

# 0580

## LAW AND ECONOMICS OF DEVELOPMENT

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### Abstract

This chapter provides a review of the main channels through which legal systems affect economic development. High costs for determining property rights are still common in most developing countries. Confiscations; multiple, high and unanticipated taxation applied to the same bundle of property rights again and again; unclear definition of contractual obligations; inconsistent application of the laws coupled with corruption, and ad hoc regulations make property rights more insecure and have also caused increased transaction costs within the marketplace. This institutional instability increases the discount rate applied to social interactions in future periods, thereby hampering investments, savings and the consumption of durable goods.

This chapter approaches the main substantive and procedural legal factors that nations need to address in order to promote economic growth and development. The substantive legal requirements for economic development are analyzed here by identifying the efficiency enhancing sources of legal norms (that is, bottom-up formalization of legal norms, legal transplants and legal integration). Economic growth and social development are also affected by legal procedures and the mechanisms through which norms are enforced and interpreted by the court system and alternative dispute resolution mechanisms. This chapter also identifies how corruption and the lack of efficiency and effectiveness found in dysfunctional court systems affect investment and economic development.

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### 1. Introduction

To what degree does law promote economic development? To what extent does creating wealth through the accumulation of human and nonhuman capital require a set of rules securing property rights, governing civil and commercial relationships, and making the exercise of the state's power more predictable? To what extent might economic growth be affected if rules are clearly defined, made public, and applied in a consistent manner? To what extent are

investment projects affected by mechanisms to resolve conflicts based on the binding decisions of an independent judiciary and procedures to change the rules when change is needed? Measuring the extent of the impact of the law is an empirical inquiry. The answers to these questions represent the new frontier in law and economics. In most less developed countries, uncertainty related to the application of the law due to discretionary power and an inefficient administration of justice are affecting trade and investment by increasing transactions costs and fostering corruption. Observations and logical truths are abundant, yet the empirical verification of these logical truths seems to be scarce.

The first part of this chapter approaches the main substantive legal factors that nations need to address in order to promote economic growth and development. This first part will address the substantive legal requirements for economic development by identifying the main efficiency-enhancing sources of legal norms (that is, bottom-up formalization of legal norms; legal transplants and legal integration). I examine the impact of legal transplants on economic efficiency and demonstrate this by reviewing the transplantation of trade-related intellectual property laws in Latin America. Also examined is the incorporation of efficiency-enhancing legal doctrines through economic integration and a jurimetric case study of trade agreements in South America. Finally, this part of the chapter analyzes the impact of laws on organizational structures.

The second part of this chapter addresses the procedural aspects of the law and economics of development. I first address the role of the judiciary and its impact on economic development. Also presented is a case study providing an economic and inferential analysis of the court systems in Latin America. Finally, the chapter provides an account of the symptoms of a dysfunctional court system (that is, inefficiency, ineffectiveness and corruption) and examines the impact of these institutional symptoms on economic development.

The conclusion to this chapter defines the scope of the field and possible future areas of research.

The process of economic transformation through deregulation and the privatization of the means of production in many developing countries coupled with intensified international trade of complex goods and services requires a legal framework with clear rules for economic interaction. The magnitude of the economic transformation experienced by many developing countries in recent years involves increasingly complicated contractual relationships among savers, producers, investors and customers. This process of growth needs a system of rules able to enhance risk management in a increasingly complex economy. Legal, judicial and alternative dispute resolution systems are potential institutional improvements in how society deals with higher social complexity and increasing risks generated by human interactions. The clear

identification and specification of these improved mechanisms is the first problem waiting to be solved by the economic analysis of law in developing countries.

A modern market economy requires laws that are able constantly to redefine rights and market relationships when new forms of corporate structure emerge; to provide ever-changing determinations of contractual obligations, and extend them to new forms of financial instruments, tangible and intangible property; to redefine and enforce the rights of victims of new technologies and activities while protecting the environment from newly emerging risks. These are only some examples of the tremendous flexibility that the legal and judicial systems require in order to adapt the laws to a dynamic economic system. As Cooter (1996a, pp. 2-3) states in his pioneering piece, 'if economic law is poorly adapted to the economy, expectations conflict, cooperating is difficult, and disputes consume resources. Conversely, if economic law is adapted to the economy, people cooperate with each other, harmonize their expectations, and use resources efficiently and creatively'. If public institutions are defective and political conditions too unstable, private contractual arrangements will also become riskier and negatively affect private investment. In short, the formation of larger markets and the possibility of longer-term contracts, both necessary conditions for economic growth, are hampered by an unclear or undefined system of legal rules and inconsistent application and interpretation of those rules. The application of the economic analysis of law to development issues sponsors a clear and consistent definition and enforcement of the conditions of ownership in developing countries undergoing transformations. As Orr and Ulen (1993, p. 3) argue,

'a government that credibly commits itself to upholding rights of property and contract enforcement not only provides a basis whereby partners in economic transactions can trust each other; it also reinforces the hope that the government itself can be trusted to transact honorably and to meet its contractual obligations'.

Yet high costs for determining property rights are still common in most developing countries. Confiscations and multiple, high and unanticipated taxation applied to the same bundle of property rights again and again, unclear definition of contractual obligations, inconsistent application of the laws coupled with corruption, and ad hoc regulations have all made property rights more insecure and have also caused increased transaction costs within the marketplace. This institutional instability increases the discount rate applied to social interactions in future periods, thereby hampering investments, savings, and the consumption of durable goods. The most interesting question then remains: What are the structures of the most effective legal and judicial mechanisms that would be able to interpret and translate those social norms into laws in less developed countries?

The economic analysis of the law in developing countries represents an attempt to identify changes in laws, regulations and enforcement mechanisms that, within the legal tradition of each country, would be able to enhance economic efficiency and improve equity. Edmund Kitch (1983) argues that law and economics focuses on the study of the impact of a system of rewards and penalties that affect individual behavior. These rewards and penalties are defined by laws, regulations, doctrines, court cases, social norms, and so on. The central goal of law and economics is then to analyze the individuals' and firms' maximizing behavior within a system of rules in order to identify the effects of laws. In this sense, law and economics follows a methodology compatible with a legal realism and within an elaborate framework of analysis provided by microeconomic theory. In this context, I will analyze how legal doctrines are not hermetically sealed, self contained, or even self sustaining. I will follow a legal realism found in law and economics where the law cannot be understood apart from its social context. Thus, an understanding of how to enhance a more efficient social order through legal reform will be attained through an empirical study of human behavior.

### **A. Substantive Aspects of the Law and Economics of Development**

#### **2. Efficiency and the Source of Legal Norms**

One recently emergent line of research in the law and economics of development literature concentrates on the microeconomic foundations of the sources of those rules that will allow the law and its enforcement mechanisms to adapt to a modern economy and, by adapting, foster economic growth. This topic is explored by Cooter (1996a) who argues that efficiency is enhanced by a 'bottom up' process of capturing social norms that are already in place as 'informally' relevant in human interaction. Norms are understood here as coordinating mechanisms for social interaction. This decentralized approach to lawmaking stands in sharp contrast to the centralization proposed by the first law and development movement that during the 1960s and 1970s proposed a clear centralization and 'modernization' of the laws through transplants. The most important works in this first movement can be ascribed to Trubek (1972), Galanter (1974), Seidman (1978), and who sponsored a comprehensive, centralized, and top-down legislative reform aimed at modernizing the public and private dimensions of the law.

There are four legal traditions relevant in this century: civil law, common law, administrative law and socialist law. Eastern Europe and China have slowly shifted from a socialist legal system characterized by the production of centralized public rules to prerevolutionary private civil law. The common or

judge-made law sustained by *stare decisis* has suffered from the significant expansion of administrative law. In this scenario, administrative law, as the framework establishing the rules to be followed in the relationship between the state and private individuals, has been the byproduct of the expansion of the government role in western societies. Therefore, these legal traditions are in a constant state of flux.

