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Legal Infrastructure, Judicial Independence, and Economic Development

*Daniel M. Klerman**

I. INTRODUCTION

Judicial independence and effective courts are generally considered to be factors that lead to economic growth, but the theoretical underpinnings of this idea are surprisingly ambiguous, and it has proven very difficult to measure the impact of the judiciary on economic growth. In general, this article argues that economic theory supports the idea that judicial independence facilitates economic growth. Independent courts enforce contracts and protect property rights, and by doing so, they encourage the investment that is crucial for economic development. Nevertheless, judicial independence is not necessary to investment. There are other mechanisms that can enforce contracts and protect property, albeit perhaps not as well as courts. For example, contracts can be enforced by reputation, without recourse to the courts. Similarly, the government can protect property rights through executive restraint and policing, even if constitutional protections are weak and private litigation is ineffective. Thus, economic growth often starts without a strong court system, and efforts to improve the quality of the judiciary are often the consequence, rather than the cause, of economic development.

The empirical literature, to the extent that it has investigated the relationship between courts and economic growth, has focused on judicial independence. Independence is, of course, only one aspect of a judicial system. Nevertheless, it is relatively easy to measure and probably is correlated to other indices of court quality. It thus serves as a rough proxy for the quality of legal infrastructure. There is some evidence that judicial independence is associated with economic growth, but that evidence is mixed and causation is unclear. It remains possible that economic growth causes judicial independence. Much work remains to be accomplished, including more accurate measurement of judicial independence and more emphasis on change over time to distinguish between causation and correlation.

This article will attempt three tasks. First, it will explore the theoretical relationship between judicial independence and economic growth. Second, it will review and critique the empirical literature on the relationship between judicial independence and economic growth. Lastly, it will suggest promising avenues for future research.

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II. THEORY

Economic growth requires many kinds of investment. It requires time and effort because growth is impossible if people are unwilling to work hard. Investment in human capital is also essential, because an educated, skilled population is a prerequisite to the production of all but the most basic goods and services.¹ Economic growth also requires investment in physical capital—tools, plants, and equipment. While a significant portion of investment is general purpose, some is specific to particular relationships or contracts. For example, if a factory receives an order for a particular kind of steel, it may need to order particular supplies and to purchase or set up machine tools for that specific purpose. In the most general sense, investment means spending now in return for future gain. Economic growth requires sacrifice today for the sake of tomorrow. Without investment, there can be no growth. This investment most often comes from domestic sources, although foreign investment can play an important role.

Investment will only occur if investors are confident that they will profit. Thus, investment is undermined if the government or a private party expropriates the investment or the profits.² Relationship-specific investments are undermined if the purchaser does not pay.³ In most developed countries, constitutional guarantees and powerful courts reduce the risk of expropriation. For example, in the United States, the Takings Clause of the Constitution⁴ prevents the government from seizing property without compensation. Courts with the power to enjoin government action or award compensation enforce this protection. Similarly, commercial law and reasonably impartial and efficient courts reduce the risk of purchaser nonpayment. If a purchaser breaches a contract and refuses to pay, the supplier can bring an action against the purchaser in court. The court can then be relied upon to adjudicate the matter fairly. Court judgments are generally respected and enforced. Of course, even in the most developed countries, there are many problems. Courts are expensive. Judges or juries may misinterpret the facts or the law. In addition, the losing party may be bankrupt or otherwise evade enforcement. Nevertheless, the legal protection of property and contractual rights is sufficient to encourage large amounts of investment. Judicial independence is an important aspect of legal effectiveness in the developed world. It ensures that courts do not favor the government in expropriation disputes. After all, there is little value in a takings clause if the courts always side with the government. Similarly, an independent judiciary provides assurance that courts do not favor politically powerful or connected parties in contractual disputes.

1. GARY BECKER, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION* (3rd ed. 1993).

2. DOUGLASS NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE* (1990).

3. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985).

4. U.S. CONST., amend. V.

Nevertheless, an independent court system is not the only mechanism for protecting property rights and enforcing contracts. Governments can adopt policies against expropriation that do not involve courts. One example is the former Soviet Union. Even though it was ruled by the Communist Party, the Soviet Union had a good reputation for protecting the property rights of foreign investors.⁵ Those property rights were not protected by courts, and the judiciary was certainly not independent. Nevertheless, because the ruling party decided that foreign investment was necessary, investments were protected through government restraint and other nonjudicial means.

Similarly, contract enforcement does not require adjudication by courts. When parties repeatedly deal with each other, or when communities are tight-knit, contracts may be respected because people fear retaliation and value their reputations. Fear of a bad reputation, and the ensuing social or commercial ostracism, can motivate people to honor their contracts, even when courts are nonexistent or corrupt. Although enforcement based on reputation may sound alien to those living in modern economies, it is a familiar part of everyday life. For example, why does a law professor honor his promise to prepare a keynote address? It certainly is not fear of a lawsuit. Instead, it is because professors value their reputations among fellow academics and the legal community at large.

