

Legal Institutions, Political Economy and Development

Gani Aldashev^{*}

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^{*} University of Namur (FUNDP) and CRED

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Gani Aldashev *

Abstract

This article reviews some of the recent literature on the relationship between the legal system and economic development. We also look at the historical, socio-cultural, and political factors that explain the differences in the characteristics of legal systems across countries and thus affect the link between the legal environment and economic outcomes. Although the field of law and economics of developing countries is still in its youth, it is growing rapidly and is a fertile ground for exciting new findings, both theoretical and empirical. Further progress in this field is likely to come from the studies of the elements of the legal system other than the substantive law (enforcement and dispute resolution) and should move beyond specific analyses of the impact of particular success or failure stories towards more general analyses of the determinants and outcomes of successful legal institutions.

* University of Namur (FUNDP) and CRED. Mailing address: Department of Economics, 8 Rempart de la Vierge, 5000 Namur, Belgium. Email: gani.aldashev@fundp.ac.be. The author thanks two anonymous referees, the editors of the special issue (Christopher Adam and Stefan Dercon) and Jean-Philippe Platteau for highly useful comments.

I. INTRODUCTION

The fundamental question of development economics, ‘Why some countries are so much richer than others?’, clearly does not have a simple, single-cause answer. Instead, it is likely that a host of inter-related factors affect the efficiency of the allocation of resources and thus eventually drives the long-run differences in economic performance across countries. While the economics profession is still far from a complete and integrated understanding of these factors, in the last decade we have made substantial progress in disentangling the separate effects of some of these factors on economic outcomes, as well as in identifying some key driving forces – in particular, history and politics – behind these factors themselves.

One of these key factors is the legal system. *A priori*, the characteristics of the legal system should affect the economic behaviour of individuals – in particular, by influencing the accumulation of physical and human capital. A better legal system should thus lead to a better allocation of resources, eventually increasing the aggregate total factor productivity. Beyond the purely efficiency-oriented paradigm, the functioning of the legal system clearly should affect other dimensions of development, such as equity. This article reviews some of the recent literature on the relationship between the legal system and economic development. We will also look at the political economy factors that explain the differences in the characteristics of legal systems across countries and thus affect the link between the legal environment and economic outcomes.

What do we mean by the legal system? It is a system of inter-related formal institutions gathered around three main functions (Gray, 1991): (1) setting rules and standards (mainly via laws and regulations) for the operation of the society; (2) law enforcement; and (3) dispute resolution.

Example: consider a person, Mr. X, which inherits a plot of land from his father. The law that governs the pattern of this inheritance and guarantees the man’s property of the plot is one of the rules and standards that govern the society in which he lives.

Now suppose that a neighbour of Mr. X, Mr. Y, tries to occupy the plot, and the owner makes recourse to police which evicts Mr. Y from the plot. This is the second function of the legal system: the enforcement of laws.

The neighbour then challenges the legitimacy of the property of the plot by Mr. X, on the ground that Mr. X’s father had a debt with Mr. Y and just before passing away left the plot to Mr. Y to extinguish the debt. Messrs X and Y then go in front of a judge who decides whether the claim of Mr. Y is justified. This is the third function of the legal system: resolving disputes that arise between legal entities.

We start by looking at the literature that studies the effects of the different elements of the legal system on economic behaviour of individuals (investment in physical and human capital, labour supply) and thus on development outcomes. We also try to understand why certain studies have failed to find any effect. We then proceed to overview different theories about the determinants of legal institutions in developing countries. This naturally leads us to question why countries often fail to implement welfare-increasing legal reforms. Here, the political factors – in particular, the opposition from the powerful insiders and elites – play a crucial role, and we also look at research that attempts to understand how such opposition might be overcome. Next, we look more in detail to implementation issues in situations where

reforms are feasible. Finally, we conclude by suggesting some directions for future research.

