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## **Commentary: Kenneth Davidson, Is There a Nexus Between Choosing Laws and Promoting Economic Growth?**

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### COMMENTARY

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Is There a Law-Growth Nexus? a commentary on Kenneth W. Dam's THE LAW-GROWTH NEXUS: The Rule of Law and Economic Development, Brookings Institution Press, 2006.

### **Is There a Law-Growth Nexus?**

Antitrust or competition law is intended to make a market economy function better. Or, to parody econotalk -- assume a free market, then we can discuss the role that antitrust does or should play. Unfortunately, although we now have over a hundred countries that have adopted antitrust laws, not all of these have what we think of as market economies. In order to probe some of the reasons why their markets do not function well, this Commentary looks at a new and very thoughtful book by Kenneth Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development*.

The requirements for creating a functioning market economy are both complicated and not very well understood. As a result, the effectiveness of (or, indeed the need for much of) competition law has been attacked by the neoclassical economists and lawyers of the Chicago School. The essence of their position is that, in general, free markets will function better than regulated markets and therefore the less a government regulates its economy, the better the economy will perform. Dam, formerly a professor at the University of Chicago, like his colleagues in the law school, the business school and the economics department, relied on neoclassical economic models and its definitions of economic man to analyze and explain economic phenomenon, and to formulate and promote policies to solve economic problems. This book is a complete departure from that approach. It is a hunt for facts, not theories, that explain how economies develop and what influence the choice of different types of legal institutions has on that development.

His hunt can be described as having two major components. The first explores what problems economic transactions had to overcome to become viable. The second is whether legal rules developed from common law traditions are as good as or better than legal rules developed from civil law traditions. The empirical setting for this second question is sometimes framed as a chicken or egg question – must you have the legal framework in order to consummate the transaction or must you develop the economic framework before the legal framework? The answer is often an iterative process in which some transactions require the preexistence of a legal framework in order for those transactions to be possible. Hedge funds, mortgage-backed securities and many other staples of modern financial transactions rest on a foundation of legally created (usually by statute) intangible rights that are enforceable by a court system. Nevertheless, it is clear that, historically, economic transactions preceded laws defining economic rights.

Dam is a scholar who has also served as Deputy Secretary of State and Deputy Secretary of the Treasury and who has represented companies such as IBM and Alcoa. Although the bulk of his book discusses or dissects econometric studies, his critiques seem to reflect his hands-on experience as a government official and lawyer rather than a mathematical evaluation of those studies. As a result, the book is highly readable to the interested lay person even though some technical academic jargon is necessary to frame his discussion.

For my present purposes, which concern antitrust, competition and competition law in developing countries, and technical assistance to those countries, that jargon is not necessary. My interest is limited to some comments on Dam's presentation of the problem of creating binding contracts and how to create an enforceable legal structure to facilitate commercial ventures. These are the predicates to an economy which can make appropriate use of a competition law.

### **Private Ownership and Enforceable Contracts**

In a primitive economy, where sale and purchase are a single event – a barter swap at a market, for example – there is probably little necessity for commercial rules or contract law. What you see is what you get. Some notion of rights to property, protection against theft and personal safety are required, but those appear to be inherent in the existence (or continued existence of the marketplace). Without some implicit agreement about those rights the market would not exist.

Dam identifies the problematic transactions as ones in which there is no simultaneous swap of properties. He illustrates this with two types of transactions. The first is where A orders a product from B to be delivered to A at a particular time and for which B will be paid a specified compensation. B agrees to the terms and starts to work on making the product. The second example concerns X, who hires Y to take a cargo to a distant marketplace (either in response to an order from Z or to a marketplace where Z and others congregate), swap the goods for compensation agreeable to X and return that compensation to X. In both of these examples, there is an opportunity for nonperformance by one of the parties after the agreement is made and before the

transaction is completed. If A pays B in advance, B might not make the product to the satisfaction of A, or might refuse to deliver the goods to A unless he pays additional amounts because the product is more valuable at the time it is finished. Y might take the cargo and never return, or might swap the cargo for less compensation than X would approve, or might secretly keep some of the compensation for himself and not give the full amount to X.

In the absence of an enforceable legal system, will businessmen enter into such agreements if they are at risk? The answer we know from history is that they did enter into such transactions. Dam's explanation for why the businessmen trust each other enough to enter into these transactions relies on the game theory experiments that show that players in a repetitive game (or set of transactions) generally find that cooperation produces more reliable and higher rewards than cheating. Dam thereby brushes past the – where did trust come from -- difficulty that long puzzled certain economists and moves to the successful examples of medieval Venetian traders and English guilds like the Merchant Adventurers and more modern examples of minority Chinese communities in Southeast Asia.