In addition, even courts that lack independence can enforce contracts. A judiciary that is subservient to the government in political cases might still render impartial justice in ordinary commercial cases, especially when neither party is politically connected. As Susan Franck and Dan Kolkey point out, arbitration can also substitute for local adjudication because it allows parties to select private judges known for their wisdom and impartiality.⁶

Finally, organizational form can substitute for contract. As Ronald Coase pointed out in his Nobel-prize winning article, "The Nature of the Firm," business entities can choose between contract and command.⁷ Large, vertically integrated firms do not need to rely as much on courts as small firms, which need to "contract out" large parts of their business. Perhaps the weakness of the courts can help explain the emergence of large, family-controlled conglomerates in much of Asia, most notably the South Korean *chaebol* and Japanese *keiretsu*.

Although other mechanisms may substitute for courts in protecting investments (e.g., executive restraint, reputation, and vertical integration), these substitutes are likely to be less effective, more costly, or more limited in their

5. POLITICAL RISK SERVICES, INTERNATIONAL COUNTRY RISK GUIDE (1986); Edward L. Glaeser et al., *Do Institutions Cause Growth*, 9 J. OF ECON. GROWTH 271, 276 (2004).

6. Don Kolkey, Address at the University of Pacific, McGeorge School of Law, Symposium on Judicial Independence and Legal Infrastructure: Private Dispute Resolution and Economic Development, (Oct. 28, 2005); Susan Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 337 (2007).

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

applicability. Government policies against expropriation can change quickly if not backed by strong institutions. Reputational enforcement of contracts restricts transactions to those with established track records, impedes new entry, and often fosters ethnic, religious, political, or racial discrimination. More generally, reliance on reputation impedes large-scale, impersonal exchange.⁸ Arbitration, especially international arbitration, is impractical for small contracts between domestic parties. In addition, the enforcement of arbitration agreements and awards ultimately depends on local courts.⁹ Vertically-integrated firms may be less efficient than the smaller, more nimble firms that must rely more on courts for contractual enforcement.

Although independent courts are usually viewed as a cause of economic growth, the reverse may be true. Economic growth may begin without independent courts, relying instead on governmental restraint and reputational enforcement. Then, as economic growth proceeds, the problems described above may become more acute. With more at risk, the possibility of executive expropriation may become less acceptable to business owners. As businesses grow in size, reliance on small groups of trading partners becomes more problematic. Also, the political power of the commercial class may grow in tandem with economic growth. In very poor societies, only military or religious elites may have the power to pressure the government. As wealth increases, private parties have more to offer the government and become more politically powerful. As a result, as economic growth occurs, demand for independent courts may increase and such demands are more likely to be heeded. China provides a good example of this process. Through the 1980s and 1990s, Chinese courts were of notoriously poor quality. Nevertheless, China enjoyed an unprecedented economic boom. More recently, as the economy has matured, demand for improvement of the country's courts has become louder, both among domestic businesses and foreign investors.¹⁰

The analogy between courts and roads, which is implicit in the concept of judicial infrastructure, illustrates the difficulty of establishing causation. Although a network of well-paved roads and highways would certainly facilitate growth, few countries possess such infrastructure at early stages of their economic development. Instead, growth begins with small vehicles on poorly-paved roads and dirt paths. As economic growth occurs, the inadequacies of the

8. Paul Milgrom, Douglass North & Barry Weingast, *The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges, and the Champaign Fairs*, 2 *ECON. & POL.* 1 (1990); Francis Delaey, *Enforcing Contracts in Transition Countries*, in *LAW IN TRANSITION: CONTACT ENFORCEMENT* 20-21 (AUTUMN 2001).

9. Don Kolkey, *TRANS. LAW.* __ (forthcoming 2007); Franck, *supra* note 6.

10. Jing Liu, Address at the University of Pacific, McGeorge School of Law, Symposium on Judicial Independence and Legal Infrastructure: The Role of Judicial Independence, (Oct. 28, 2005); Wang Juan, Address at the University of Pacific, McGeorge School of Law, Symposium on Judicial Independence and Legal Infrastructure: The Role of Judicial Independence, (Oct. 28, 2005); Conversation with Laura W. Young, Wang & Wang, LLP (October 28, 2005).

transportation system become more apparent. Bigger businesses seek to use larger trucks, and the production of higher-value products makes transport delays more costly. Thus, business demands better roads. Growth also provides the resources for better infrastructure. A poor country cannot afford high-quality roads, but after some growth, they become affordable.