The civil law systems are currently facing a choice between either legalizing and enforcing social norms in a bottom-up approach by following the policy prescriptions of Hayek (1973) or creating regulations in a centralized top-down manner. For example, the civil code can either capture the norms of local and international business communities or simply impose rules on a top-down approach. One of the most important dilemmas facing developing countries in their current legal evolution is the choice between centralized law versus decentralized law-making capabilities. Following Hayek (1973), one could argue that the higher information constraints that are the product of added social complexity require public policy to decentralize law-making by capturing norms and thus reducing market transaction costs. As Cooter (1996a, p. 148) states, 'efficiency requires the enforcement of customs in business communities to become more important relative to the regulation of business'. As he (p. 154) also argues, 'customs arise when external effects align with incentives for signaling'. From this perspective, the irrelevance of the laws enacted by parliaments in many countries must be understood as a reflection of the lack of links between the essence of what the law stipulates and the social norms followed by people and businesses in their daily life. When regulations or laws show this lack of compatibility, the costs of complying and enforcing the law become higher. These are the so-called 'bad laws' mentioned by de Soto (1989) in his path-breaking work in which he identifies a deficient rule by comparing the approximate transaction cost of complying with the law against the transaction cost of following the social norm within an informal market. In de Soto's work one can observe that these higher transaction costs are rooted in the drive of governments to centralize lawmaking without regard to the true social practices followed by people. Only when the laws and regulations reflect these practices will the transaction costs of the social interactions affected decline and a movement towards efficiency occur. From de Soto's (1996a) perspective, the size of many informal sectors around the globe is intimately related to the way laws and regulations fail to capture the social practices followed by society.

By following the pioneering studies by Cooter (1994, 1996a) and Mattei (1993) we could argue that the laws generating obedience are the ones truly compatible with the ethical code prevailing in society. Individuals in social frameworks seek the kind of predictability that will tend to increase their capacity to generate wealth through their interactions. The state of nature or 'grab what you can' is not a priori desirable or compatible with long-term

survival under a 'veil of ignorance'. Different levels of concentration of political and economic power may be compatible with predictable rules of the game. Yet for all levels of concentration of political and economic power, the social norms and values supporting the prevailing and predictable rules of political and economic interaction would tend to enhance allocative and productive efficiency by reducing transaction costs of interacting. In this scenario, civil society's norms will be found by public institutions and transformed into formalized legal rights and obligations.

One could here extend Cooter's analysis and state that, in order to enhance efficiency, politics must follow not just the market but also the non-market social norms. In a more comprehensive fashion, civil society's market and non-market rules for social interaction provide a law-making guide for the legislature and the judiciary. By making laws familiar to the individual, the transaction costs of human interactions decrease and allow society to achieve efficiency in its market and non-market activities. The evolution of intellectual property laws in developing countries, described in the next section, provides a good example of how legal transplants provided a channel through which national laws started to capture business practices and social norms.

### **3. Legal Transplants and Economic Efficiency**

Let us now address the economic analysis of efficiency-enhancing substantive legal reform in developing countries. There are two main choices for a developing country when selecting the source of its laws. A country can adopt a law from within its own institutional mechanisms, or it can transplant rules from outside its political-legal zone of dominance. A key need in the economic analysis of the law is to determine a framework for predicting which of the two options is the most efficiency-enhancing alternative. Watson (1978a) has shown that most legal reforms are due to transplants. Therefore, we should also explain why, from an international pool of laws available for transplant, certain rules and institutions are commonly used while others are rejected. For example, why is it that some countries adopt the same rules to protect intellectual property? In more general terms, we should also explain why some countries adopt civil law as opposed to common law systems, or separation of powers as opposed to parliamentary systems. As Mattei (1994) and Ulen (1996) pointed out, one reason could be simply 'prestige'. Yet they point out that prestige is not a measurable variable and, thus, it is difficult to verify the hypothesis in a scientific manner. Microeconomic theory, on the other hand, can provide a justification for the transplant by testing if the legal rules transplanted are also the most efficient ones. In other words, an intertemporal cost-benefit analysis may provide an explanation of why some legal rules and systems are adopted and others rejected. Within this scenario, Eggertson (1990)

and Ulen (1997) point out that the economic efficiency hypothesis proposes that different legal systems may compute the costs and benefits of legal rules for the same situation differently because real economic factors (such as resource endowments and tastes) are different across regions and nations. At the same time, it is also true that legal reforms are subject to the political supply and demand given by vested interests. That is, professional interests which may be threatened by any profound alteration in the legal system as it exists and from which they have benefited. To a large extent, the successful implementation of any reform depends on these agents, ultimately responsible for effective law-enforcement.

#### **4. Case Study: Intellectual Property Laws in Developing Countries**

Buscaglia and Ulen (1994) apply the above cost-benefit approach to transplants to the recent adoption of intellectual property laws under the GATT umbrella. Recent empirical studies conducted by Foray and Freeman (1993) show that in order to ensure a 'catching-up' growth process, developing countries need to expand the size of their domestic savings and human capital pools through the application of clear laws and consistent enforcement. The observed differences in wealth among countries has always captured the attention of scholars in many fields. Lucas (1988) describes the powerful effects of technological change and the need to enhance technological learning in the process of economic development. Yet 'catching-up' is a process that depends on much more than just technological change, understood as increasing the incorporation of new technologies into the production capacity of firms. Bell and Pavitt (1993) bring to our attention the importance of technological learning, defined as an increase in the resources needed for generating and managing technical change. In this context, what needs to be addressed is not just the lack of industrial capacity or technical change but also the dearth of technological capability as the most basic and acute deficiency in most less developed countries (LDCs). Technological learning, however, requires a deeper transformation in a society than technological change does. Technological learning implies the building of institutions and skills capable of generating technical change in the future. It is at this deeper level that, for example, the intellectual property framework will affect future technical change.

The increasing permeability of national frontiers subject to international trade and ideas is of such magnitude that it has forced national authorities to reconsider the legal foundation of intellectual property rights. The Paris and Berne Conventions provided a legal framework for more than a century containing two main doctrines. The doctrine known as 'territoriality' sustaining that property rights are to be honored according to each state's rules; and the

doctrine of 'independence' establishing that granting property rights within one state did not force other states to grant the same rights. These two doctrines have become irrelevant under the new order emerging after the Uruguay Round. Under the supervision of the newly created World Trade Organization, the harmony or uniformity of laws has been sought as the ideal way to encourage the international flow of goods and services. This new framework has solidified the view that the justification for granting intellectual property rights, such as a patent, is based on social norms required by the need to exchange benefits between society and the innovator. The innovator receives a monopolistic return from an investment in order for society to be able to benefit from an incremental diffusion in knowledge that otherwise would have been kept as a secret.

The international enforcement of intellectual property rights experienced a drastic evolution during the past three decades. For more than a century, the international intellectual property regime was governed by the Paris and Berne Conventions which provided ample scope for cooperation but at the same time left to national legislation to define the main aspects of intellectual property rights. After World War II, a concern with the balance between the rights of the author and the benefits of diffusing knowledge to less-developed countries (LDCs) as fast as possible challenged the norm based on the aforementioned exchange of benefits between society and the innovator. The need for rapid industrialization and vast improvements in technologies were justifications for LDC governments to impose requirements limiting the rights and benefits of innovators. Two typical examples of limitations to the rights of innovators occurred in most LDCs when: (a) a patent can only be granted if the intellectual property is worked and exploited within the national frontiers of a country (a working requirement); and (b) the terms and royalties for licenses of intellectual property can be determined by the government in the absence of agreement by the innovator (compulsory licensing). Under these two types of restrictions, LDC governments abandoned the formula of exchange based on monopoly for diffusion and replaced it with an approach based on granting intellectual property rights in exchange for foreign direct investment. Difficult problems remained, however. Common features of many legal systems in LDCs show intellectual property rights subject to inconsistent coverage, uncertain terms of protection, arbitrary transferability, compulsory licensing regimes and inadequate enforcement. The national character of this type of legislation, however, has been increasingly called into question by industrialized countries. The advanced economies' challenge to the old legal order can be explained by drastic changes in business practices and norms of behavior. More specifically, the need for legal reforms were caused by the technological breakthroughs of the 1970s and the subsequent revolutionary impact of microelectronics, biological inventions, computer software and other high technology sectors. These sectors required increasing investments in research and development



paid by businesses from those industrialized countries mainly responsible for the production of these knowledge-intensive products. Under this scenario, international trade of knowledge-intensive products gained relevance as a proportion of each developed countries' exports and national production.