While Dam notes that these communities succeeded where others did not because of a social cohesion that would exile members of the business community who cheated, he does not look more closely at the anthropological, sociological or other literature that examines why trust communities arise, or fail to arise, or fall apart. It is unfortunate that he does not further examine the trust issue. As Kenneth Arrow pointed out long ago, trust is the key element that makes market transactions possible, “but [the trust elements of transactions] are not commodities for which trade on the open market is technically possible or even meaningful.” Certainly Dam is correct when he states: “If everything must be treated in a book, nothing can be.” On the other hand, he might have focused more on issues that he demonstrates are more central to economic growth than legal origins.

Nevertheless, his conception of law throughout this book is broad. He insists that law is the decision which is applied in a case, rather than the words of a statute. Moreover, he makes intermittent references to possible effects of religious restraints on commercial and financial development (for example, Islamic texts, may have more effect than Christian texts, in the way prohibitions on usury are interpreted). It seems, therefore, that the underlying historical, social, ethical and religious context of societies ought to have a more prominent place in this description of economic development. Dam, himself, provides a penetrating example of the importance of social context to economic analysis in his discussion of the phenomenon of the “tragedy of the commons.”

The tragedy of the commons is reputedly the inevitable ruination of resources that are available to all. Dam points out that the literal commons – a grazing area where all of the local population have rights to graze their animals – was a very successful arrangement that lasted for centuries in Western Europe and other places. To be sure, the commons system worked because it was highly regulated (by the Lord of the Manor, by the council of elders, by tradition, etc.) in a manner that ensured the commons was not overgrazed.

Dam even allows that the allocation of feudal farming land in strips that were not adjacent might have been more efficient than a single contiguous plot for each farmer. The geographic separation of strips may have permitted the farmer to grow different crops in different places and may have reduced his risk of total crop failure.) The tragedy of the commons occurs when individual ownership rights replaced the traditional rights and access to the commons ceased to be regulated. In an unregulated society, the danger of the tragedy of the commons is more real.

Jared Diamond, in his book *Collapse*, provides very pointed examples of the efficiency of some traditional societies in New Guinea and Tikopia. They have worked out farming and fertility rules that have permitted dense populations to persist for 46,000 years without degrading their environment. More recent attempts to implement modern cultivation techniques not only failed but showed the sophistication of these traditional societal rules.

While Dam does not pursue the societal underpinnings of trust that make commerce possible, he does note that social understandings can be a barrier to adoption of western legal systems by traditional societies. He sets out, but does not pursue, the theme that adoption of modern legal rules may not only not work, but may create problems that make the population worse off. He uses this insight to suggest that legal reform, as practiced by industrial technical assistance programs, should be careful not to create harm as a by-product of “modernization.” He also notes that the development of modern trading relationships took centuries and we should not expect commercial development in transitional economies to be quick, appropriate, or easy.

Like his truncated treatment of the relationship of social phenomena to law as applied, he almost shrugs off the deleterious effects of corruption in transitional economies. He simply notes that commerce would be more efficient if governments, judges in particular, were more honest, more better educated and better paid. His reasons for not focusing on these issues are that both issues have been more fully explored by others and he cannot cover everything. I think it is unfortunate that Dam does not give these issues more direct attention because they are central to issue of the role of law in developing transitional economies and he refers repeatedly to social factors, but generally as brief asides to his main points.

Notwithstanding his aversion to probing the role of corruption, he takes up essentially the same issue as a legal-economic issue that he describes as predatory actions by rulers, elites, majority shareholders and management dominated firms. He points out that commerce could not develop if the ruler had the right and power to confiscate all of his subjects' property. No sensible person would lend money or voluntarily make products for a ruler who regularly exercised an unlimited power to renounce all or any agreements about payment or repayment. In this context, Dam finds the Magna Carta a significant, but limited, beginning in which the King acknowledges that he, like his barons, is subject to the law, and the law is a separate entity from the decrees of the King. Only as a result of the 17<sup>th</sup> Century Glorious Revolution and the 1701 Act of Settlements does it become clear that the King may not remove judges, may not default on his economic obligations

and that only parliament may raise funds. It is to the elimination of the predatory sovereign that Dam credits the faster growth in English GDP during the 18<sup>th</sup> Century. Significantly, once it becomes clear that the King may not default, it becomes easier for the King to borrow.