II. DO CHARACTERISTICS OF THE LEGAL SYSTEM MATTER FOR DEVELOPMENT OUTCOMES?

The early research studying the effects of the legal system on economic outcomes was started by La Porta and co-authors (see La Porta et al. 2008 for a detailed survey of this strand of literature). This research mainly consisted of looking at cross-country correlations, for a large set of countries, between legal characteristics (substantive law in corporate/bankruptcy sphere, labour, etc.; judicial independence, procedural formalism, regulation of entry, etc.) and various economic outcomes (stock market development, private credit, labour market outcomes, corruption, size of the unofficial economy, etc.). These correlations clearly cannot be interpreted as causal relationships, given that legal characteristics can be themselves driven by economic outcomes. The authors overcome this reverse causality problem by instrumenting legal characteristics with legal origin (the origin of the legal family to which the legal system of a given country belongs). Legal characteristics are highly correlated with legal origin: there are, for instance, striking differences in procedural formalism and the details of bankruptcy law between the English common law tradition and the French civil law tradition (for more details on the historical determinants of legal systems, see Section IIIA of this paper). The authors then show that the variation in legal characteristics explained by legal origin are still strongly correlated with economic outcomes, which allows them to claim that the relationship between the aforementioned characteristics of the legal system and the economic outcomes is causal.¹

The main shortcoming of this early literature is that it relies exclusively on cross-country comparisons. Individuals in two different countries can use the same characteristics of the legal system in a surprisingly different manner (this also implies that the effects of “legal transplants” are far more unpredictable than envisioned by the legal origins literature; see Section V of this paper for the discussion of this point). This calls for more in-depth micro-economic studies that, for instance, look at the economic effects of *changes* in the legal system *within* the same country. Below we discuss some of this micro-literature, as well as the empirical problems that they have to surmount. One should note, however, that the cross-country studies have led to very important measurement efforts to compare the detailed characteristics of legal and regulatory systems across countries. The most well known initiative – “Doing Business” – is run by the World Bank (for the findings of this initiative concerning regulation and feasibility of reforms, see World Bank 2004, 2007).

A. Substantive law

The micro-economic studies that analyse the effects of substantive laws abound. Without attempting to be comprehensive, we will discuss several key studies in such diverse domains as land titling, bankruptcy law, and the regulation of entry.

One of the first careful empirical analyses of the effects of property rights on economic behaviour (investment) is Besley (1995). He looks at the decisions by farmers in two regions of Ghana (Wassa and Anloga) to do long-run investments in land plots (in the form of

¹ Some recent research (e.g., Lamoreaux and Rosenthal 2005) put in to question the advantage of the English common law system over the French civil law in facilitating economic activity. These authors find that during the XIXth century the U.S. businesses had a more limited menu of organizational choices and a lower ability to adapt the basic forms to meet their needs than French businesses.

planting trees) as a function of the security of individual property rights on the plots. An important empirical problem, however, is the potential endogeneity of the individual property rights, especially in the environment under transition from communal to individual rights on land, which is the case in Ghana. In such environment it might well be that farmers that have made important improvements in land plots claim communal approval for their individual rights, justifying such claim with the irreversibility of investment. If this factor is important, simply regressing the investment on the current property rights might lead to finding a spurious correlation. The author handles this problem by instrumenting the current property rights with the following variables: (1) whether there is a transfer deed for the field, (2) whether the household has ever litigated over its right to that field, (3) how the field was acquired, and (4) how many years the field has been owned. He finds, in the two-stage regression, that more secure property rights lead to significantly higher long-run investment in Wassu (but not in Anloga).

Galiani and Scharfrodsky (2007) and Field (2007) consider instead the following question: does *formalization* of property rights on land affect economic behaviour, such as investment and labour supply? Both papers study the titling of urban land in two Latin American countries (Argentina and Peru), where urban squatting has been an important phenomenon. In both of these countries, the government implemented a legal reform that formalized the rights of squatters on the urban land that these had occupied earlier.

A key empirical challenge is again the fact that the allocation of land rights is typically endogenous: the individuals entitled might systematically differ from those without titles and thus it is difficult to disentangle the effect – on the economic performance – of the titling and of these differences in other individual characteristics. To resolve this problem, Galiani and Scharfrodsky use a natural experiment from Buenos Aires. Over twenty years ago, a large group of poor citizens occupied (squatted) a territory on the outskirts of Buenos Aires. Later, the Argentinean Congress passed a law expropriating the land from the rightful owners (and transferring the entitlement to squatters) and proposed those owners a compensation in exchange. Since some of the owners decided to refuse the compensation and tried to get back their land via the courts, a subset of the squatters did not receive the land title. Crucially, this subset does not systematically differ from those that received the title. In other words, it is as if a randomly chosen group of squatters was subjected to titling while the rest was not. This natural experiment allows then to circumvent the problem of the endogeneity and to identify purely the effect of titling.