### **5. Trade-Related Intellectual Property Rights**

The new reality shows that the United States (US), the European Union (EU) and Japan are increasingly dependent for their competitiveness on their ability to protect the value inherent in intellectual property. At the same time, most of the LDCs are extremely dependent on exports to advanced economies. Many of these LDC exports benefit from the Generalized System of Preferences (GSP) granted by the European Union and the United States, whereby special lower tariffs or preferences are applied to designated LDC exports. This mutual dependence made it possible for advanced and developing economies to start bilateral negotiations with a potential for mutually beneficial agreements in order to find a solution to the lack of protection of intellectual property rights. The 'stick' in these negotiations was provided by the threat of loss of access to the United States and European markets through the cancellation of GSP benefits. But foreign pressure is not the only force that is able to explain legal reforms in LDCs.

Since 1995 and under the World Trade Organization (WTO) supervision, many less-developed countries have adopted trade-related intellectual property rights (TRIPs) that are more compatible with the American and European minimum standards of protection. Some may even classify these legal reforms as 'transplants'. As part of the GATT framework, the WTO will (a) finally enforce a set of internationally recognized standards for the protection of intellectual property rights for incorporation into national laws; and (b) develop a consultation and dispute settlement mechanism for overseeing the implementation of the international norms and resolve any government to government disputes regarding the interpretation of such norms.

Primo-Braga (1990a) observes that modern intellectual property rules have not been applied or enforced by governments in developing countries even when the benefits of such rules are widely recognized by local business interests and by the countries generating the essential technologies needed for development. However, the forces explaining this pre-GATT inertia or the causes behind the current emergence of a region-wide intellectual property reform throughout Latin America have been overlooked. This oversight is explained by the failure to recognize how the costs and benefits of legal reform operate on a different time frame. More specifically, the costs of legal reform are seen by politicians in less developed countries as a short-term liability

hampering their chances for reelection. On the other hand, the benefits of defining and enforcing intellectual property rights are perceived as more distant and less tangible.

As stated in Buscaglia and Ulen (1994, p. 159), legal reforms in developing countries must be seen as the joint effect of local political conditions and foreign economic pressures. These two forces explain the international legal convergence observed in the intellectual property arena. As stated above, the foreign economic pressures to reform intellectual property laws arise particularly because an increasing proportion of imports to Latin America consist of information-intensive goods and services. From a domestic policy perspective, the movement toward intellectual property reform corresponds with the complete failure of the import substitution approach to development. From the early 1930s until the late 1980s, most developing countries encouraged domestic (import substitution) manufacturing investment, suppressed agricultural prices and expanded the size of their public sector enterprises while attempting to stimulate savings and investment through taxation and credit allocated by the public sector. The prevailing view, represented in Prebisch (1950), was that a shortage of domestic physical capital was the key impediment to development. Import substitution industries grew behind protective walls based on subsidies and tariffs in a *milieu* where many other determinants of the rate of economic growth, such as investment in human capital and the role of microeconomic incentives, were completely ignored by policymakers. Protection of import substitution industries allowed domestic prices and costs to far exceed international prices and created little incentive for efficiency. These protected industries produced substitutes for imports but usually depended on the import of raw materials and technology. Import demand grew rapidly as these firms imported capital goods to accelerate investment. The anti-export bias, combined with the import-substitution program, caused a scarcity of foreign exchange and this, in turn, created a structural barrier to the investment in expensive first-rate technologies. Within this environment protected from international trade, however, firms could still survive investing in second-rate technologies. As described in Buscaglia (1993) this approach to development came to an end during the international debt crisis of the 1980s when developing countries' policymakers realized that internal markets and import substitution were not enough to assure sustainable growth. The demise of the import-substitution model left most developing countries with no other option for economic growth than to eliminate trade barriers and promote competitive exports through the incorporation of world-class technologies. As a result of these foreign and domestic pressures, LDCs were forced to reconsider many of their legal institutions, including their national intellectual property laws. In this context, the international economic and political environment described here has produced a convergence of LDC laws towards the intellectual property legal frameworks prevailing in nations generating standard technologies.

## **6. Legal Transplants and Economic Integration**

Legal transplants are a key main source of trade-related legal changes in developing countries. Most LDCs have chosen an export-led approach to economic growth and they are also eager to attract much needed foreign direct investment (FDI). In order to enhance trade openness abroad and at the same time attract foreign investment to their domestic markets, they must provide a more stable environment in which to do business. Therefore, competitive pressures arise on LDCs to harmonize their legal systems with those in countries exporting capital by incorporating foreign legal frameworks that developed-country firms perceive to enhance their productive efficiency.

A central topic to be addressed in law and economics of development must focus on the study of what are the main economic factors explaining the formation of legal transplants and legal integrations that tend to enhance productive efficiency. As stated in Ulen (1996, p. 9), 'Law and Economics has been one of the most important and productive innovations in legal scholarship of the twentieth century. Yet its contributions to the issues of constitutional law, including federalism, are relatively modest'. From this perspective, we could add that the attention paid to the analysis of legal and economic integration have also been insufficient.

The mechanisms through which parliaments and the judiciary in civil law countries would capture and translate these norms into law would require an identification of those practices that have become standard in business communities and a required justification of how those practices create efficiency-compatible incentives. The efficiency aspects of these practices must be analyzed with the aid of the theoretical and empirical tools used by economists. For example, this approach to law-making could use empirical techniques within the so-called jurimetric framework of analysis. In this way, the economic impact of legal reforms could be captured through the use of parametric and non-parametric techniques. Relatively few empirical studies have been advanced in law and economics and even fewer within the economic analysis of development. Yet studies by Long and Buscaglia (1997), Cooter and Ginsburg (1996) and Buscaglia and Guerrero (1995) have clearly shown the great advantages of applying statistical techniques to the economic analysis of the law. Without any doubt, jurimetrics represents a real frontier in the law and economics of development. The potential to rationalize public policymaking with the help of jurimetric techniques represents a clear improvement in the analysis of the economic impact of legal reforms proposed in all developing countries.

Many may argue that civil law systems would tend to reject the economic analysis of their laws. Yet, quoting Cooter (1996a, p. 145),

Judges allegedly make law in civil law systems by interpreting codes, not finding social norms. Compared to common law countries, the codifiers in civil law countries apparently have more influence and the judges allegedly have less influence. Interpreting some codes, however, looks a lot like finding social norms. Comparative lawyers, consequently, debate whether the apparent differences in the two systems are real or illusory<sup>7</sup>

From this perspective, one could argue that civil law systems have the capacity to react to efficiency forces as much as common law systems do. Moreover, it may come as a surprise to many sponsoring a centralized legal system that the civil law originally evolved as a common law system. In Watson (1978a) we can find an excellent account of this evolution. Let us not forget that, before the nineteenth century, the European *ius commune* was based on the judge's interpretation of Roman law within the local norms and practices. The centralization of law making through legislatures aimed at replacing laws based on social norms, practiced by people and found by judges, with what Cooter (1996a) calls 'rational' rules that were 'designed' to engineer a better way of life for society. The judge was supposed to only interpret laws generated by legislatures and not find norms. The interpretation of norms, however, was also subject to an implicit and subtle application of social norms as inputs in the opinions of judges. Yet, this post Napoleonic framework took away power from the judicial branch and made it more dependent.