Dam attributes the growth of English commerce to the same assurance of contract performance by individuals and companies. By making clear that individual ownership rights exist and are transferable, businesses become able to attract capital by borrowing. The large company becomes possible by the aggregation of individually enforceable loans or stock holdings. Although judicial enforcement is nowhere quick, cheap and sure, the public expectation that owners and creditors rights will be enforced allows the creation of the modern economy. How these expectations became generalized over centuries from small homogenous groups of traders within a society to the society at large is not discussed beyond reference to the fact that it took a long time.

It is precisely the absence of these expectations that casts doubt on economic development in transitional economies. The problem of the predatory state remains unsettled. Also in doubt is whether private debts will be enforced in the courts. Furthermore, there is uncertainty whether majority owners of businesses will respect the claims of minority investors. The dubious credibility of those who control businesses is a deterrent to foreign and domestic investment. Industrial countries have developed capital markets despite intermittent frauds – from the South Sea Bubble to the Enron Scandal – and despite possibly legal abuses by owners and managers of minority stockholders of large corporations. From the early 20th century classic case in which minority shareholders in the Ford Motor Company, the Dodge brothers, sued Henry Ford to distribute some of its enormous accumulated profits as dividends to the 21<sup>st</sup> Century's \$100 million compensation packages for CEOs, the potential for predatory actions by owners and managers has been recognized, but neither these nor stock market crashes have destroyed the capital markets that continue to grow in “developed” countries but find it difficult to become established in transitional economies. The lesson is, I suppose, that markets need not be perfect to be sufficiently credible to attract capital, but they do not succeed in the absence of some minimal threshold of credibility.

Without trust, market economies do not develop and, if they exist, they do not work well. If there is no confidence that agreements in the market place can be enforced, anticompetitive agreements are indistinguishable from procompetitive agreements because the effects of any agreement are indeterminate. Whether particular laws make a difference in formulating or sustaining expectations that agreements will be honored is the subject of the next section.

### **Studies on the Effect of Laws and Legal Traditions on Commerce**

The bulk of Dam's book concerns an academic debate as to whether common law provides a more favorable environment for economic development than civil law. For many analysts this debate has focused on a comparison of British law with French law. Although he does not say so forthrightly, Dam criticizes the seminal studies because they

look at the wrong legal attributes, mischaracterize the laws, and confuse the statutory laws for the laws that are in fact applied. The assumption of these mostly econometric studies is that it makes a difference to economic growth whether a country has obtained its legal traditions from England or France. Is a bureaucratic judiciary that is explicitly subservient to the legislature less likely to protect the rights under contracts or the rights of shareholders and creditors? Does an independent judiciary guaranteed by the separation of powers in a written constitution help protect commercial rights and promote economic development?

Dam's critique of these studies is so devastating that by the end of his discussion it looks as if he has chosen to attack the theories of straw men. Although it is clear that he has great respect for these studies, it is equally clear that he believes that the assumptions of the researchers about law and legal institutions were often wrong. His view is that the legal origins literature are often wrong because countries do not fit neatly into civil law or common law patterns, and that commercial development is not meaningfully correlated with origins. In large part, he argues that origins are irrelevant because modern commercial law is the product of 19<sup>th</sup> and 20<sup>th</sup> Century statutory development rather than common law cases. In addition, he notes that the idea of constitutional separation of powers establishing an independent judiciary is typical of Latin American "civil law" countries that were influenced by the written constitution of the United States and that the progenitor of common law, the United Kingdom, does not even have a written constitution.

It is not helpful to this Commentary to review in greater depth his critique of the econometric studies. Some of Dam's factual recitations are, however, provocative. As noted above, he credits the faster growth of the British economy than the French economy during the 18<sup>th</sup> Century in part to the 1701 statutory establishment of an independent judiciary. Accordingly, British GDP was far ahead of French GDP by 1800. However, following the adoption of the Napoleonic codes in the early 19<sup>th</sup> Century and continuing through the late 20<sup>th</sup> Century, the rate of growth of the French economy averaged 3.5% in contrast to a 2.5% rate of growth of the British economy. As a result, the French per capita GDP eventually exceeded that of the British. For reasons that are nowhere explained, the number of French limited liability companies far exceeded the number formed in Britain. On the other hand, the large European companies have been traditionally dominated by a single family or a bank. Only in Britain and the United States has there been a long history of companies that have widely held stock. Dam also notes that the allegedly distinctive common law practice of developing law from prior decisions is similar to the practice of French courts of citing (although not discussing) prior decisions in their decisions.