Galiani and Scharfrodsky find that the families in the group that received the land title increased their housing investment, reduced the household size (both by reducing the number of non-nuclear relatives living in the household and by reducing the number of offspring of the household head), and improved the education of their children. However, the authors find no effect in terms of access to credit markets and on labour income.

Field (2007), instead, concentrates precisely on this latter dimension – labour market outcomes – in the context of Peru. She starts from a theoretical proposition that informal property rights put the burden of enforcement on the community, while the formalization of rights transfers (at least partly) the enforcement problem on the state. If enforcement is costly (in terms of human resources), then formalization of property rights should free up some resources for the individuals whose property rights are being formalized and thus should have a positive effect on their labour supply.

The government of Peru launched a nationwide program of issuing formal land titles for 1.2 million urban households. The program ran between 1995 and 2003, and its introduction was staggered across different areas in the country. This, together with the fact that even before the program the security of property rights varied across households, allows the author to clearly identify the effect of the formalization on household economic behaviour. She thus compares the behaviour of households in neighbourhoods where the program was already introduced to the behaviour of those living in neighbourhoods where the introduction happened later. She also compares the households who had relatively weak security rights before the program to those who had their property rights already highly secured, and the households who had relatively few adults (thus facing very high costs of enforcement of their property rights) to those with relatively many adults.

The paper finds significant and sizeable effects on economic behaviour. The change in household labour supply between 1997 and 2000 is 16 hours per week greater for the households reached by the program. The members of these households are twice more likely to work outside the house. Moreover, this effect of obtaining a property title decreases with the residential tenure and the number of household members. Finally, for households with fewer than four potential workers, formalization of the property rights significantly reduces child labour hours.

Gamboa-Cavazos and Schneider (2007) look at the economic effects of changes in bankruptcy law in Mexico. Mexican bankruptcy law that dated back to 1943 was overly protective of debtors, in particular, imposing no penalties for excessive litigation. Thus, debtors used this tool to extort concessions from creditors. In May 2000, Mexico implemented a major bankruptcy law reform, which mainly consisted of imposing restrictions on litigation and reducing opportunities for objection at different stages of the bankruptcy process. The authors of the study find, using a dataset of 78 bankruptcy cases from 1991 to 2005 (and litigation information for each case) that the changes in the law led to a decrease in average time spent in bankruptcy from 7.8 to 2.3 years and to an increase in recovery rates from 19 to 32 cents on the dollar.

Yakovlev and Zhuravskaya (2008) study the economic effects of the Russian reform in the regulation of entry of firms. Between 2001 and 2004, Russia has implemented a drastic reform in this area, which mainly consisted of liberalizing registration and licensing of new firms. The authors use a micro-level panel data on regulatory burden and find that, on average, the reform had a positive effect in reducing the administrative costs of firms. However, the effectiveness of the reform varies substantially across regions. The enforcement of deregulation reform was better in regions with a higher quality of local government (more transparency, lower corruption, better access to independent media sources, and a stronger fiscal autonomy). The authors use the fact that the interaction of reform with its institutional determinants created a quasi-exogenous variation, to estimate the effect on entry and employment. They find a substantial positive effect of regulatory reform on net entry into the official sector and small-business employment.

Aghion et al. (2008) study a similar reform but in a different country. They look at the national reform episode in India – the dismantling of the License Raj during the 1980-1990s. This reform abolished the system of central controls that existed since 1951 which regulated entry of new firms in the official manufacturing sector. This deregulation of entry happened at the national level, but since local labour market regulations differed widely at the state level (some states having pro-employer labour market institutions, while some others had strongly

pro-worker institutions), theoretically one expects that the economic effects of the entry deregulation would differ across states. Indeed, the authors find that following deregulation, production grew substantially more quickly in the states with pro-employer labour market institutions as compared to those with pro-worker institutions. This finding, together with those of Yakovlev and Zhuravskaya (2008) indicate that understanding the economic effects of the substantive law (at least in the area of entry regulation) requires going beyond simple comparisons of laws “on the paper”: one needs to take into account the complex interactions of the substantive law with other institutional characteristics and laws in other relevant economic areas.