Thus, causation is likely to be complex. Neither independent courts nor paved roads are necessary for economic growth, but economic growth is likely to increase demand for both. In turn, improvement in the quality of roads and courts is likely to facilitate increases in growth, which will further increase demand for improvements in legal and physical infrastructure.

III. EMPIRICAL WORK ON COURTS, JUDICIAL INDEPENDENCE, AND ECONOMIC GROWTH

In recent years, there has been a flurry of research on the relationship between courts and economic growth.¹¹ Unfortunately, it is very difficult to measure judicial quality. Judicial independence is often used as a proxy for the quality of a court system, but it is obviously imperfect. Recent interest in this line of research has been sparked in large part by a series of papers by economists Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, joined in some papers by Edward Glaeser, Cristian Pop-Eleches, and Robert Vishny.

The first two papers by this set of researchers—*Legal Determinants of External Finance* and *Law and Finance*—examine the impact of investor protection and legal origin on the strength of capital markets in forty-nine countries.¹² They find that countries with strong investor protection and common-law legal origin have stronger equity markets. These articles do not, however, analyze judicial independence or other measures of court quality (aside from common-law origin), nor do they investigate effects on economic growth. Of course, there is presumably some relationship between strong capital markets and economic growth, but these articles never use economic growth as a dependent variable.

A later paper, *Judicial Checks and Balances*, examines the impact of judicial independence and other institutions on the protection of rights in 71 countries.¹³ Countries with independent judiciaries are more likely to have strong protections for property, political, and human rights. Again, there is no direct analysis of economic growth or economic performance more generally, although it is

11. This article focuses on more recent, quantitative literature. There is also quite a bit of nonquantitative work on the subject. *See, e.g.*, THE LAW AND ECONOMICS OF DEVELOPMENT (Edgardo Buscaglia et al. eds., 1997); Tom Ginsburg, *Does Law Matter for Economic Development? Evidence from East Asia*, 34 LAW & SOC'Y REV. 829 (2000); Richard E. Messick, *Judicial Reform and Economic Development: A Survey of the Issues*, 14 WORLD BANK RES. OBSERVER 117 (1999); Amanda Perry, *Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence*, 49 INT'L & COMP. L. Q. 779 (2000).

12. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

13. Rafael La Porta et al., *Judicial Checks and Balances*, 112 J. POL. ECON. 445 (2004).

plausible that protection of private rights would encourage growth. In addition, causation is unclear. The evidence presented is consistent with the view that increased private rights cause judicial independence, as well as the idea that some other factor, perhaps education, leads to both increased private rights and judicial independence.¹⁴ Finally, as discussed below, the measurement of judicial independence is very problematic.¹⁵

In *Do Institutions Cause Growth*, Glaeser, La Porta, Lopez-Silanes, and Shleifer directly address the causation question.¹⁶ They find no connection between judicial independence and economic growth. More generally, there is no connection between institutions, such as constraints on the executive, and economic growth. Instead, education is the most important determinant of economic growth. Most countries that emerged from poverty started as dictatorships with few institutional protections. Sound economic policies, such as protection of private property, resulted from ruler choice rather than institutional constraints. As countries grew richer, they improved their institutions (e.g., granted independence to their judiciaries and imposed constitutional restraints on the executive). This, they argue, was the history of most of Western Europe, and can be observed most recently in the Pacific Rim, especially Taiwan and South Korea.

Although this last article is the most informative so far, it has several problems. First, the authors analyze judicial independence data from only 1995. The most powerful test in the article is the relationship between constraints on the executive and economic growth from 1960 and 2000. Because they find a positive relationship between growth and constraints on the executive in 2000, but not in 1960, the authors conclude that constraints on the executive do not cause economic growth; rather, the reverse may be true. But, they did not perform equivalent tests for judicial independence because the authors did not have data for judicial independence in 1960. The article thus lacked a good test for the causal relationship between judicial independence and economic growth.

In addition, the authors use a crude, idiosyncratic measure of judicial independence based on two factors: (1) whether judges of the highest courts have life tenure; and (2) whether “judicial decisions are a source of law.”¹⁷ The first factor is very simplistic because it ignores the tenure of lower court judges and numerous other factors, such as salaries and promotion practices that affect judicial independence. The second factor, whether “judicial decisions are a source of law,” is irrelevant to judicial independence. The authors seek to justify this factor by arguing

14. The authors recognize this problem and argue that “judicial independence is to a significant extent a feature of colonial transplantation, and as such is likely to be causal.” *Id.* at 465. This is plausible, but without detailed investigation into the history of judicial independence (i.e., whether it is, in fact, a feature of transplantation rather than choice), it remains merely a conjecture.

