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## Rule of Law and Economic Performance



## Introduction

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### Abstract

This entry explores the connection between the rule of law and economic performance. First, we analyze the role of interjurisdictional competition, and how the rule of law emerged as a by-product of this competitive process, initially in Western Europe. Second, we discuss the role of intrajurisdictional competition between interest groups, which reinforced the emergence of the rule of law within states. Finally, we discuss the mechanism by which the rule of law successfully or unsuccessfully became established in Western offshoots, particularly in Africa and the Americas, affecting the long-term economic performance of these areas.

### JEL Codes

O12; P14; P16

[W]e may say that the movement of the progressive societies has hitherto been a movement *from Status to Contract* – Henry Sumner Maine (emphasis original, 1861 [1982]: 170)

The most incredible fact in recent economic history is the rapid decline of extreme poverty throughout the developing world. According to the World Bank, the percentage of individuals living on less than two dollars per day has fallen from 37% in 1990 to less than 10% of the world's population by the end of 2015. This dramatic fall in poverty has been due to a turn towards the protection of private property, freedom of contract, and most importantly, the establishment of the rule of law during this same period, particularly in areas that abandoned central economic planning, such as China, India, and Central and Eastern Europe. This more recent phenomenon of modern economic growth is a part of a progressive transition in societies that began first in Western Europe, from one in which wealth is accumulated through political transfers of privilege to a politically connected few, to one in which wealth is created through voluntary market exchange and innovation among many anonymous strangers. This social and economic transition is fundamentally based on an *institutional transition* towards the emergence and establishment of the rule of law, or as Maine put it, “*from Status to Contract*.”

However, the importance of the rule of law is not simply due to economic development in terms of increasing growth rates (Ručinská et al. 2016). Wealth creation produced by productive entrepreneurship within the rule of law is necessary, but not sufficient for explaining human progress.

Boettke and Subrick (2003) find that the rule of law also positively affects human capabilities, which refers to ability of individuals to lead the sort of lives that they value. That is, a variety of *noneconomic* fundamental aspects of the human existence, including life expectancy, child mortality, literacy rates, and immunization, are positively related with the protection the rule of law. Therefore, the rule of law is good for development, and development is not just good for one's stomach but also one's mind and soul.

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### **The Emergence of the Rule of Law Via Interjurisdictional Competition**

The degree to which the rule of law will lead to economic development depends upon whether or not the discretionary hands of a ruler are tied from altering property rights arbitrarily. Otherwise, entrepreneurship will be directed into unproductive activities. According to North and Weingast (1989: 804), "A ruler can establish such commitment in two ways. One is by setting a precedent of 'responsible behavior,' appearing to be committed to a set of rules that he or she will consistently enforce. The second is by being constrained to obey a set of rules that do not permit leeway for violating commitments." Beginning in a world in which governments have not established a credible commitment to predate its subjects, the question, then, is how did the rule of the law first emerge in the West?

Weingast (1997: 245) attempts to explain "the remarkable variation among states in the rule of law." In his framework, the rule of law is understood as "a set of stable political rules and rights applied to all citizens," one among many possible equilibria in a political-economic game between the government and the different subsets of the citizenry. Governments are often tempted to act arbitrarily to their own advantage. The citizens as a collective have an interest in constraining the arbitrary actions of the government. But any subset of the population will sometimes gain something from these violations of the rule of law.

The logic of the classic prisoners' dilemma game applies. As evidence of this, historically, most societies have been trapped in a subpar equilibrium. Members of society disregard (and sometimes encourage) the violation of the rule of law whenever it benefits them. Escaping the subpar equilibrium requires coordination among citizens. Oftentimes, this can be so costly to being unfeasible. To make the rule of law a self-enforcing constraint on governmental interference with society, the interests and beliefs of large sections of the citizenry must be aligned, at least to some degree. Thus, societies with high degrees of fractionalization (ethnic, cultural, political) are less likely to coordinate than more homogeneous ones (Weingast 1997).

These obstacles notwithstanding, coordination is possible. The rule of law, as it emerged first in Western Europe, was an emergent phenomenon of human action, though not of human design. Given the politically fragmented nature of Western Europe, violent international competition between states required European political leaders to finance the maintenance of strong military forces against the threat of conflict. In order to finance military expenditures, such political leaders were incentivized to expand their tax revenue base in a wealth-maximizing manner, the unintended result of which was for the political elite of each state to attract merchants, bankers, and technological innovators by securing property rights in their resources. The effect of this institutional change was to encourage the development of capital markets capable of mobilizing large concentrations of wealth from which to tax and

borrow. Moreover, in order for the political elite to have tapped this economic potential, this required not only security from arbitrary expropriation and confiscation but also toleration of technological experimentation and new ideas that would yield savings and investment. These institutional changes facilitated the expansion of technological innovation and productive specialization under the division of labor. As an unintended consequence of such action, feudalistic privileges were gradually eroded and economic and political liberty was reinforced until a critical threshold was met, leading to an explosion of economic growth in the early nineteenth century (Rosenberg and Birdzell 1986; Cowen 1990).