B. Enforcement

The studies of the effect of legal enforcement on development outcomes are more scant. Below we describe the findings from one recent study.

Gibson, Williams, and Ostrom (2005) analyse the problem in the context of local resource management (forests). Different communities have been trying to cope with the well-known « tragedy of the commons » problem using different mechanisms, including formal rules, against deforestation. However, the degree of enforcement of these rules - monitoring and sanctions - vary substantially across communities. The IFRI research program studies these communities in 12 countries of Asia, Latin America, and Africa. The authors analyse the data that come from 178 communities of this program and find that, keeping constant the level of social capital, group organization, and forest dependence, better enforcement - in the form of more regular monitoring and more severe sanctions – is strongly correlated with the quality of forests. Moreover, this finding is robust both for government-owned and community-owned forests.

It is difficult to interpret causally the results of this study, though. The main problem is the endogeneity of enforcement: it may well be that the communities that monitor better and have better quality of forests do so because of some unobserved third factor. In other words, the correlation does not imply causality and thus we cannot say, on the basis of this study, that better enforcement *leads* to better economic outcomes.

C. Judiciary

There are several interesting recent studies on the effect of judiciary reforms on economic performance. Below we describe the findings from two of them.

One of the mechanisms through which judiciary affects economic outcomes is studied by Visaria (2006). She analyses the effects of the introduction of a new judicial institution in India starting in 1993: Debt Recovery Tribunals (DRT), whose aim was to reduce the time required to recover a non-performing debt. Using the fact that only the loans beyond a certain threshold (1 mln Rupees) could be processed by the DRTs and that the DRTs have been introduced in different parts of the country in a staggered manner, she finds that the establishment of the DRT reduced the delinquency on loan repayment by 3-10 percent. Moreover, this effect was present for the same loan: the post-DRT instalments of the same loan are more likely to be repaid than the pre-DRT instalments. The paper also estimates that the introduction of the DRTs has led to a reduction in the interest rate that the banks charge by 1-2 percentage points. This finding clarifies one mechanism through which judiciary affects development outcomes. Better judiciary leads to a faster processing of legal claims. This leads

to higher loan repayment rates, which, in turn, implies that banks provide cheaper credit.

Chemin (2009) studies the effects of a major judiciary reform in Pakistan on entrepreneurship. In 2002, the government of Pakistan, in collaboration with the Asian Development Bank, implemented a pilot program called « Access to Justice ». The program covered 6 out of 117 judicial districts and aimed at providing training (e.g. case flow management techniques) to civil and criminal judges, to facilitate faster disposal of cases. Analysing the data on the performance of 875 judges between 2001 and 2003 and several rounds of labour force surveys, the study finds striking effects of the program on entrepreneurship: the disposal of cases by a judge increased by one quarter, on average, and the entry rate of new firms increased by one half. This latter effect to a large extent came from a 30% in the transition from unemployment status to becoming an employer or a self-employed worker.

D. When legal institutions do not matter, why they do not?

Contrarily to the results described above, there are numerous papers that find negative results: legal institutions seem not to matter in some settings. Looking closer at these papers, however, we can identify several key themes concerning why law does not matter for development outcomes in a particular context. Below we analyse them in more detail.

