Can Legal Institutions Pave the Way for Economic Development?

The White House is requesting a record $20.27 billion dollars for foreign aid for fiscal year 2008. Much of it will be used to provide economic and development assistance to some of the poorest countries in the world. In what has become a well-worn formula, the U.S. will give billions to developing nations while promoting liberalization and privatization.

But with the economies of many developing nations stalling, University of Chicago Law School Professor Kenneth Dam ’57, Max Pam Professor Emeritus of American & Foreign Law, puts forward a different approach to growing economies in his new book, The Law-Growth Nexus: The Rule of Law and Economic Development. Here, Professor Dam and his colleague, Ruoying Chen, a recent Olin Fellow at the Law School, discuss that approach as well as how it affects China, the fastest-growing economy in the world.

Kenneth Dam: There has been a succession of economic policy fashions since the movement to independence of former colonies in the 1960s. At first the principal idea was that since the “poor” countries, as they were then called, were long on workers and short on capital, the task was to transfer capital to them. This idea is central to foreign aid programs, and even though more and more serious empirical work shows that foreign aid, taken as a whole, does not work very well, it is still a popular idea. And, yes, foreign assistance is preferred by the developing countries themselves.

But in the 1970s, it was widely recognized that inflation and protectionism in the developing countries were undermining development prospects of many such countries. Thus was born the Washington Consensus—sound macroeconomic policy (no budget deficits) and openness to international trade are the keys to economic development. But developing countries did not like the Washington Consensus because no country wants to sign up for having no budget deficits. And building institutions is hard.

Despite the rapid growth of many countries, such as China and India, many countries—most notably in sub-Saharan Africa—have not been doing well at all. As a result of work by some “neo-institutional” economists, the idea came to the fore that sound “institutions” were what really counted. This is now the reigning doctrine in academic circles and to a certain extent in the research departments of places like the World Bank.

To me that meant that legal institutions needed to be examined seriously. Some economists did path-breaking empirical studies showing that legal rules really do matter, and by using cross-country statistical studies they purported to show that common law was better than civil law. In my book I set out to show that the inherent superiority of the common law is dubious (not least because most economic law is statutory). At the same time the basic insight that legal institutions do matter for development is not only correct but such central Rule of Law ideas as the separation of powers, independence of the judiciary, and sound regulation of financial markets are key to economic development.

Ruoying Chen: Your theory is sensitive to the thorny task in developing countries of adopting institutions that are favorable to economic development. You recognize that the accumulation and development of the compatible human capital takes time and can take a generation or two. Even if a society and its powerful interest groups have decided to adopt a set of rules and institutions that are pro-economic development, it still begs the question as to how quickly the people who are to implement these optimal and efficient rules, and who are to run the well-designed institutions, can pick up the compatible skills and professionalism. There is no doubt that unprecedented information flow and labor movement throughout the world would definitely improve the situation, but it cannot happen overnight.

But you also recognize that the rules that protect minority shareholders are key, and therefore it is the enforcement institutions that really matter to the result. While a market
may develop various self-help mechanisms, the judiciary is still the undisputable core of law enforcement.

KD: Of course, with all that being said, if the Rule of Law is essential to economic development, then explaining the rapid economic growth in China is something of a challenge. The explanation is twofold. First, Chinese institutions in general (putting legal institutions to the side) are not at all bad compared to those in most developing countries. And second, the Chinese are spending a lot of the resources created by their growth on improving their institutions. In their pragmatic step-by-step leadership approach, the Chinese are helping themselves up the institutional ladder. But there is still a problem. Can Chinese growth continue when it is clear that there is no separation of powers (and indeed the Party controls the government at every level) and no independence of the judiciary and where financial institutions are all too often at the service of Party officials and government bureaucrats?

To this intellectual challenge to the idea of the primacy of institutions there are no clear answers. The tendency to extrapolate current growth at compound rates into the distant future seems deeply entrenched in popular thinking. In the United States we had been expecting in the 1980s Japan to take over the world economy and in the 1990s the Asian Tiger countries to grow forever. We have seen this movie before! And here is how it too often ends: Japanese growth rates have been lower than U.S. growth rates for most of the past two decades. The Asian Tigers hit a wall in the Asian financial crisis of 1997. And in the Asian Tiger case a prime cause was weak institutions, especially weak legal institutions. So could it happen to China? Stay tuned!

RC: You are not alone in staying aware of the potential problems to China's economic growth. The passing of a property law is definitely a hard-earned achievement in tackling systematic inefficiency. However, instead of ending a journey with a satisfactory result, the property law actually started a journey for China. It's the fruit of decades of Chinese learning on the political and philosophical implications of private property. But it also launched a tough, if not more difficult, challenge to China to establish a modern property institution that corresponds to and promotes economic growth. Whether the Chinese can successfully transition from a normative approach to private property to a positive approach is critical for the future of China's economic growth. No matter how glorious the property law on paper, it does not provide automatic answers to operational questions in real life.

Rule of Law ideas such as the separation of powers, independence of the judiciary, and sound regulation of financial markets are key to economic development.

KD: So you have to ask yourself how China can develop an independent judiciary and other independent institutions. Our preaching to China won't achieve it. There has to be a local constituency behind political change, otherwise the Chinese leadership won't be able to overcome resistance from the millions of Party officials and government bureaucrats who don't want courts telling them what to do. As for the developed world, all we can do is to focus more foreign assistance on promoting institutional development, particularly for Rule of Law institutions, and to carry out the research that I believe will show that institution building pays long-term dividends.

After all, we should ask ourselves how Europe achieved the Rule of Law and the answer is slowly, and with difficulty. It would be self-defeating to be too impatient or too critical in the case of China.