### **The Emergence of the Rule of Law Via Intra-jurisdictional Competition**

The rule of law first emerged not only via interjurisdictional competition between competing states but also through intra-jurisdictional competition between competing interest groups. North et al. (2009) provide a generalized version of this framework, with a stronger focus on the role of the elites. The fundamental puzzle driving their investigation is why the elites would ever extend their rights and liberties to the public at large. Historically, the natural state of human societies has been one dominated by relatively small groups or coalitions of a few large interest groups. These interest groups have the ability of using violence to appropriate wealth from the rest of the population. But as conflict is potentially very costly even for the stronger parties, the interest groups (and the subjects as well) face a strong incentive to institutionalize wealth extraction to minimize the expected costs from conflict. The resulting coalition of interests must therefore generate enough rents for each of its members to prevent defection. Legal monopolies and other special privileges are the way in which these rents are generated (Olson 1982). The public at large suffers from the resulting welfare losses, but it is actually better off than the more likely alternative of a civil war.

To operate effectively, the rent-seeking coalition needs a set of rules to govern the interactions

among its members. The resulting norms are the seeds of the modern rule of law. Thus, the government will enforce property rights and contracts by providing institutions for the resolution of disputes between coalition members. Once these institutions have been established, society is on the brink of what the authors call “open access order,” or a rule of law regime. In a pacified society, where all gains from trade within the coalition have been exhausted, there is a potential benefit from extending these institutions to a broader subset of the population. The coalition can credibly commit not to reverse the process by decentralizing political power (Weingast 1995) or extending political enfranchisement (Acemoglu and Johnson 2005).

The classic example is post-Glorious Revolution England (North and Weingast 1989; Acemoglu and Robinson 2012). The seeds for the self-enforcement of the English constitution after the Glorious Revolution can be traced back to the reissue of the Magna Carta in 1225. Leeson and Suarez (2016: 43) emphasize how the eventual self-enforcement of the Magna Carta required three conditions: (1) common knowledge among groups of citizens about when the ruler has violated the constitution; (2) rendering it in the interest of each group of citizens to rebel in order to enforce constitutional constraints on the ruler; and (3) creating a shared expectation among those groups that the others will rebel if the ruler violates the constitution, which in turn makes it rational for each such group to itself rebel in this event. These conditions also apply to explain the success of the Glorious Revolution in England.

Following the short interlude of Cromwell’s republican regime, the English parliament had restored the Stuart dynasty to lead the country. Within the next few years, the Crown took a series of actions to undermine the interests of the reformist and constitutionalist Whig party. Finding these actions to their own advantage, the Tories (the members of the conservative and monarchist party) aligned themselves with the Crown. This lasted until the 1680s, when the Stuarts started to take similar actions against the Tories. In 1688, the two parties coordinated their efforts, dethroned James II, and establish the Prince of

Orange as the new monarch under a new constitution agreed upon by both parties. The Glorious Revolution resulted in the establishment of the rule of law and had other positive economic results. By establishing a permanent role for Parliament in the management of the government, it directly checked the discretion of the Crown to call and disband Parliament unilaterally. Moreover, parliamentary veto over expenditures, the right to monitor the expenditure of funds, and the established supremacy of common law courts assured the protection of private property rights from expropriation and discretion.

### The Colonial Origins of the Rule of Law

In the previous sections, we discussed the endogenous formation of the rule of law through competition between states and competition between interest groups within states. However, the literature on the colonial origins of economic performance illustrate where and how the rule of law can be exogenously established. The empirical research on the relationship between rule of law and economic performance falls under the umbrella of development economics. Building on the theoretical insights of Smith (1776), Hayek (1960), North (1990), and others, by the early 2000s economists started paying attention to the role of institutions as determinants of economic development. This institutional paradigm emerged in response to the (at the time) influential view that geography was a major factor in determining a country long-run economic prospects (Diamond 1997; Sachs and Warner 1997; Gallup et al. 1999). The first major contribution to this literature is a famous paper by Acemoglu, Johnson, and Robinson on the “colonial origins” of economic development (Acemoglu et al. 2001). Here, the authors attempt to disentangle and identify the causal effect of geographical and institutional factors on long-run economic growth. To do so, they take advantage of a natural experiment of history: the European colonization of Africa and the Americas.

