

# 1. How we got here

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Mahmoud Mohieldin, World Bank Corporate Secretary and President's Special Envoy, speaking at the opening session of the Bank's *Law, Justice and Development Week 2015* stated:

Without the legal institutions that allow innovation and entrepreneurship to thrive, other attempts to spur economic growth are destined to fail. Sustained growth occurs through innovative business ventures. A primary challenge to such growth is a problem of trust between innovators with new ideas and financiers with capital. Property, contracts, and corporate law provide the legal framework to overcome distrust and launch innovative business ventures. This will be especially important for delivering the 2030 agenda for Sustainable Development.

This statement encapsulates the role which the World Bank and others see for the law and legal institutions in providing the foundations of growth-oriented market economies which are seen as the means of generating sustainable development. As development policy has shifted away from the state as the driver of growth and development to the market as the driver, it has become necessary to consider the institutional foundations of the market economy. At the core of these foundations is the legal system. Without an effective legal system markets will not operate smoothly and resources will be consumed in supporting transactions, that is, transaction costs will be high. Creating a market economy involves more than the government withdrawing from the real economy. It requires a legal system which reduces transaction costs. This book is concerned with our understanding of what factors make for such a legal system.

This chapter sets the scene for the book. It discusses the reasons for the interest in the relationship between the law and economic development beginning with a review of different theories of development and the role which the law plays within each. This is followed by a discussion of the US law school-based *Law and Development Movement* of the 1960s and 1970s. There are lessons to be learned for our understanding of the role which law and the legal system plays in the process of economic development by examining the rapid rise and demise of the Law and Development Movement. The final section of the chapter sets out the objectives of the present book and outlines how these are to be achieved. It draws lessons

from the failure of the Law and Development Movement: in particular, its lack of a theory explaining the role of law in the process of development which has been seen as a major weakness of that movement. We argue that New Institutional Economics provides such a theory. It is suggested that an important feature in understanding the role of markets in development is paying attention to the role of institutions and the role of culture in constraining how institutions operate.

## 1.1 APPROACHES TO DEVELOPMENT

Before considering the relationship between law and economic development it is necessary to understand the process of development. This has been a much contested terrain. Since the Second World War a range of models of economic development have held sway with policymakers. Each of these has implied a role for the law and legal institutions.

In the immediate post-war period the dominant theory was Rostow's linear stages of development model.<sup>1</sup> In this approach to development it was argued that all economies underwent a similar process of development provided certain preconditions were met. These preconditions required the mobilization of capital through increased savings and investment including foreign aid and direct foreign investment. Essentially, in this view, the road to development involved a process of industrialization by which developing countries 'modernize' themselves. Thus this model was a Modernization Theory. It implied that development was a process of convergence towards modern western industrialized society and that traditional institutions were one of the sources of underdevelopment. As well as increased investment, modernization was seen as requiring the adoption, *inter alia*, of western legal institutions. It required the adoption of appropriate property, commercial, human rights and administrative laws and a competent and independent judiciary. It encouraged the transplanting of laws and legal institutions from the developed west.

Another theory of economic growth with a strong modernization theory bias was based on the idea of structural change: the shifting of employment from traditional agriculture to an industrialized sector.<sup>2</sup> This view of development has continued to have its adherents well beyond Rostow's linear model. The structural change model did require government intervention to promote industrialization, education and urbanization but little attention was paid to the role of the legal system.

In reaction to Modernization Theory, which was largely conceived by economists in the developed world, there emerged from developing countries a view of development which became known as Dependency Theory.<sup>3</sup>

Under this approach underdevelopment is seen as a consequence of the established economic order with an industrialized centre and a periphery based on agriculture. The former colonies were kept in a subservient position and exploited by the developed nations. Consequently, development was conditioned by complex economic, social and political relations. This meant that the road to development would differ from country to country. Dependency theorists rejected the transplanting of laws from the west but nevertheless saw an important role for the law in redistributing power and wealth. Thus change in property rights distribution was required particularly with respect to land tenure. Development would require fundamental changes in political, social and economic rights.