The best-known paper is perhaps that by Acemoglu and Johnson (2005). In this paper, the authors try to disentangle the effects of two types of institutions - 'property rights' and 'contractual' - on long-run differences in economic performance between countries. There are two major empirical problems that the authors had to address. First, the problem of endogeneity: it is not clear whether institutions cause growth or vice versa (for instance, as the country gets richer, the elites might ask for better protection of property rights). Second, there is substantial quality overlap in those two types of institutions: the countries that score highly on property-rights institutions usually also score highly on contractual institutions. Restricting the sample of countries to ex-colonies, the authors use instruments from colonial history to address these problems. Settler mortality in 1500 strongly predicts the quality of property-rights institutions in 2000, while the legal system of the colonizer strongly predicts the contractual institutions in 2000. Using these instruments, and regressing current income per capita on the two types of institutions, the authors find that the differences in the property-rights institutions drive the differences in economic performance, while the differences in contractual institutions have no statistically significant effect on income per capita, but only on the degree of financial development (stock market capitalisation). Thus, the authors conclude, once the differences in the quality of property-rights institutions are taken into account, the legal system – as measured by contractual institutions – does not matter for economic growth. The reason for this, according to the authors, is that gaps in contractual institutions - that regulate the relationships between private parties - can be closed by informal institutions such as reputation-building mechanisms, while the gaps in property-rights institutions - that regulate the relationships between the government and private citizens - cannot, because of the monopoly of coercion that the government enjoys.

We think there are several reasons why this conclusion is misleading. Let's mention three main ones. First, as we discuss below, only a part of the variation in the quality of contractual institutions can be explained by legal origin. Therefore, since the remaining variation is not captured by the instrument, it is likely that the effect found in the analysis is weaker than it is in reality. Second, the measure of contractual institutions - legal formalism index of the World Bank - is a very thin proxy that fails to reflect the entirety of the legal system. It is clearly the

case that the countries that score equally on this measure in reality vary enormously in other aspects of the legal system. Finally, given the complexity of the legal systems, the crude cross-country differences do not tell us much in terms of whether changes in legal institutions over time within the same country have an effect on economic performance: for this, we have to make resort to more micro-level studies.

The second - and a more pertinent to this paper's interest - theme behind failing to find the effects of legal institutions on economic outcomes is legal pluralism, i.e. the co-existence of formal and informal legal institutions. Platteau (2000, Chapter 4) discusses in detail the contradictory findings concerning the effects of legal institutions of land tenure, in particular in Africa. For instance, one of the most carefully implemented studies - Brasselle, Gaspart, and Platteau (2002) - tries to analyse the effect of land titling in Western Burkina Faso on agricultural investment. The authors face the challenge of the endogeneity of titling: when titling is voluntary, *a priori* it is possible that farmers tend to register the plots with relatively higher expected returns on investment (or in which they have already invested earlier), which means that if one finds an effect of titling on investment, it could simply be driven by these expected returns or past investment. Once this endogeneity is controlled for, the authors do not find a statistically significant effect of titling on investment. Why this is the case? A closer look reveals that the pre-existing informal tenure system, often based on kin, on the one hand gives extensive guarantees of security of property (even in the absence of formal titles), and on the other hand strongly limits the impersonal character of exchange that exists under the formal freehold system. In other words, if the informal system is not abandoned by a large majority of economic agents in favour of the formal system, formal titling is unlikely to have any effect.

The study by Goldstein and Udry (2008) further qualifies this idea. The authors look at the investment effects of land property rights enforcement in the setting where such enforcement is carried out informally. Based on data from Akwapim region in Ghana, they find that the intensity of investments (i.e., the length of fallowing) on a plot owned by an individual depends on this individual's security of tenure of that particular plot. This security of tenure is endogenous and depends on (i) the individual's position in the local political hierarchy, and (ii) the way in which the property on the plot was obtained in the first place. Thus, if one looks only *within* the informal system, one finds that the security of property rights matter for the economic outcomes. These findings have important implications concerning the reforms of the formal legal system in settings where informal institutions play a key role; we discuss this issue in Section V of this paper.

Finally, the third reason why we might fail to find a consistent effect of legal institutions on economic outcomes mainly applies when we look for the effects of the substantive law. One should keep in mind that the elements of the legal system are not substitutes for each other, but on the contrary, exhibit strong complementarity (Cooter 2006). To give a somewhat caricatured example, suppose Nigeria and Norway have a similar on-the-books contract law and contemporaneously implement an identical legal reform in this domain. Given the huge differences in other elements of the legal system (i.e., enforcement and dispute resolution), it is very likely that we will find strikingly different effects of such a reform on economic outcomes. Thus, studying the effect of substantive law does not make much sense out of the precise context of the country and timing. In economic jargon, getting good economic outcomes using better substantive law can be described as a production function, where different components of the legal system enter as complementary inputs. Then, the marginal product of one element (e.g. improving substantive law) crucially depends on what is the state

of the other elements.