According to their story, the mortality rate of early settlers influenced the adoption of

institutions by the colonial governments. Where settlers’ mortality was low, colonial governments encouraged the immigration of individuals from the homeland. To move to the colonies, European settlers demanded the adoption of a set of institutional measures associated with the rule of law (the protection of basic human rights and private property and some form of political representation). In other regions, higher settlers’ mortality prevented similar migratory patterns. Dealing with a mostly indigenous population, colonial governments adopted political and economic institutions aimed at the extraction of resources (including indigenous labor’s services).

Relying on the sluggish nature of institutional change, and using settler’s mortality as an exogenous determinant of institutional diversity, the authors find the quality of institutions adopted by colonial governments is a strong predictor of today’s economic performance. Furthermore, the authors find that, controlling for institutional quality, geographical factors usually assumed to play a causal role in the dynamics of development such as distance from the equator, have no *independent* effect on long-run economic growth. According to Acemoglu et al. (2001), geography affects economic performance only through their effect on institutions.

In a follow-up to their original article, the same authors adopt a different empirical strategy to reach similar conclusions (Acemoglu et al. 2002). Here, urbanization and population density at the arrival of the Europeans take the place of settlers’ mortality rate as instruments for institutional quality. A higher population density at time of discovery provided colonial governments with a pool of disposable and cheap labor to be exploited, while less inhabited areas required the influx of large numbers of workers from the homeland. In the former case, the colonists adopted the indigenous extractive institutions where they were already in place and made-up their own otherwise. In the latter case, they imported private property and constitutional government. This exogenously determined institutional diversity, the authors find, accounts for the puzzling case of the “reversal of fortune” of the last five hundred years: those extra-European

regions that were the richest (poorest) before colonization are today among the richest (poorest) in the world. Glaeser et al. (2004) and La Porta et al. (2008) provide an alternative (but similarly influential) empirical approach to the same question. In their strategy, the initial institutional variation across countries is due not to the decision of formal political institutions, but the prevalent legal regime in the colonists' home country. They separate between (English) common law on the one hand and a variety of "families" of civil law (French, German, Scandinavian, and Socialist). The authors find that, in general, common law countries outperform civil law ones on most measures of institutional quality that are strongly positively correlated with economic performance, including constraints over governmental arbitrary powers, quality of public officials, property right protection, and so forth. All these findings are consistent with the traditional understanding of the beneficial nature of the rule of law: the closest a country's institutions to the ideal of the rule of law, the more effective these institutions and the more dynamic and productive the economy.

## Conclusion

Private property rights and entrepreneurship are necessary, though not sufficient for economic development. Given the scarcity of resources, property rights and entrepreneurship are ubiquitous, but their manifestation is ultimately contingent on the presence of the rule of law. Property rights over resources can be acquired through productive entrepreneurship via market exchange (i.e. profit-seeking) or through unproductive entrepreneurship via political exchange (i.e. rent-seeking). Fundamentally, the rule of law is *the* institutional filter that restricts the exchange of private property and productive entrepreneurship to the coordinating invisible hand of the market process, rather than being guided by the discretionary visible hand of the political process (Boettke and Candela 2014).

Recognizing the link between the rule of law and economic performance has important

implications not only for economic theory but also for economic policy as well. As evidenced by the American financial crisis of 2008, the European sovereign debt crisis, and the recent Brexit vote of June 2016, discretionary monetary policy, fiscal policy, public administration, and labor market policy has lead increasingly to a movement away from societies based on contractual exchange to societies based on the status of expert rule, which privileges nondemocratic, expert administration of independent regulatory agencies that violate the rule of law. If this trend continues, the overall effect will not only lower standards of living but also erode civil liberties and increase the fractionalization of societies, as a result of legislation privileging certain groups of people at the expense of another. As we have tried to argue in this entry, political officials cannot violate the rule of law for the purpose of expediency without simultaneously stifling the principles upon which the spontaneous creative powers of a free civilization are based.

## Cross-References

- ▶ [Austrian Perspectives in Law and Economics](#)
- ▶ [Austrian School of Economics](#)
- ▶ [Common Law System](#)
- ▶ [Customary Law](#)
- ▶ [Efficiency](#)
- ▶ [Hayek, Friedrich August von](#)
- ▶ [Liberty](#)
- ▶ [Mises, Ludwig von](#)
- ▶ [Rule of Law](#)

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