While both Modernization Theory and Dependency Theory gave a central role to the state in the process of development, the Growth Theories of the 1980s and 1990s suggested that the state's role in development should be limited. Many regarded it as counterproductive. The so-called neoclassical model proposed that freedom from government intervention was necessary for markets to develop so that resources could be allocated efficiently and growth achieved. Often referred to as the neo-liberal model, this approach became known as the Washington Consensus (Williamson, 1990). The association of the neo-liberal model of development with the term 'Washington Consensus' has been challenged by the originator of the term, John Williamson. In John Williamson (2000, p. 251) he argues that his original intention was to describe the 'lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989'. It involved ten<sup>4</sup> policies whose use would be sensitive to the particular circumstances of the country concerned. However, the term 'Washington Consensus' subsequently became associated with an extreme form of market liberalism. As John Williamson (2000) puts it, what he conceived as a 'technocratic policy agenda' that survived the demise of 'Reaganomics' became the term used to describe an extreme form of 'Reaganomics' (p. 255). This may largely have been due to the vigour with which officials of multilateral development institutions in Washington proposed the reduction in the government's role in the economy, often as a bargaining position. Joseph Stiglitz (2002, p. 73 *et seq.*) argues that such 'market fundamentalism' embodies a naïve view of how markets work in the circumstances of developing countries which often suffer from market failure. This view, he asserts, was out of tune with current economic theory.

In the neo-liberal view, the role of the legal system is to provide the stable institutions which promote market activity. Thus emphasis was placed on property rights, formal contract law, corporate law promoting investment and reform of bankruptcy law.

More recently, growth theorists have recognized the role of institutions, including legal institutions. This has come in the wake of the development of the New Institutional Economics. It has become recognized that new institutions only develop slowly. However, this has not stopped policymakers from recommending the adoption of laws and other institutions from successful systems to developing countries. A major purpose of this book is to examine whether, indeed, such transplanting of institutions enhances economic development.

In all of the aforementioned approaches to development the emphasis has been on the economy. Other approaches to development which include or emphasize non-economic factors exist. The most significant follow on from the World Bank's Comprehensive Development Framework. This is seen as the basis for achieving sustainable development and poverty reduction. The recognition of wider goals of development is also embodied in the United Nations' (UN) Millennium Development Goals.<sup>5</sup> These wider development goals include not only the reduction of poverty but the enhancement of the role of women in society. These, *prima facie*, reintroduce a major role for the state but Kerry Rittich (2006) argues that effectively these social objectives have been conditioned on economic growth by the international financial institutions and multilateral aid organizations. Rittich (2006) argues that these organizations have reconceived development as 'good governance' with legal and judicial reform regularly appearing in lists of structural reforms: 'policy documents of the IFIs [International Financial Institutions] are pervaded with statements to the effect that . . . economic development requires respect for the rule of law, protection of property and other investors' rights, and now often human rights as well' (p. 210). She effectively argues that the social dimensions of Law and Development policy have been captured by the multilateral agencies as elements in the promotion of economic growth. The statement from a senior World Bank official quoted at the beginning of this chapter would seem to confirm this view.

Although the focus in this book is on the role of the law and the legal system in a market-led approach to development this should not be taken to imply that the market-led approach is being endorsed as the only valid model of economic development. Nor that legal reform is a necessary precondition for economic development. The phenomenal development of China in recent decades has been achieved without the sort of legal system promoted by the World Bank as part of market-led development. More recently, however, as the Chinese authorities have introduced a more market-based system through the promulgation of what is called the 'New Normal Economy' (Angang, 2015), advances have been made in the field of commercial law.<sup>6</sup> It is also arguable that the earlier developmental suc-

cesses of Japan and South Korea did not come about through market-led development policies (Chang, 2007). The purpose of the present book is not to argue for a particular model of development but to examine the role of law and the legal system within the dominant market-led model using the lens of New Institutional Economics.

## 1.2 THE LAW AND DEVELOPMENT MOVEMENT

During the 1960s and 1970s the work of a group of largely American scholars became known as the Law and Development Movement. Although two leading members of that movement announced its demise as early as 1974,<sup>7</sup> it is worth examining its short life to gain insights which are fundamental to the analysis of the role of law in the process of development.

As well as Trubeck and Galanter's (1974) review of the failings of that Law and Development Movement there are two often-cited discussions by Merryman (1977) and Messick (1999). This 'movement' grew out of the engagement of academic scholars from leading US law schools in development assistance programmes funded by the US government, international agencies and charitable foundations (Trubeck and Galanter, 1974, p. 1063). These assistance programmes were largely directed at reforming legal education in countries of Asia, Africa and South America. Trubeck and Galanter (1974, pp. 1073–4) argue that motivating this activity was an implicit model of 'liberal legalism' which embodied a view of the relationship between law and society and a particular explanation of the relationship between legal systems and development. The legal system was seen as a purposive entity drawing on the power of the state, disciplined by its own norms, which will affect human behaviour. Law is described as a potent instrument for achieving social welfare. It implied impersonal governance through universal rules which would promote inclusion and equality. The development of legal institutions was thus seen as a way of curbing arbitrary government and would become a powerful tool for planners in enhancing social welfare. This could best be achieved by training legal professionals to understand the instrumentality of the law and how it could be used in the furtherance of development goals.

