the pub's neighbor for years, the court was enforcing a relationship the parties had created over time, in effect enforcing settled expectations. That is an important, albeit not surprising, principle worthy of reinforcement. Suppose the neighbor, instead, was a recent purchaser of the land who was surprised and bothered by the pub's

8. Impediments to bargaining stem from the typical transaction costs involved in negotiating a deal, as well as the consequences of wealth effects, endorsement effects and bipolar monopolies. *See, e.g.*, Coase, *supra* note 6, at 15.

9. 25 Q.B.D. 481 (1890).

10. *See* Coase, *supra* note 6.

11. *See Bass*, 25 Q.B.D. at 481.

12. *See id.* at 481-82.

13. *See id.*

14. Coase, *supra* note 6, at 15.

15. *See Bass*, 25 Q.B.D. at 484.

16. *See* Coase, *supra* note 6, at 15.

exhaust gases. The *Bass* decision has important lessons for this type of real estate purchaser as well. First, the buyer must seek a remedy from the seller of the property, not from the pub or a similarly situated neighbor. Second, the buyer is obligated to inspect the property, inquiring about the use of visible aspects of the property, like the well. This prophylactic rule, designed to encourage physical investigation of the property and prevent problems like those in *Bass* from ever arising, has positive downstream economic effects.

On the other hand, one could argue that the *Bass* court was wrong, because a ruling for the neighbor would have created an incentive for all easements (including the right to use someone else's property for ventilation or exhaust purposes) to be reduced to writing and then recorded on the public records. This could be said to reduce transaction costs in the aggregate since a buyer need only rely on the land records and not make a physical investigation of the property. A ruling for the neighbor, however, probably would have actually raised aggregate transaction costs because it would have compelled the unnecessary recording of other untold minor transactions. It would be helpful to know empirically which ruling would actually reduce transaction costs, but this appears to be one of those issues that cannot be resolved empirically. My sense is that the court's ruling for the pub owner was the one that did the most to further economic growth, both in terms of short-term productivity and downstream economic effects.

Both criminal and commercial law regulate relations between individuals. Sustained economic growth also depends upon legal institutions that constrain government. These necessarily take two forms. First, it is important that the law somehow prevents governments from acting as a mafia and extracting wealth for the rulers, without any consideration of the economic well-being of citizens. Democracy is one solution to this problem, since citizens can vote out rulers who disregard their economic well-being. A constitutional structure of government with checks and balances between various parts of the government and with allocation of various powers to different branches also constrains rulers from governing solely for their own self-interest. Second, the history of economic growth in the Western economies has shown that market participants need to be able to trust the promises of government.¹⁷ There are many incentives for a government to renege on its commitments. This is especially true for financial obligations, where the short-term financial gain to the state (or to certain groups of voters) will be seen as outweighing uncertain long-term consequences. In the United

17. See Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HIST. 803 (1989).

States, for example, the contracts clause in the Constitution¹⁸ prohibits state and local governments from repudiating debt obligation.¹⁹ Similarly, most nations prohibit outright expropriation of property. Governments can also “take” property through various kinds of regulations that fall short of expropriation. The United States and Germany, to cite two examples, have constitutional provisions limiting the taking of private property through excessive regulation.²⁰ The existence of these kinds of provisions, even though seldom enforced, deter government actions that would otherwise undermine the credibility of the government and harm the workings of the market.

Even if a country were to follow the prescription for the “rules of the law” as described in this essay, it would do little for economic growth unless there also was a way to effectively enforce the laws. The best laws are worthless unless they can be enforced. Enforcement can come about in different ways. Take a breach of contract, for example. The party who desires to breach may restrain himself (first-party enforcement); the aggrieved party may prevent the breach through self-help such as by holding security or retaliating in response to the breach (second-party enforcement); or the aggrieved party may resort to a court or other body to enforce the contract (third-party enforcement). Of these, first-party enforcement is the most efficient, least costly method of enforcement. To the extent that a society, or even a group of traders, follows norms of behavior that stress adherence to contract obligations, enforcement costs are minimized. Second-party enforcement can be difficult to structure and sometimes impossible to achieve in complex economies. That leaves recourse to the courts (or a comparable tribunal) as the only feasible enforcement mechanism in many cases. With third-party enforcement often extremely expensive, countries would help themselves economically by reinforcing norms that support compliance with contract obligations.