The formation of trading blocks can be analyzed with the same tools that law and economics has applied to the analysis of federalism. This approach focuses on identifying and measuring the benefits *versus* the costs of generating added political and economic integration. Long and Buscaglia (1997) recently advanced empirical research in this area. It is useful to present a summary of this empirical study on economic integration below. The methodology used in this piece provides an alternative research path where the links between the existence of legal transplants and economic structures can be explored and discussed in future studies.

Developing nations are currently facing a unique opportunity created by global free trade, the continuous decline in transportation and communication costs coupled with the unprecedented availability of generic applied knowledge and the expanding flows of international financial investments. However, many of these countries lack the institutional capability to create or absorb the applied knowledge aforementioned. Legal and economic reforms that are currently occurring in LDCs are, in some cases, strengthening the foundations for economic growth. In all cases, these legal and economic reforms are based on strategies aimed at giving domestic producers a more important role in the development of their economies.

During the 1980s, increasing competition and volatility in world markets have induced industrialized and developing countries alike to cluster together in regional economic blocs. This trend was spurred by three additional main factors: (i) technological innovations in transportation and communications have expanded the relevant size of the markets for an increasing number of goods and services; (ii) the overall economic slowdown in world trade during the period 1988-92, accelerated by the collapse of the Communist regimes; and (iii) the near failure of the multilateral trade negotiations sponsored by GATT at the Uruguay Round. In turn, the near-breakdown in multilateral trade negotiations served to create an environment compatible with bilateral and regional accords.

## **7. Legal Integration and Economic Development**

Legal integration is another main external source of legal changes that have an impact on efficiency in many developing countries. Of central interest, in our analysis, is why governments choose some strategies over others in pursuing legal/economic integration. Long and Buscaglia (1997) propose that a successful legal/economic integration is a function of the convergence of three broad conditions: (1) the compatibility of political systems; (2) the public sector's expectation of gains from liberalizing international trade; and (3) the private sector's expectation of gains from regionalizing production, transferring capital and technology and harmonizing trade-related rules. Some or all of these factors are key driving forces behind the main trade agreements within the western hemisphere, Europe and Asia: the North American Free Trade Agreement (NAFTA) of the United States, Canada and Mexico; the Andean Pact involving Bolivia, Colombia, Ecuador, Peru and Venezuela; and the Common Market of the South (MERCOSUR) covering Argentina, Brazil, Chile, Paraguay and Uruguay, the European Union and the Asian Economic bloc. As a case study, the empirical study summarized below concentrates on providing an empirical verification of the above third condition in Latin America.

The ongoing Latin American economic transformation has created a need for new and major legal developments. Yet, what are the main economic forces explaining the drive to integrate throughout Latin America's economic history? A jurimetric analysis in Long and Buscaglia (1997) shows that growth in international intra-sectoral trade comes hand-in-hand with the private sector's growing demand for the harmonization of trade-related laws. In addition to the legal issues mentioned above, harmonization does occur in many other areas. A survey of the legal history of economic integration reveals that harmonization occurs in specific areas such as banking, insurance, securities, liberal professions, international securities exchange regulations and transport. We see that the future of hemispheric integration and trade processes

necessarily entails the deepening and development of these legal areas. However, Latin American economic history has been littered with the hulls of shipwrecked trade agreements seeking legal integration. Yet, the compatibility in the evolutionary natures of two or more legal systems has to be introduced as a factor that will affect the need and feasibility of legal integrations. Moreover, the empirical review of patterns of trade in Long and Buscaglia (1997, pp. 10-12) shows that this legal compatibility is driven by international similarities in economic structures.

Table 1 aims at associating legal agreements seeking harmonization in trade-related rules with other economic factors such as the number of high growth non-agricultural trade-related sectors of the economy of selected LDCs. A review of Table 1 below shows that there exists a strong association between the emergence of high growth (above 5 percent annual growth in sales) non-agricultural sectors (that is, changes in economic structure) and the number of legal amendments in the commercial codes on the one hand and the drive of a country to harmonize its legal system through international trade-related agreements on the other. For example, we observe that Argentina and Brazil who possess the most dynamic economies during the period 1850-1990 (with 16 and 14 new non-agricultural trade-related sectors respectively) are also the countries with the largest number of amendments to their commercial codes and with the largest number of trade-related legal treaties signed (that is, 31 for Argentina and 35 for Brazil). As expected, more complex economic systems (that is, a larger number of high growth new trade-related sectors) experience more complexity in their legal systems by undertaking more amendments in their commercial codes. At the same time, Table 1 shows that dynamic economies are also more likely to harmonize their legal systems through international legal agreements.

**Table 1**  
**Legal Changes vs. Economic Structure During 1850-1990**

<b>Country</b>	<b>No. of Amendments in Commercial Codes</b>	<b>No. of Trade Related Non-Agricultural Sectors</b>	<b>No. of International Legal Agreements</b>
Argentina	515	16	31
Bolivia	19	1	3
Brazil	521	14	35
Chile	467	11	25

Colombia	9	0	7
Ecuador	14	1	6
Peru	56	0	12
Uruguay	12	1	5
Venezuela	5	2	1

Table 2 shows a clear pattern where the region's most dynamic economies are also the ones that are more likely to enter into international legal agreements with each other involving harmonization of private law. One can argue that as an increasing number of business exchanges occur in countries with overlapping growing trade-related sectors, their need for legal harmonization will tend to increase. This explains why in Table 2 we observe that most attempts to harmonize legal frameworks have mainly involved countries such as Argentina, Brazil and Chile. These countries all experienced growth in the most dynamic trade-related sectors (for example, agro-manufacturing, minerals, steel, financial services, transportation and energy).

**Table 2**  
**Matrix of Inter-Country Legal Agreements**  
**Covering Commercial Areas**

	Arg.	Bra.	Bol.	Ch.	Col.	Ec.	Peru	Urug.	Ven.
Argentina	0	14	1	10	2	1	2	1	0
Brazil	14	0	2	7	3	2	4	2	1
Bolivia	1	2	0	0	0	0	0	0	0
Chile	10	7	0	0	2	1	3	1	1
Colombia	2	3	0	2	0	0	0	0	0
Ecuador	1	2	0	1	0	0	2	0	0
Peru	2	4	0	3	0	2	0	0	1
Uruguay	1	2	0	1	0	0	0	0	1
Venezuela	0	1	0	1	0	0	1	1	0