The literature produced by the Law and Development Movement, in Trubeck and Galanter's (1974) words, 'took for granted the existence of some natural tendency for legal systems in the Third World to evolve in the direction of the ideal model of liberal legalism' (p. 1079). This is obviously predicated on a Modernization Theory of development in which liberal legalism represents the highest level of legal development and that it could be transplanted to developing countries. Indeed, Neil Duxbury (1995)

writes of it being a response to pressure ‘put on American universities by development agencies, to assist Third World nations in the process of “modernization”’. However, as Messick (1999) points out:

In the United States judges play a significant role in policymaking, and as a result, lawyers are often able to engineer significant changes in policy through litigation. This is not true in civil law systems or indeed even in the United Kingdom and other nations that share the same common law background as the United States. (p. 126)

The movement was not only naïve but also ethnocentric.

Messick (1999) further argues that the movement lacked any theory of how law affects development. Neither did it engage lawyers and others from developing countries in the process of designing reforms. The focus was on the formal legal system and took no account of how local legal culture or local norms affected behaviour. Merryman (1977) sums up his view of the movement’s failure pithily:

The law and development movement has declined because it was, for the most part, an attempt to impose U.S. ideas and attitudes on the third world. In its rawest and most unsophisticated form, law and development meant enacting American statutes, translated into the national language. (p. 483)

Trubeck and Galanter (1974) also suggest internal reasons why the Law and Development Movement faltered and failed. The proposed reorganization of legal education in developing countries along the lines of US legal education further presumed that the US system embodied liberal legalism. However, it became apparent to major participants in the movement that the American legal system did not, in fact, embody liberal legalism. It did not reflect the interests of society in general but the interests of specific groups within society. Those who applied the rules exercised discretion in the application of the law in favour of certain groups. There were also structural biases in the system which discriminated against other groups in society. Thus training lawyers in developing countries in the American way no longer seemed to promote legal liberalism.

Neil Duxbury (1995) argues, in effect, that the problems encountered by those engaged in the Law and Development Movement had an important effect on the expansion of the Law and Society Movement. It had raised the need for empirical study. As the Law and Development Movement faded away, the Law and Society Movement strengthened.

In their remarkable self-critical assessment of the Law and Development Movement Trubeck and Galanter (1974) see the critical challenges which led to the failure of their movement as:

the improvement of empirical knowledge about legal reality in the Third World, the loss of faith that the liberal legalist model accurately reflects the role of law in the United States, the growing doubt that United States society can be a valid model for the Third World, and the realization that American and Third World policy makers may not, in fact, be committed to the basic values which the liberal legalists believed they were fostering. (p. 1089)

Why have we taken this excursion into the history of a minor and failed movement in American legal thought? We believe that it should sensitize us to key features that must be taken account of in any scholarship which attempts to examine the role and influence of law and the legal system on the process of development:

- We need a theory of the role which the legal system plays in the process of development.
- We should avoid a modernization or ethnocentric view that the legal systems of developed countries should be transplanted to developing countries.
- We should examine the empirical validity of our assumptions and policy proposals.
- We should be concerned about law in action and not just the law on the books.

We will see later in this book that the strong policy proposals advocated by multilateral development agencies in recent years are predicated on scholarship which fails to take account of some of these warnings.

### 1.3 THIS BOOK

In the present book we intend to apply the lessons learned from the failure of the Law and Development Movement to provide a basis for understanding the role which law and the legal system plays in supporting the process of economic development. As argued earlier in this chapter, even though multilateral development agencies espouse wider objectives for development than just 'economic' development they still see economic development as an enabler of these non-economic goals. Consequently, in the rest of the book we will use the terms development and economic development interchangeably. This should not be taken as an endorsement of this view but simply the recognition that this view dominates development policy and motivates much of the work of the World Bank and other multilateral development agencies.

As we have argued earlier, any analysis of the role of law and the legal

system in the process of development not only requires a theory of how law and the legal system influences development but also a theory of development itself in which to imbed law's role. The view which currently dominates development policymaking is a Growth Theory which assumes that development should be a market-led process. Again this should not be seen as endorsement of this view but the recognition of the dominant policy imperative. As a consequence of this, what follows in the book should be seen as an analysis of the role of law and the legal system in a market-led approach to economic development.