To be effective, third-party enforcement requires honest, unbiased decisionmakers. That can be difficult to achieve, especially in developing countries in which judges are paid poorly and in party-dominated countries in which judges are expected to follow the party line. Many countries are fortunate enough to have, in general, an honest, unbiased judiciary and

18. U.S. CONST., art. I, § 10, cl.1.

19. See John N. Drobak, *Credible Commitment in the United States: Substantive and Structural Limits on the Avoidance of Public Debt*, in *THE FRONTIERS OF THE NEW INSTITUTIONAL ECONOMICS*, *supra* note 4.

20. See U.S. CONST., amend. V; see generally RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* (1985); DONALD P. KOMMERS, *THE CONSTITUTIONAL JURISPRUDENCE OF THE FEDERAL REPUBLIC OF GERMANY* 241-97 (2d ed. 1997).

bureaucracy. What leads to that, however, is far from clear. In the United States, for example, lifetime tenure for federal judges surely helps. The Constitution allows federal judges to be impeached for "Treason, Bribery, or other high Crimes and Misdemeanors."²¹ The Senate in the early nineteenth century attempted to use the impeachment clause for political purposes, but the failure to impeach Justice Chase ended that attempt and minimized the influence of politics on sitting federal judges.²² An impartial judiciary also stems from the socialization of lawyers and judges beginning with their education in law school — judges are expected to be impartial and to play by respected and established rules in deciding cases. It also helps that a judgeship carries a rank of prestige and that lawyers move into judgeships after achieving at least some financial success. Further, the legal profession ostracizes a crooked judge, whose legal career is ruined. Finally, the federal government brings criminal proceedings against dishonest judges frequently enough to make the threat of criminal conviction another inducement for honest and unbiased decisionmaking.

Laws dealing with official corruption and bribery are extremely important for sustained economic growth. Not only do these laws lead to an honest judiciary and bureaucracy, making dealing with the government more predictable and less expensive, they also help produce a foundation of trust and honesty throughout a society. If government leaders, judges and bureaucrats are corrupt, market participants can more easily justify and rationalize their own dishonest behavior. This leads to a society in which the rule of law may be espoused, but is not carried out.²³

21. U.S. CONST., art. II, § 4.

22. See Irving Dilliard, *Samuel Chase*, in 1 THE JUSTICES OF THE UNITED STATES SUPREME COURT 1789-1978, 185, 195-97 (Leon Friedman & Fred L. Isreal eds., 1986).

23. Recent events in the Czech Republic illustrate the relationship between perceived government corruption—creating uncertainty in the market—and economic growth. After successfully moving towards privatization faster than any of the other Central European countries, the Czech Republic's economy regressed in spring 1997 when significant funds flowed out of the Czech stock market. That outflow of funds was a product of years of ever-increasing concern about fraudulent and shady activities by businessmen and government officials. The crisis prompted the ruling coalition to create the equivalent of a Securities and Exchange Commission with laws regulating capital market transactions, in contrast to the government's earlier efforts to minimize government regulation and establish a *liaise faire* economy. In 1995 the ruling party had accepted a large "anonymous" donation, supposedly from two individuals who turned out to be fictitious. At the time, this event reinforced the public's suspicion that corruption existed at the highest levels. In fall 1997, two senior members of the ruling party disclosed that the contribution had come from a Czech businessman who, at the time, had been actively involved in attempting to buy a large industrial firm as part of the privatization process. This revelation led to the resignation of the Prime Minister, despite repeated denials from him and other senior members of the party that they were aware of the true source of the donation. Regardless of their denials, many citizens continue to believe that accepting such a large anonymous donation was improper. The toppling of the government is a refreshing sign to many that corruption will no longer

While this essay has described the importance of formal law as a foundation for economic growth, it has also stressed the importance of informal institutions, such as norms of behavior, that conform to the rule of law. In economies where the formal institutions are weak, especially in developing countries, the informal institutions can be the most important “rules of the game.”²⁴ Even in those countries, however, the rule of law, coupled with effective enforcement, can help the informal norms converge toward the formal legal rules. Consequently, for purposes of sustained economic growth, in any country of the world, law matters.

be tolerated by government leaders. Many hope that reinforcing the norms of honesty among the government leaders will have ripple effects throughout the economy.

24. See text accompanying notes 2-4.