## **8. Inferential Jurimetric Analysis of Legal Integration**

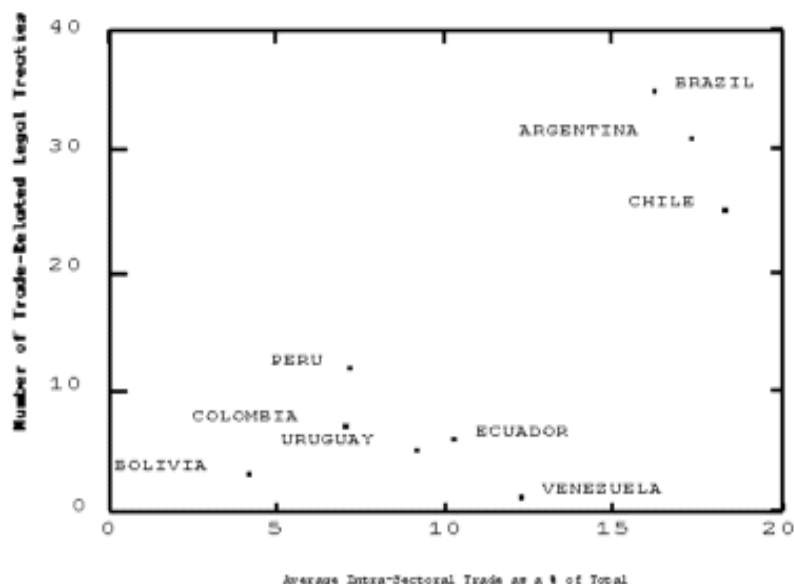
Based on the evidence found in Table 1 and Table 2 taken from Long and Buscaglia (1997), we can assert that many Latin American experiments aimed at legal harmonization may have failed to produce substantive results due to a lack of private sector lobbying pushing for compatible legal solutions addressing trade issues. More specifically, countries with overlapping dynamic trade-related sectors (that is, experiencing a higher proportion of intra-sectoral international exchanges as a proportion of total trade) will at the same time possess private sectors demanding compatible legal frameworks within the areas affecting their products. This also explains the push for intellectual property and competition reforms and harmonization of rules among Argentina, Brazil and Chile. In this context, imagine two types of countries hoping to harmonize their commercial laws: countries where private commercial laws are not far from their evolutionary base and where no dynamic trade-related non-agricultural sectors producing information-intensive products exist (for example, Bolivia, Colombia, Uruguay) and, in contrast, countries with relatively evolved commercial legal systems and with a high proportion of their trade concentrated on dynamic sectors (such as Argentina, Brazil, Chile). The quantitative evidence (Tables 1 and 2) and the analysis advanced above would predict that legal harmonization between these two types of countries will have less chances of success. In these cases, the private sectors within each of these types of countries will demand different kinds of commercial legal frameworks. As a result, integration will be more difficult. For example, one can observe that private sector firms in Bolivia importing Brazilian computer software and hardware, compact disks, or movies, do not have an incentive to lobby for the enactment of intellectual property, government procurement, or competition laws compatible with the needs and interests of the Brazilian firms exporting these products to Bolivia. Figure 1 shows that the main drive to harmonize trade-related laws was concentrated among those countries experiencing high levels of international intra-sectoral trade. For example, we see that Brazil and Argentina with 35 and 31 trade-related legal agreements, respectively, are also the countries with the highest level of intra-sectoral trade.

Clearly, Argentina, Brazil and Chile are the countries with the highest levels of intra-sectoral trade as a proportion of their total trade that, according to our argument, also possess the most dynamic private sectors lobbying for legal integration. The number of legal agreements attached to each of these three countries during the period 1890-1990 clearly support our claim. In fact, those industries involved in intra-sectoral trade within MERCOSUR were the main forces lobbying for legal harmonization of standards and regulations. Let us note that intra-sectoral trade within MERCOSUR grew at an unprecedented rate after tariffs were first reduced in 1988 as part of the ABIP Treaty. The



relative importance of intra-sectoral trade between Argentina and Brazil increased from 19.2 to 39 percent of total exports in Argentina and from 5.3 to 23.8 percent in Brazil. These industries included the automobile, energy, steel, pharmaceutical, mineral and textile sectors.

**Figure 1**  
**Legal Treaties vs. Average Sectoral Trade: 1890-1990**



One could also claim that the relatively larger countries (Argentina and Brazil), due to the larger stakes in trade and their larger GDP, will seek to determine a specific type of legal harmony with their main trade partners through legal agreements. On the other hand, smaller countries in Latin America (for example, Uruguay and Ecuador) will just 'free ride' by transplanting legal frameworks to their own environment. A regression analysis covering the variables aforementioned will test this and the above claims. We can see in Table 3 below that the number of legal agreements during the period 1890-1990 in the twenty countries surveyed is our dependent variable. The number of amendments to the commercial codes (AMEND), the number of non-agricultural trade-related sectors (NO\_TRNA) and the average intra-sectoral trade as a proportion of total trade (AV\_INTRA) are all predictors. These are all variables that help to predict the drive to harmonize legal frameworks within Latin America during the period 1850-1990. As we

can see, all these explanatory variables are significant at the 5 percent level. On the other hand, the relative size of the GDP (%GDP/T.GDP) is not a significant variable. In other words, relative size does not explain the drive to harmonize legal frameworks. Finally, we see that 62.7 percent of the variability in our dependent variable is explained by the independent variables included.

**Table 3**  
**Multiple Regression Analysis**

DEP VAR:NO_LEGAG SQUARED MULTIPLE R: 0.627		N: 20		MULTIPLE R: 0.792 STANDARD ERROR OF ESTIMATE: 2.04	
Variable	Coefficient	Std	Error Tolerance	T	P (2-tail)
CONSTANT	146	12	0	1216	0
AMEND	10	1	95	749	2
NO TRNA	43	5	95	861	0
AV INTRA	72	23	99	316	0
%GDP/T.GDP	5	15	86	33	34

### 9. The Impact of Laws on Organizational Structures

The impact of substantive norms on productive efficiency needs to be assessed by identifying the type or organizational structures that would emerge under different sets of legal rules. The full identification of the implicit price transmitted by institutions to firms and individuals, on the one hand; and the specification of the institutional structure needed to attain allocative and productive efficiency on the other, are two areas where law and economics possesses a comparative advantage with respect to other social sciences. Thus, the works presented in this field cover a positive and a normative approach to the economic analysis of the law. Douglass North (1990) has already pointed at the relationship between the property rights framework, transaction costs and economic growth. Moreover, the study of market and non-market behavior reacting to implicit prices established through laws falls within the best tradition of the University of Chicago approach to law and economics. Yet other approaches need to be incorporated into the legal and economic study of

development, such as the study of the behavior of organizations and their economic environment proposed by Oliver Williamson (1991) and the analysis of the factors related to intermediate organizations with the potential to hamper economic growth described by Mancur Olson (1982, 1993). In short, the understanding of how laws have an impact on market and organizational structures also need to be the focus of attention of development economists in search of answers explaining the lack of international convergence in economic growth rates.

Coase (1960) has shown that transaction costs determine the nature and organization of economic activity and the distribution of income. One interesting aspect to be addressed in development studies are the changes in legal rules and their enforcement mechanisms that are needed to promote the existence of public and private organizations in which their members' increase in wealth position is compatible with attaining the goals of the organization and improving the overall wealth of society. In this scenario, behavioral patterns such as low factor productivity incentives and corruption (that is, a transfer of wealth caused by the use of public office for private benefit) can be understood as symptoms of organizational defects explained by systems where individuals perceive that their wellbeing does not go hand in hand with the wellbeing of the organization in particular and society in general. In this scenario, a pattern of defective organizational structures hampers the creation of wealth and economic growth.

There are specific key variables whose dynamic interplay determine the performance of all organizations. These key variables correspond to the following two main areas: (a) the internal organization of an economic or political unit that includes the internal structures and arrangements between the principal and the agents by which the owner causes the managers to act for the goals set by the owner; and (b) external incentives that are composed of all those variables relating primarily to market factors that, although not under the control of the principals, discipline the agents and principals in performance. The past eight years of economic and political reforms across eastern Europe, Latin America and Africa have made it clear to those working on public policy reforms that the social and economic development of nations require newly designed organizations that are able to harmonize the incentive to create private wealth with the progress of society in general. This amounts to an invisible hand within the organization that can be explained by its own structure.

The links between the impact of private and public law on organizational structures in developing countries has not been explored until recently. The work advanced by Trebilcock (1997) goes into the main links between the quality of public sector governance, organizational structures and the economic progress of nations. This work covers the relationship between the nature of a political system and its economic performance. Subsequently, it answers two main questions: (i) what type of institutions are most conducive to economic

development and (ii) what factors or conditions encourage or alternatively impede the adoption of efficient institutions.

The research conducted by de Soto (1989, 1996a) follows an original examination of the property rights framework in developing countries, in this case Peru and describes the way in which the lack of predictable property rights rules have affected the structure of private firms, investment and economic growth. De Soto's historical analysis provides a decisive link between ownership rules and the complexity in the pattern of market transactions. Clearly, his analysis provides answers to key questions through the use of the economic theory of property. First, de Soto asks what should be privately owned in an environment where state ownership has been the norm until recently; and second, how should property rights be enforced in order to assure a compatibility between social norms and written law. In this scenario, de Soto requires this compatibility in order to assure that the law will be followed by the average citizen. In this context, he stresses the fact that in the absence of clear and enforced legal rules, people will substitute clear and enforceable customs and norms for the collectively enforced set of legal rules. As stated in Buscaglia and Ratliff (1997), from an economic standpoint, regionally-determined bubbles of customary systems may not be as efficient as a bottom-up collectively enforced set of legal rules.