In the discussion of the Law and Development Movement in the preceding section of this chapter we saw that a deficiency of that movement was that it lacked a theory of law's role in the process of development. Part II of this book seeks to provide such a theoretical framework based on New Institutional Economics. In order to provide a basis on which to develop this framework in Chapter 2 we introduce the major concepts and modes of analysis of New Institutional Economics (NIE). Institutions are conceptualized as influencing the costs of running the economic system (i.e. they affect the magnitude of transaction costs). We discuss the sources of transaction costs and the development of governance structures which minimize them. We then discuss property rights. We outline the conventional economic role accorded to property rights in the functioning of markets through an examination of their nature. The distinction between individual and collective rights is discussed. Then the consequences of the absence of property rights are dealt with through an examination of externalities.

The purpose of Chapter 2 of this book is to assemble the conceptual and theoretical framework required to understand the role of the law and legal system in the process of development. Part II of the book is concerned with previous research on Law and Development and the explication of an NIE framework. Chapter 3 considers the question of legal reform in developing countries through an examination of what has become known as *Legal Origin Theory*. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998) have argued that economies based on the Common Law legal system have higher growth levels than those based on other legal systems such as Civil Law. This chapter begins by outlining this theory and examining both the empirical evidence adduced to support it and the criticisms of it. Legal Origin Theory may be seen as based on a Modernization Theory of development as it suggests that the development process can be aided by transplanting laws and legal procedures from some developed countries to developing countries. There is also a hint of ethnocentrism as the theory was developed by economists from leading US universities. Legal Origin Theory provides the intellectual basis of the World Bank's 'Doing



Business' project which assesses the legal systems of countries from the perspective of the speed and cost of completing various specimen transactions and also those legal processes required to establish a business. In reviewing this literature attention is paid to the distinction between the content of the law and how costly it is to operate.

A powerful critique of Legal Origin Theory (as a foundation of policy) is based on the *transplant effect*. This considers the factors which influence the effectiveness of transplanting laws or parts of legal systems from one jurisdiction to another. There is controversy in comparative legal scholarship between those who argue that laws may be transferred easily from one jurisdiction to another and those who believe that laws are a product of a particular social and political context and cannot be understood outside that context. Thus the potential for transplanting laws is related to culture, as discussed in Chapter 3. Research on the transplant effect discussed in Chapter 3 argues that whether a transplant is successful or not is seen to be related to the motives behind the transplant. Is the recipient jurisdiction receptive to the transplant or not? Are legal actors in the recipient jurisdiction familiar with the legal system from which the transplant comes? Is there a demand for the transplant? The answers to such questions influence the transaction costs associated with transplants and thus their effectiveness. This chapter examines the evidence to support this approach and discusses the implications for legal reform as a route to economic development.

In Chapter 4 we develop an NIE-based framework for the analysis of the role of law and the legal system in the process of economic development. However, prior to this we examine two issues in relation to property rights which have arisen in the literature. The first deals with problems which arise when the costs of establishing and enforcing property rights are high. Here the work of Hernando de Soto is critically examined as are the policies adopted by multilateral institutions to support the reduction of these transaction costs. The empirical evidence on the validity of de Soto's analysis is assessed. Second, we also note the imprecision with which the term 'property rights' has been used in the literature on property rights and economic development. We argue that in many empirical studies what are described as 'property rights' are not concerned with the content of such rights but are actually measuring how well the legal system protects individual rights in general and particularly against the state.

We next develop our NIE-based framework. Oliver Williamson's (2000) framework of four levels of social analysis is presented and used to demonstrate the constraints imposed on institutions by culture and on economic organization by institutions. Central to this analysis is the concept of transaction costs. Oliver Williamson's four levels of social analysis are:

embeddedness; institutional environment; governance; resource allocation. Embeddedness includes informal institutions, customs, traditions, norms and religion. The institutional environment determines the rules of the economic game and includes property rights, courts, government and regulators, law and legal institutions. Governance covers the organization of economic activity such as firms, corporations, partnerships, trade unions and so on. Resource allocation covers the functioning of markets. We then discuss the relationship between Oliver Williamson's framework and Douglass North's analysis of the role of institutions in the process of economic change. While there are many overlaps between these two approaches we note that there are differences which arise from differences in focus of these authors. Oliver Williamson's framework is seen to be static and concerned with the constraints placed on economic agents while North has a more dynamic focus on the factors which promote institutional change. Oliver Williamson's (2000) framework treats embeddedness as given. In this chapter we operationalize it by introducing the dimensional theories of culture developed by Hofstede and Schwartz. The chapter finishes with an application of the framework extended to incorporate an analysis of cultural influences to the transition from socialist to market economies in Central and Eastern Europe.