The current state of the literature in this broad domain now started to move beyond the mere analyses of substantive law to other elements of the legal system (judiciary and enforcement). More of such research is likely to follow. What is perhaps necessary (and still too limited) is to go beyond simple empirical findings: we need to inspect in detail the mechanisms by which different elements of the legal system affect economic development: why judicial reform has an effect? Why a change in substantive law in some contexts has different effects than in other contexts? These are exciting questions, answering which probably requires to move beyond purely economic or legal framework and to borrow some findings and insight from legal anthropology and political science.

III. WHAT ARE THE DETERMINANTS OF LEGAL INSTITUTIONS?

A. History

One strand of literature claims that the major determinant of legal institutions of a developing country is its legal origin or a legal ‘family’ (see La Porta et al., 2008, for a review). There are two major legal families: common law and civil law. Their main difference is the role of the judiciary: in the common law tradition it is an active law-making body, while in the civil law tradition, the law-making role is (almost exclusively) reserved to legislators, while the judges’ main task is to interpret the existing codes. This difference has historical origins in the XI-XII centuries, when England was a relatively peaceful place where most disputes were efficiently delegated to independent knights or juries. This was further reinforced during the Glorious Revolution, when the English lawyers happened to be on the same (winning) side as the property owners and against the Crown, which guaranteed that the post-revolution role of the judges was made even stronger. Contrarily, the Medieval France was a relatively less peaceful place, where the nobility had the power to subvert the independent judiciary. Thus, the efficient administration of law had to be centralized and Roman law was adopted as a natural candidate. This was reinforced during (and after) the French Revolution when the judges happened to be on the (losing) side of the king. Revolutionaries thus further reduced the independence of the judges and Napoleon completed the centralization by establishing an extensive system of codes.

These differences in the main characteristics of the legal system were transplanted into the colonies of England and France. The (somewhat mysterious) process of transmission of legal institutions over time has guaranteed the persistence of these institutions, and - according to the legal origin theories - the current state of legal institutions in developing countries can thus be explained by the historical determinants of the legal institutions in the colonizing country.

B. Social and cultural characteristics

Gray (1991) makes a conjecture that the legal institutions in developing countries reflect “direct or indirect adaptation to risk (from natural, commercial, or political sources) and to the high cost of information”. For instance, the highly common collective responsibility system inside a kin for the offences committed by one member arises from the need for self-policing (given the high cost of information and low verifiability of individual action). Looking at the case of Indonesia, Gray explains the fact that the Indonesian legal system heavily emphasises compromise and conciliation as an adaptation to the social structure of this society which relies on collective insurance mechanisms to spread risk and which also has a very high population density (thus involving huge costs in case of violence).

At the same time, it is likely that not only the culture affects the society's choice of the legal system, but at the same time the legal system affects the cultural norms. Di Tella et al. (2007) study, in the context of the urban squatting episode described in Section IIA, the effect of the change in property rights on the beliefs of squatters about the market system. They find that the squatters that ended up with unchallenged legal titles report beliefs that are more favourable towards a free market and an individualistic society (such as the belief that money is important for happiness or the belief that one can be successful without the support of a large group). The size of the effect is large: the value of the catch-all index of "market" beliefs is 20 percent higher for titled squatters than for squatters whose titles were challenged, *ceteris paribus*. Moreover, the effect is sufficiently large so as to make the beliefs of the squatters with legal titles broadly comparable to those of the general Buenos Aires population, in spite of the large differences in the lives they lead.

C. Politics

Another natural candidate for explaining the differences in characteristics of legal systems is politics. Perotti and Volpin (2007) build a model that tries to explain the cross-country and cross-industry variation in the degree of investor protection. In their model, entrepreneurs differ in wealth and thus in their need of external finance. On the other hand, higher entry by new firms increases competition, which is feared by the existing firms. The wealthy entrepreneurs thus lobby for weaker legal investor protection. However, lower competition resulting from weaker investor protection reduces the welfare of voters. Thus, the degree of political accountability (explained by the political institutions of the country) affects the degree of investor protection. The authors then take the model to the data and find that, on one hand, in financially dependent sectors, the entry rates positively correlate with the degree of investor protection, and, on the other hand, a higher degree of investor protection is found in countries with more accountable political institutions.