## **B. Procedural Aspects of the Law and Economic Development**

### **10. The Judiciary and Economic Development**

As developing countries continue their process of economic reforms, the need for a well functioning judiciary becomes increasingly evident. Yet, the empirical dimension of the economic analysis of legal procedures is in its infancy. As stated in Buscaglia and Domingo (1996), democratization, growing urbanization and the adoption of market reforms have all created additional demands for court services throughout the region. These three factors have increased the complexity of social interactions, thereby making the enhancement of the judiciary's conflict-resolution capabilities even more necessary. In addition, the shift of most economic transactions toward the market domain and away from the public administrative sphere of the state has created an unprecedented increase in private sector demand for an improved definition of rights and obligations.

The judiciary is a key element of economic development. The judicial system includes all the mechanisms needed to interpret and apply the laws and regulations. More importantly, the judiciary is the main link through which the economic impact of the legal system can be identified. The productive role of

the judicial sector within the economic system consists of resolving conflicts by providing the substantive and procedural structure to facilitate the exchange of rights to physical and intangible assets. Judiciaries in most developing countries, however, suffer from increasing backlogs, delay and corruption. As shown in many Gallup polls, this has generated complete distrust of the system by the private sector and the public in general. Moreover, the judiciary can also affect the behavior of private investment. Lack of access to an equitable and efficient judicial system creates added uncertainty and hampers the realization of beneficial transactions. In the absence of an impartial and efficient judiciary, the performance of mutually beneficial transactions depends upon the presence of pre-existing reputation and repeated transactions among parties. This requirement excludes many potentially beneficial transactions involving previously unfamiliar parties or startup businesses from occurring.

Legal principles supporting the prevailing economic systems in many developing countries are nominally based on the freedom to exercise individual property rights. But legislation is meaningless without an effective judicial system to interpret it. Consistent interpretation and application of the laws by courts provides a stable institutional environment in which the long-term consequences of economic decisions can be assessed by businesses and the public. In this context, an ideal judicial system is composed of institutions capable of applying and interpreting laws equitably and efficiently. Under most of the judicial systems in Latin America, however, laws are not subject to predictable interpretation. This uncertainty, coupled with delays in resolving cases, further increases the costs of access to justice and doing business.

### **11. Judicial Systems in Developing Countries**

The belief that the judicial sector in Latin America is ill-prepared to foster private sector development within a market system is growing. Business surveys conducted by the World Bank (1993) indicate that the judicial system is considered to be among the top ten significant constraints to private sector development. Basic elements that constitute an efficient judicial system are missing: relatively predictable outcomes within the courts; accessibility of the courts by the population, regardless of income level; reasonable time to disposition; and adequate court-provided remedies. Increasing delays, backlogs and the uncertainty associated with expected court outcomes have diminished the quality of justice throughout the region. The judiciary is faced with several obstacles, including a dysfunctional administration of justice, lack of transparency and a perception of corruption.

As an example found in Buscaglia (1995), Table 4 presents country comparisons in the monthly percentage changes in delays and backlogs in

federal jurisdictions of selected Latin American countries that have reliable data. Average changes, in monthly terms, for the period 1983-93 show a pronounced deterioration compared to the period 1973-82, which helps explain the public's dissatisfaction with judicial systems throughout the region.

**Table 4**  
**Change in Delay and Backlogs in Latin American Courts, 1973-93**

Country	% Change in Median Delay		% Change in Backlogs	
	1973-82	1983-93	1973-82	1983-93
Argentina	167	478	92	479
Brazil	23	391	22	197
Chile	84	111	121	294
Colombia	34	278	91	281
Mexico	N/A	N/A	72	341
Venezuela	31	483	118	513

Sources: Supreme Court Bureau of Statistics for respective countries.

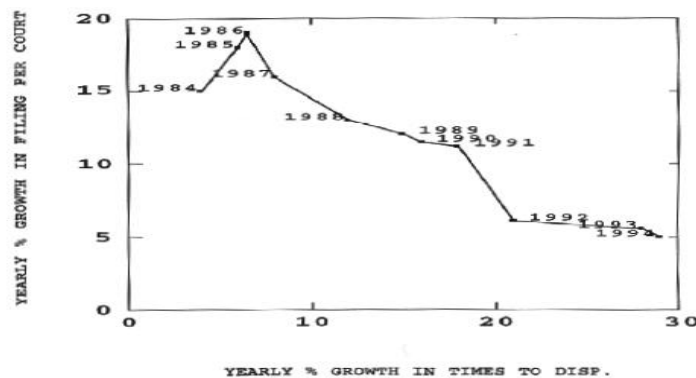
This data may also explain the results from a recent survey of the region's judicial systems conducted by the World Economic Forum (1993) that shows the majority of court users are 'not inclined' to bring disputes to court because they perceive the system as slow, uncertain and costly, or of 'poor quality'. Lack of confidence in the administration of justice is more pronounced among small economic units and low-income families.

One of the main premises within the economic analysis of the law is that institutions transmit implicit prices. An empirical analysis of legal procedures must identify the extent to which the prices imposed by legal procedures change the court users' behavior. The following example given in Buscaglia (1996a) provides an option for future research. In this example, the court system can increase the cost of resolving disputes when times to disposition increase. Figures 2 and 3 apply to the Civil Courts in Ecuador and Argentina. These graphs clearly show that the yearly percentage growth in the times to dispositions faced by the general public (measured on the horizontal axis) have been increasing in both countries since 1984. The median percentage increase in the times to disposition have been pronounced during the period 1984-94.

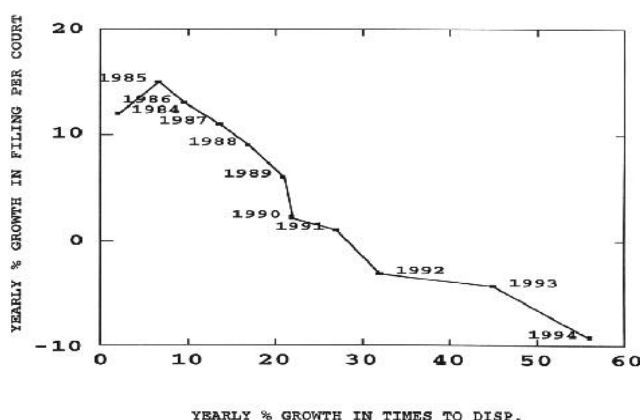
This clearly represents an increase in the average costs of litigation. We observe that the public reacts to this increase in costs by decreasing their filings per capita. This price effect explains the decrease in the average filings per court after discounting for changes in the number of courts, forms of case termination and for economic and population growths within the Federal District in Argentina and Quito in Ecuador. We can then interpret this graph as an expression of the effects of the increase in the implicit price imposed by the growing times to disposition faced by the general public. People react to this added cost by reducing their filings and not redressing their grievances within the court system. Our results also confirm the account of the informal courts of justice given by de Soto (1989) in Peru where people quit the formal court system and resolve their disputes within neighborhood councils.

A judicial crisis is also identified with precision for the first time in the literature in Buscaglia (1996a) and Buscaglia, Ratliff and Dakolias (1995) by using the quantitative measures based on growth rates in times to disposition and growth rates in filings per court. Specifically, a judicial crisis begins at the point where backlogs, delays and payoffs increase the cost (implicit or explicit) of accessing the system. When costs become too high, people start restricting their use of the judiciary, as we also see in Figures 2 and 3 below. By examining these graphs, we see that the points of inflexion show when a judicial crisis - more specifically, the judicial crises occurring in Ecuador in 1986 and in Argentina in 1985 - starts. Let us note that the collapse of the Latin American judiciaries takes place under the complete absence of legally enforced alternative dispute resolution mechanisms (for example arbitration or mediation).