Part II of the book exposes recent multilateral development agencies' views on how legal reform can be undertaken to enhance development to critical appraisal, which suggests that it is not on a firm basis. It is suggested that it is not only modernist in its theoretical underpinning but that it is based on an ethnocentric view which is at odds with the criteria set out in Chapter 1 for a successful understanding of the role of law and the legal system in the process of economic development.

The market-based approach to economic development requires that entrepreneurs developing new firms and those seeking to expand capacity through investment have access to financial resources to support such investment. An efficient financial system, it has been argued, is necessary to ensure that scarce investment funds are mobilized from dispersed savers and allocated to the entrepreneurs with the most profitable projects. Part III examines: the fundamental role of the financial system; what factors are believed to influence its size and structure; and the particular problems associated with financial systems in developing countries. It draws on the institutional analysis of the preceding section of this book to critically evaluate both policy and practice in financial sector development in developing countries. Part III also provides an empirical application of the NIE theoretical framework developed in Part II to examine whether the theory adequately describes the role played by law and legal institutions in the process of growth.

Chapter 5 begins by outlining the role which the financial sector plays in market-based economic development and the role played by the legal system in financial sector development. It then moves to a discussion of the fundamental functions of any financial system. Different types of markets and institutions which may constitute a financial system (e.g. banks, capital markets) are then discussed. There is then a discussion of how financial sector development might be measured. This is followed by an examination of the evidence on the relationship between financial sector development and economic growth. Particular attention is paid as to whether bank-dominated or capital market-dominated financial systems achieve better growth results.

Chapter 5 continues with a critical examination of the performance of the financial sector in developing countries. Building on the empirical evidence demonstrating the relationship between financial sector development and growth, the factors which promote financial sector development itself are examined. The chapter draws not only on the finance literature but the institutional literature discussed in Chapters 2 and 4. These tools are then utilized to examine the problems faced and potential opportunities open to financial sector development in developing countries. In this regard, particular attention is paid to the relative merits of credit markets and capital markets in financial sector development in developing countries. The important role which financial sector development plays in the market-based approach to development together with the centrality assigned to legal reform in developing the financial sector (as attested to by the quotation from Mahmoud Mohieldin, World Bank Corporate Secretary and President's Special Envoy, given at the beginning of this chapter) suggest it is a relevant context in which to interrogate the New Institutional Economics framework for examining the role of the law and legal system in the process of development. This is done in Chapter 6 in which we use a well-known and widely available data set on financial sector development. The data is used to estimate an econometric model in which we identify the influence of cultural context on the content of the law and legal effectiveness (the legal environment), their influence on financial sector development and in turn the influence of financial sector development on economic growth. The fact that the data relates to the mid 1990s does not undermine this exercise since its purpose is to examine the validity of the theory and not explain the fundamental determinants of growth or financial sector development. Using this data set removes any questions concerning its accuracy and reliability. The model appears to perform well. More than 50 per cent of the variation of growth across the economies covered is explained with a significant role being played by financial sector development. In its turn, over 75 per cent of the variation

in financial sector development is explained by the legal environment and informal institutions. The legal environment is found to be heavily influenced by cultural factors. In particular, almost 70 per cent of the variation in the effectiveness of the legal system is explained by culture. There is evidence of a transplant effect reducing the effectiveness of the law. It appears that culture dominates legal origin both in the adoption of investor and creditor protection laws and in the effectiveness of the legal system. There is only one jurisdiction where legal origin has more influence than culture.

Chapter 7 assesses how successful our NIE-based framework has been in meeting the criteria set out in this chapter for a theory of the role of law and the legal system in the process of economic development. The theory successfully avoids the traps of modernization and ethnocentricity while being successful empirically in assessing law in action. It points to the importance of culture in shaping the development of the financial sector and consequently economic development.

## NOTES

1. Rostow (1960).
2. Lewis (1954, 1955).
3. See, for example, Frank (1966, 1969).
4. Fiscal discipline; a redirection of public expenditure priorities towards fields offering both high economic returns and the potential to improve income distribution (primary health care, primary education and infrastructure); tax reform (to lower marginal rates and broaden the tax base); interest rate liberalization; a competitive exchange rate; trade liberalization; liberalization of inflows of foreign direct investment; privatization; deregulation (to abolish barriers to entry and exit); secure property rights.
5. UN Development Goals, available at <http://www.un.org/millenniumgoals>. See also 'What is CDF: ten things you should know about CDF', available at <http://www.worldbank.org/cdf>.
6. For an analysis of the Chinese system before and after recent reforms see Guangdong Xu (2014) and Ding Chen et al. (2017).
7. Trubeck and Galanter (1974).