Each of these explanations is, perhaps, only a partial account for the variation in legal system characteristics, if taken separately. What is needed is a synthesis of these approaches. On the one hand, within the same legal family there is a great variation in the fine details of legal institutions, which probably are explained by social and political characteristics of the country. On the other hand, some main traits of the legal institutional inheritance are strikingly persistent over time and show at least some similarity within the same legal family. To our best knowledge, there are no attempts to integrate these approaches, and this line of research seems very promising.

IV. WHY LEGAL REFORMS DO (NOT) OCCUR?

There exists a small but growing literature that studies the political economy of legal reforms. These studies start from the point of view that legal reforms are not exogenously given and that they reflect the interests of some groups in the society and ask the question what are the conditions for a country to embark on a legal reform.

Besley and Ghatak (2009) build a model where producers and suppliers engage in a contractual relationship. Suppliers face a moral hazard problem and thus need some collateral to align their interests with those of producers. This can be done in two ways: either using a fixed asset as formal collateral or using some kind of social collateral (social networks and personalized relationships). The property rights are imperfect, however, and this limits the possibility to use the formal collateral. Therefore, the legal enforcement capacity in the

network-based relationship is better than that using formal collateral. This means that there exist two groups of suppliers: network suppliers which obtain rents thanks to their superior legal enforcement technology (the traditional elite) and the market suppliers whose source of rents comes from their being more efficient (the new elite).

In this situation, the legal reform that aims to strengthen the property rights (and thus to improve formal collateral) would be in the interest of the new elite and against the interest of the traditional elite. The prediction of the Besley-Ghatak model is then that the societies where the traditional elite has more political power are less likely to implement legal reforms aimed at improving the property rights, than the societies in which more political power lies with the new elites.

Caselli and Gennaioli (2008) look instead at the issue of feasibility of two main types of legal reforms: deregulation of entry and financial/enforcement reforms (i.e., reforms concerning corporate governance, bankruptcy legislation, shareholder protection, and judiciary). Their analysis also starts from the idea that powerful incumbents stand to oppose reforms in which they lose their rents because of an increased competition from new entrants, i.e. both types of reforms. However, if there exists a market for control, i.e. the market where control rights over the incumbent firms are traded, the political feasibility of the two types of reforms is different. In particular, the financial reform increases the ability of talented outsiders to buy the control rights of the existing firms and thus, in general-equilibrium framework, induces less entry. More importantly, this implies that there is an endogenous mechanism for compensating the incumbents, while the deregulation of entry simply destroys rents of the incumbents. This means two things: first, that in the presence of the market for control, the financial/enforcement reforms are less likely to meet the political opposition of insiders; second, the two types of reform become complementary if financial reforms are implemented first.

In the context of transition economies, Sonin (2003) asks why the rich might favour poor protection of property rights and thus the economy overall exhibits a poor legal environment. He argues that when the protection of property rights by the state is imperfect, agents have incentives to invest in the private protection of property rights. Given that the private protection exhibits economies of scale, the rich have a significant advantage in that they could expropriate other agents using their private protection capacities. The rich then are opposed to the full public protection of property rights which would cause them to lose their rents coming from the scale advantage. Such an environment does not allow grassroots demand to drive development of new market-friendly institutions (such as public protection of property rights). This situation then becomes self-sustaining, as shows the example of the Russian 'oligarchs' - a small group of politically powerful agents that controlled large stakes of newly privatized property.

V. IMPLEMENTATION ISSUES

Let us now consider a setting in which a legal reform is possible (i.e., the opposition of the incumbents is not too strong) and turn to two key implementation issues.