**Figure 2**  
**Ecuador's Civil Cases: 1984-1994**



**Figure 3.**  
**Argentina's Civil Cases: 1984-1994**



## 12. Economic and Inferential Analysis of the Courts

The enhancement of the capability of the courts to satisfy the demand for dispositions is one of the most challenging and important aspects of judicial reform. Almost everywhere in Latin America, courts are unable to supply enough services to satisfy the current demand. The lack of ability to satisfy this demand manifests itself through the increasing backlogs and time delays observed in Table 1. These delays are usually ascribed to lack of resources or procedural defects. For example, it is often argued that many countries in Latin America provide inadequate budgets to the courts, which impedes the judiciary from sustaining even the minimal needs to ensure the public's access to justice. It is also believed that inadequate budgets perpetuate the dependence of the judiciary, generate corruption among court personnel and prevent the judiciary from attracting well-qualified judges and support staff. In this context, many judges and legal scholars argue that the judiciary must have a separate budget subject to its control and management. The jurimetric analysis in Buscaglia and Ulen (1997) provides a statistical framework within which those key variables affecting the times to disposition are identified through non-parametric techniques.

If the judiciary is to provide the impartiality and efficiency necessary for public trust, a well defined program for judicial reform needs to address the

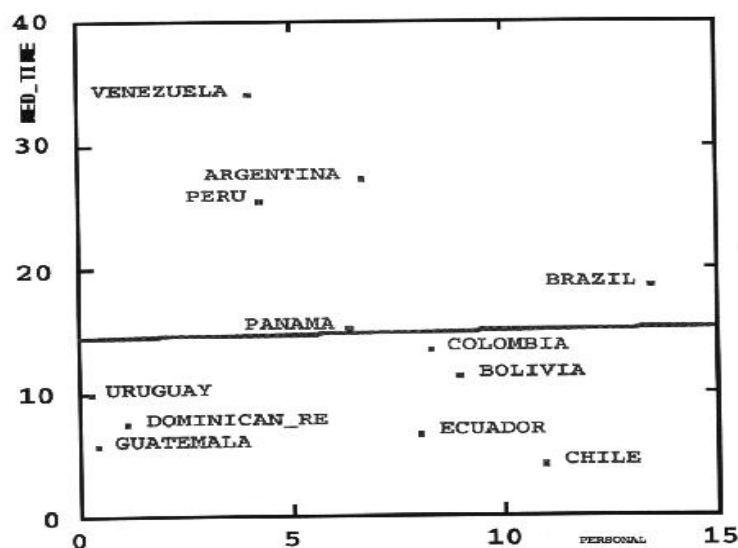


major causes of deterioration in the quality of court services. This reform effort must address the root political, economic and legal causes of an inefficient and inequitable judiciary and not simply deal with its symptoms. Basic elements of judicial reform must include improvements in the administration of the courts and case management practices; the redefinition and/or expansion of legal education programs and training for students, lawyers and judges; the enhancement of public access to justice through legal aid programs and legal education aimed at fomenting public awareness of its rights and obligations in the courts; the availability of ADR mechanisms, such as arbitration, mediation and conciliation; the existence of judicial independence (that is, budget autonomy, transparency of the appointment process and job security) coupled with a transparent disciplinary system for court officers; and the adoption of procedural reforms, where necessary. Each component is an integral part of judicial reform as a whole. It is unrealistic, however, to think that all the components can be dealt with at once. Stages of action must be planned with consideration given to the costs and benefits of reform as perceived by the judiciary.

Some countries in Latin America have proposed allotting a pre-specified proportion of the government's budget to the judiciary as a way to address the low-salary problem but also as a mechanism to reduce times to disposition and backlogs. However, a country-by-country approach is always required. International differences in procedural requirements, substantive law and cultural legal history mean that the resources needed by courts in commercial jurisdictions to produce a certain type and quantity of services (for example, 1000 bankruptcy rulings) will greatly vary among countries. This means that 3 percent of the government budget devoted to the judiciary in one country may have a very different impact on times to disposition than the same amount devoted to the courts in another country. Therefore, it is doubtful that a higher fixed proportion of the government's budget would necessarily improve the functioning of the judicial system.

Based on these figures and the times to disposition in Figure 1, there is no proven significant international correlation between judicial efficiency (measured in terms of backlogs and times to disposition) and size of the government budget allocated to the courts. Figure 4 clearly demonstrates this lack of correlation within Latin America. The country-specific average percentage changes in the median times to disposition are measured on the vertical axis with a two-year lag after the average percentage changes in real spending devoted to the judiciary (measured on the horizontal axis) are introduced. The changes in real spending are adjusted for population and economic growth in each of the countries considered. These measurements are applied to the civil jurisdictions in each country. As we can see, countries with the largest changes in spending are not usually those experiencing the lowest times to disposition. For example, Brazil and Chile are clear examples of this lack of correlation.

**Figure 4**  
**Judicial Efficiency and Allocated Budget**



The reason for this lack of correlation lies in the fact that, on the one hand, additional resources (personnel and capital) initially reduce backlogs and delay due to improvements in court productivity. But after our two-year lag, a better endowed judiciary starts attracting additional demand (filings per court) from citizens and businesses that otherwise would be reluctant to use the courts due to the previously high litigation costs. The joint effects of both forces make it difficult to determine the consequences of adding or subtracting resources devoted to the judiciary. It is therefore much more sensible to implement a budgetary mechanism where courts can request funds based on projected increases in filings within each subject matter and geographical jurisdiction.

The enhancement of the courts' capacity to satisfy the demand for dispositions is one of the most challenging and important aspects of judicial reform. Everywhere in Latin America courts are unable to perform their basic function as mechanisms for the interpretation and application of the law. The inability to satisfy this demand manifests itself in increasing backlogs and time delays observed throughout the region. These delays are due, in part, to the lack of resources or, in many cases, to procedural defects. Other reasons are the lack of legal training, the absence of an active case management style, or an excessive administrative burden falling on judges. For example, Buscaglia, Ratliff and Dakolias (1995) found that approximately 70 percent of Argentine

judges' time is spent on nonadjudicative tasks. The same administrative duties occupy 65 and 69 percent of available judicial time in Brazil and Peru, respectively.

### **13. Corruption and Institutional Inertia: Causes and Consequences**

The development of an economic theory of judicial and procedural reform is in its infancy. Only by defining the factors enhancing or hampering judicial reform can we propose policy prescriptions for the modernization of the judiciary. In this context, we must take into account not only the present and future costs and benefits of reforms to society, but also the changes in present and future individual benefits (rents) as perceived by court officers in particular and government officials in general. We need to examine two elements of judicial reform implementation. First, the causes of institutional inertia that impede much needed court reforms need to be identified. Second, we also need to ask why reforms occur in some places but not in others by identifying the costs and benefits of implementing judicial reforms, as perceived by members of the court. Nevertheless, one key question remains: Why are the very judicial reforms that would eventually benefit most segments of society often resisted and delayed by the judiciary? The answer stems from the institutional inertia observed during the implementation of judicial reforms.

There is a widespread perception in Latin America that government officials use the courts as rent-seeking mechanisms. We can here identify substantive, procedural and organizational factors explaining the increasing presence of corrupt activities within the courts. Let us first point at the lack of consistency found in the jurisprudence that gives judges discretionary power to decide cases within a wide range of possibilities. The lack of a computer system that would permit judges and lawyers to monitor the latest decisions and to detect doctrinal inconsistencies adds to the persistence of irregularities and corrupt practices. Moreover, poorly trained judges in an overburdened legal system are also susceptible to corrupt influences and create an environment where the rule of law cannot be guaranteed. From a procedural standpoint, *ex parte* communication is permitted and common practice in most Latin American countries where judges can spend a good part of the day meeting lawyers and parties separately. Such communication creates incentives for corrupt behavior and lack of accountability within the courts. A second procedural element contributing to the existence of corruption has to do with the lack of standards applied to the times to disposition experienced by each type of case. Lack of time standards coupled with court delay allow court personnel to 'charge a price' for speeding the procedure. From an organizational perspective, the concentration of power given by the multiple roles assumed by a typical judge (that is, in most courts the judge is responsible for strategic planning, managing personnel, administering resources, budgetary

control and planning and adjudicating cases) create incentives for corrupt behavior due to the lack of external and internal organizational control mechanisms. Addressing these substantive, procedural and organizational factors is a necessary condition to eradicate corruption within the court systems.