15. Glaeser et al., *supra* note 5. For a critique of this article, see K. Daron Acemoglu, Simon Johnson, James A. Robinson & Pierre Yared, *From Education to Democracy?* 95 AM. ECON. REV. 44 (2005).

16. Glaeser et al., *supra* note 5.

17. *Id.* at 300.

that “the binding power of precedent checks the ability of the sovereign to influence judges in specific instances,”¹⁸ but one could easily argue that judiciaries in countries without a strong doctrine of precedent are equally constrained by detailed codes.

A study by Feld and Voigt develops more sophisticated measures of judicial independence.¹⁹ They distinguish between de jure and de facto independence. The former comprises twelve variables, including life tenure and appointment by professionals, while the latter is composed of eight factors, including the average length of actual judicial service, whether salaries have been eroded by inflation, and how often laws relating to courts have been changed. The authors examine the relationship between judicial independence and economic growth in fifty-seven countries. They find that de jure independence is not related to economic growth, but that de facto independence is. Unfortunately, because the measurement periods for the independent and dependent variables overlap—de facto judicial independence was measured from 1960-2000 and economic growth was measured from 1990-98—the study cannot fully distinguish between causation and correlation.

An article by Paul Mahoney and I takes a different approach, looking at change over time in a single country—England in the eighteenth century.²⁰ Unlike other articles discussed here, we did not look at dozens of countries with a variety of confounding cultures and political systems. Further, this approach did not take snapshots of different countries at one point in time, but instead looked at change over time.

As a result of the Glorious Revolution in 1688, England began to grant its judiciary more independence. We tried to examine the impact of these changes on the economy. Unfortunately, we could not examine the impact on economic growth directly because good high-frequency data on growth from this period was lacking, and even if such data existed, it would be difficult to disentangle the effect of judicial independence from the effect of the many other institutional changes enacted during that time. Instead, we looked at effects on equity prices.

England has had a flourishing stock market since the 1690s, and surviving contemporary newspapers recorded daily prices. Because this market, like modern ones, responded quickly to news, we could isolate the effect of judicial independence from the effect of other institutional changes by looking at price movements the day before, day of, and day after important legislative actions, (that related to judicial independence—introduction of legislation, amendment of legislation, votes on legislation, etc.). We found that improvements in judicial independence were

18. La Porta, *supra* note 13, at 451. The data on judicial independence used in *Do Institutions Cause Growth* is the same as that used in *Judicial Checks and Balances*, and is described more fully in the latter. Because the two articles use the same measures of judicial independence, the critique in the text applies also to *Judicial Checks and Balances*.

19. Lars P. Feld & Stefan Voigt, *Economic Growth and Judicial Independence: Cross-Country Evidence Using a New Set of Indicators*, 19 EUR. J. POL. ECON. 497 (2003); see also Lars P. Feld & Stefan Voigt, *Making Judges Independent—Some Proposals Regarding the Judiciary* (CESifo Working Paper Series No. 1260, 2004).

20. Daniel Klerman & Paul Mahoney, *The Value of Judicial Independence*, 7 AM. LAW & ECON. REV. 1 (2005).

associated with increases in equity values. In particular, legislation granting life tenure was associated with a 10% increase in stock prices, while other changes, including increases in judicial salaries, were associated with smaller increases. Of course, there are problems with this approach. The stock market measures contemporary perceptions and predictions of economic impact, and not actual impact. In addition, England's economic development may have differed from that of other countries. Further the relationship between judicial independence and economic growth may be different today than it was 300 years ago.

IV. FUTURE RESEARCH

There obviously is a vast potential for future work. For example, one could improve upon the analysis of Glaeser, La Porta, Lopez-Silanes, and Shleifer by collecting data on judicial independence in 1960, and analyzing its impact on economic growth in the period from 1960 to 2000. One could also build upon Feld and Voigt's analysis by using different data on de facto judicial independence. Reports compiled by the American Bar Association Central European and Eurasian Law Initiative ("ABA-CEELI") might provide a rich vein of data for this purpose, albeit one that is restricted, at least at present, to only sixteen countries.²¹ Finally, the analysis that Paul Mahoney and I performed could be extended to other countries and perhaps even to individual American states. With a larger sample of countries, it might also be possible to use economic growth as a dependent variable in addition to equity returns.

In conclusion, economic theory suggests that effective, independent courts promote investment and economic growth. Nevertheless, independent courts may not be necessary for growth, because executive constraint and reputational contract enforcement may be adequate substitutes. If growth starts without a solid judicial infrastructure, economic growth may cause demand for quality courts. The empirical literature provides some support for the idea that independent courts encourage economic growth, but causation remains unclear and much work remains to be done.

21. The author thanks Bruce Janigian for bringing this source to his attention.