The first issue is whether the elements of the legal system can be borrowed as a blueprint from one country into another. It is very tempting for a developing-country reformer to directly 'copy and paste' the existing and well-functioning laws from some developed country. Unfortunately, the literature on this 'legal transplants' gives an overall negative

answer concerning the effectiveness of transplanting. The theory (Milhaupt and Pistor 2008) suggests that the legal transplants are likely to be effective only when they satisfy two general conditions. First, they have to ‘micro-fit’, i.e. be compatible with the surrounding legal infrastructure (e.g., whether judges are familiar with the underlying doctrines of the law, whether the plaintiffs have the right incentives to make use of the new law, etc.). Second, they have to ‘macro-fit’, i.e. the transplant must be compatible with the political-economic institutions of the county (e.g., whether the new laws are likely to be used given the local interest-group structure). Thus, in general the home-grown laws are more likely to be effective than the legal transplants, because they naturally satisfy the above conditions. Berkowitz, Pistor, and Richard (2003) analyze the cross-country data from 49 countries with legal transplants, and find that the way the law was initially transplanted and received by the local legal community is a more important determinant of its effectiveness than belonging to a particular legal family. Countries that have developed legal orders internally, adapted the transplanted law, and/or had a population that was already familiar with basic principles of the transplanted law have more effective legality than countries that received foreign law without any similar predispositions.

The second issue is the effect of a legal reform in a setting of legal pluralism, i.e. where informal legal institutions play an important role. Aldashev et al. (2008) study the question of how the substantive legal reform (in particular, a reform that enhances the rights of disadvantaged groups in a developing country such as minorities, women, or the poor) affects the behaviour of actors of the informal legal system (customary judges and mediators) and what might be the resulting effect of such a reform on the well-being of the disadvantaged group. In their model, the disputes arise between the rich and the poor and a customary judge (normally on the side of the rich) first tries to settle the dispute. If a poor plaintiff is unhappy with the settlement, (s)he might bring the case to the formal court, but at the cost of the exclusion from the community. The customary judge, however, tries to keep the community coherent and therefore might go some way towards the preferred verdict of the poor. In this setting, the authors find that a pro-poor legal reform can cause the customary judge becoming more or less conservative, depending on the distribution of outside options of the poor plaintiffs. The effect on the welfare of the poor is ambiguous: while the poor plaintiffs that have opted out of the informal legal system are clearly better off after the reform, those that stay within the ambit of the informal system might be hurt (both through the customary judge becoming more conservative and the destruction of the social capital). The paper then looks at the case-study evidence from Sub-Saharan Africa and India and finds that in the domain of women’s rights, moderate formal reforms have caused the custom to adjust in the right direction, thereby increasing the welfare of women.

VI. CONCLUSION

In this paper, we have reviewed some of the recent literature on the legal systems and economic development. It seems that the progress in different parts of this research program has been somewhat uneven. We certainly know a lot concerning the effects of changes in substantive law in different domains and specific contexts. However, we know much less about why in some contexts we find large effects of such changes while in others these effects are practically absent. We also know relatively little about the impact of the other elements of the legal system (enforcement and judiciary), even though, fortunately, the literature in this direction has been growing.

Concerning the determinants of the legal systems, the different strands of the literature that

underline history, social characteristics, and politics have been developing separately. Our feeling is that trying to integrate these different strands should definitely give a much better understanding about the real determinants of the legal system, rather than going more in depth in each research line. Legal systems are just too complex to be reduced to some one-dimensional cause.

With regards to our understanding of what might help to push through legal reforms, the small but growing literature seems to suggest that we should look more carefully at the elements of the institutional setting that might help to compensate the potential losers of the reforms. This literature is still at the outset; however, our modelling tools seem to be mature to start handling this question more in depth.

Finally, concerning the implementation issues of reforms, our knowledge in this domain so far seems to be limited to negative results: we know that legal transplants are unlikely to work, unless they are well embedded in the legal infrastructure of the country. However, as some recent work on legal pluralism shows, there might be also some positive messages, concerning how formal legal reforms affect the informal legal setting of the country.

Overall, despite the field of law and economics of developing countries is still very young, it is growing rapidly and seems to be a fertile ground for exciting new findings, both theoretical and empirical. Our further progress in this field is likely to come from the attempts to move beyond specific analyses of the impact of particular success or failure stories towards more general analyses of the determinants and outcomes of successful legal institutions.

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