If the judicial sector and other members of the government use the courts for rent-seeking purposes, then it should not be surprising to find members of the bench and their clerks blocking efficiency-enhancing judicial reforms. In this context, court reforms promoting uniformity, transparency and accountability in the process of enforcing laws would necessarily diminish the courts' capacity to extract rents, in the form of illicit payments from the private sector.

Previous studies argue that judicial inertia in enacting reform stems from the long-term nature of the benefits of reform, such as added economic growth or investment. These benefits cannot be directly captured in the short term by potential reformers within the government. Contrast the long-term nature of these benefits with the short-term nature of the main costs of reform, notably a perceived decrease in rents to the courts (for example, explicit payoffs and other informal inducements provided to court officers). This asymmetry between short-term costs and long-term benefits tends to block judicial reforms and explains why court reforms, which eventually benefit most segments of society, are often resisted and delayed. Reform sequencing, then, must ensure that short-term benefits compensate for loss of rents by court officers responsible for implementing the changes. That is, initial reforms should allow for short-term benefits for court officers. In turn, court reform proposals generating longer-term benefits to the judiciary need to be implemented in later stages of the reform process.

Additional forces also enhance the judicial reform process. We usually observe that periods of judicial crisis come hand-in-hand with a general consensus to reform the court system. As stated above, a judicial crisis begins at the point where backlogs, delays and payoffs increase the cost (implicit or explicit) of accessing the system. When costs become too high, people restrict their use of the judiciary, as shown in Figures 2 and 3 above, to the point where the capacity of the courts to extract rents will diminish. At that point members of the court and governments embrace judicial reforms in order to recover their prestige and rent seeking capacity. The judiciary would more likely be willing to conduct deeper court reforms during a crisis as long as reform proposals contain sources of short-term benefits, such as greater administrative power of lower courts, judicial independence and increased court resources.

It comes as no surprise, then, that those Latin American countries undertaking judicial reforms have all experienced a deep crisis as characterized above - that is, sharp decreases in average filings per civil court. Important judicial reforms are being implemented in Ecuador, Mexico and Venezuela. In

each of these three cases, additional short-term benefits guaranteed the political support of key magistrates who were willing to discuss judicial reform proposals only after a deep crisis diminished their capacity to serve the public. These benefits included generous early retirement packages, promotions for judges and support staff, new buildings and expanded budgets. Nevertheless, to ensure lasting judicial reform, short-term benefits must be channeled through institutional mechanisms capable of sustaining reform. The best institutional scenario is one in which judicial reforms are the byproduct of a consensus involving the judiciary and at least one of the other two branches of power, the legislative and executive branches. Additionally, the political leverage of expected winners from reform should counteract the activities of potential rent-losers.

#### **14. The Social Impact of Corruption**

In short, according to Buscaglia, Ratliff and Dakolias (1995, pp. 34-36), two counteracting forces explain why many developing-country governments have failed to provide an efficient judicial sector compatible with a market economy. On the one hand, efficiency-enhancing institutional change accounts for the actual reform and institutional transformation of Latin American judiciaries, while on the other hand, issues related to corruption within the courts account for institutional inertia in enacting judicial reform. Then, the nature of the relationship between a society, its legal rules and its judicial sector can be explained in terms of political rent-seeking activities and economic efficiency arguments. These two influences can also contribute to the understanding of the legal and judicial development of a nation.

Before a judicial crisis strikes, however, corruption runs rampant within the judiciary. In all cases one can observe that corruption generates immediate positive results for the individual court-user who is *willing and able* to pay the bribe. Nevertheless, the widespread effects of corruption on the overall social system are extremely pernicious. Those court-users who are not able or willing to supply illicit incentives will be excluded from the provision of a supposedly 'public good' (that is, court services) that in reality corruption transforms into a private good subject to an uncertain price. Even though corruption may remove red tape for those who are able to pay the bribe, the judicial system becomes inequitable in the perception of all of those who are excluded from the system. This sense of inequity has a long-term effect on social interaction. A corrupt judiciary promotes an inequitable social system where the allocation of resources subject to adjudication is less correlated to rights and obligations and more directly determined by the initial endowment of resources held by the court-user.

Buscaglia (1996a) shows that a 'perceived' inequitable allocation of resources hampers the productive incentives of those who are excluded from the provision of basic public goods, such as court services. One may initially think that, by eliminating bureaucratic red tape, the payment of a bribe can also enhance economic efficiency. However, this is a fallacy. As in a typical prisoner dilemma, corruption may benefit the individual who is *able and willing* to supply the bribe. However, the macro-social environment is negatively affected by a diminishing economic productivity over time caused by the general perception that the allocation of resources is determined by corrupt practices and therefore is inherently inequitable. In this respect, present corruption decreases future productivity, thereby reducing dynamic efficiency (that is, the present value of future national income). From this perspective, a more efficient public court system coupled with available ADR mechanisms provided by the private sector can foster the necessary balance between equity and efficiency in the provision of justice - a balance that is notably lacking throughout Latin America. Even more so, judicial reform programs must also address the lack of court access afforded to low-income segments of the population. Court reform increases efficiency and reduces these barriers to low-income segments, thereby contributing to the stabilization of democracy in Latin America.

### C. Conclusion

#### 15. Scope of the Field

As a body of knowledge within the social sciences, the economic analysis of the law certainly needs to reinforce its power to verify claims based on observations. Here, of course, we would depart from the Austrian School's tradition of limiting itself to the identification of logical truths in the study of human action and interaction and side with a legal realism which allows to develop a more structured public policy in the legal realm. In no other area is the development of a 'tool kit' of empirical capabilities more necessary than in the legal and economic study of development.

We have approached law and economics of development in this chapter by covering the main theoretical and empirical scholarly work identifying the substantive sources of efficiency-enhancing legal doctrines (that is, bottom-up approach to law making, legal transplants and legal integration) in less developed countries. We have also discussed the main procedural requirements needed to sustain an economic system based on impersonal exchange (a judicial sector with alternative dispute resolution mechanisms) while also exploring some of the main symptoms of a dysfunctional judiciary (corruption and lack of efficiency in the courts).

## 16. Future Research Path

The measurability of the price matrix set by institutional frameworks relates, of course, to achieving efficiency in consumption and production through much needed reforms in private and public law. Yet these legal reforms and their impact on efficiency must also connect to the issue of fostering political stability through a widespread perception of equity within the members of society. This brings us to one of the most important areas of law and economics to be developed in future studies: the links between legal reform, efficiency and equity. Economists tend to shy away from the microeconomic study of 'ethics'. Yet, as Cooter's (1996b) study has shown, the rigorous microeconomic analysis of the compatibility between equity and efficiency is real and useful. As demonstrated in Alesina et al. (1992), developing countries face a social environment in which a vast proportion of their population lives under material conditions incompatible with social and political stability. Paying close attention to the links between legal reforms and efficiency is only one step in the right direction.. From all those possible 'efficiency' scenarios one could argue that the economic analysis of the law needs to provide a framework within which one can select among the many efficiency-enhancing legal institutions and rules that would foster a perception of equity among the population. From this perspective, as stated in Buscaglia (1996a) a perception of a level playing field can be traced to the individual's incentives to enhance its own productivity within the economic system. At this point in time, there is much more scholarship to be offered in this area.

## Acknowledgments

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