### **Can Legal Institutions Help Economic Growth?**

Where does this leave us concerning the influence of law on growth and the relevance of antitrust to growth? Confused, to be sure. If one were in doubt, Dam's final chapter concerns the practically miraculous economic growth of China since Chairman Deng moved to adopt a market economy in 1978. China is notorious for the absence of an

independent or trained judiciary and yet Dam says it has the fastest growing economy in the world. He could have used other examples. Singapore, which was a poor third world country when it gained its independence from Britain and Malaysia in the mid-1960s, became a first world country in less than forty years with a higher per capita GDP than Britain, and did this without an antitrust law. Or he could have examined other economic miracles -- the Asian tigers, or post-WW II Germany or post-war Japan or the historical examples of Britain or the United States, none of whom had the benefit of competition laws.

Dam chooses China as his “test case” precisely because the rule of law there is so uncertain. His explanation of the dynamics of the Chinese economy is lucid. Its analysis is factual, outlining the interest groups and the reasons they have to cooperate. In this respect, it is more like his early chapters on how commerce developed than like the later academic analysis of economic impact of particular legal systems. His conclusion is more suggestive than prescriptive. He indicates that economies can grow rapidly without well defined rule-of-law institutions, but that they tend to reach a crisis in growth that requires the development of stronger, more reliable legal institutions. He points to the no longer recent Asian financial crisis as evidence of the eventual need for such legal institutions. But he seems agnostic as to what these institutions must be and what specifications in these institutions will work best. Dam closes his book with a quote from Zhou Enlai on the success of the French Revolution: “It’s too early to tell.”

My view is somewhat less equivocal. Dam’s hunt for the best, most effective legal traditions and institutions shows that economic success and failure come in many forms. His review of the literature is a significant contribution. It allows those who provide aid and advice to developing countries to focus less on what kind of laws should be enacted and more on how to make those laws work.

The absence of consistency in the studies, like Sherlock Holmes’ hound that did not bark, suggests that the key to economic growth and development is not the adoption of a particular legal architecture. Dam concedes that “trust, social capital and religion” as well as other cultural factors may be more important than particular legal devices, but he is dissatisfied with this answer because it “gives little guidance to a policymaker seeking to quicken the pace of economic development.”

I suggest these factors provide relevant guidance to policy makers and Dam’s analysis does a service by destroying the illusion that there is a magical set of laws or constitutions. There is no quick and sure universal legal fix that will encourage economic growth. The guidance that comes from Dam’s book is that aid and advice should be derived from what, in a particular country at a particular time, will enable that society to restrain the predatory practices that inhibit or discourage investment and commercial development or, at least, will enable entrepreneurs and investors to work around such practices. Policy makers can choose between various legal models, such as the French, English, American, or German. The models are helpful because they illustrate systems that have worked and therefore do not need to be reinvented, but the choice must be

dictated by what will work in that particular country, with its unique characteristics, at that time.

To be sure there are frequently differences of form between common law and civil legal systems. The civil law idea that the true law can be found in the words of the statute or the constitution is consistent with the Supreme Courts of Brazil and Indonesia that have numerous justices who decide cases in small panels whose decisions are both unappealable and they also are not binding on future panels who face the same issue. As a result the Brazilian Supreme Court has an overwhelmingly large docket that requires it to repeatedly decide the same issues. But this institutional quirk is not a necessary aspect of the civil law, nor is it completely inconsistent with the more hierarchical structure of courts in the United States. Decisions of Federal District Court Judges do not bind other District Court Judges. Federal Courts of Appeal sit in panels that may disagree with other panels of the same Court. To be sure such disparities can be resolved either by an entire Court of Appeals sitting *en banc*, or by decision of the United States Supreme Court. But these efforts to enforce uniformity of result are rarer than one might think and they do not provide the finality that is imagined. *Brown v. Board of Education*, *Roe v. Wade*, *Miranda*, and *GTE Sylvania* are but a few of the notable cases in which the Supreme Court has changed its decisions despite clear precedent. And, as Dam notes, French courts do cite precedents of other French courts to support their decisions. The issue in choosing to follow a particular legal model should be decided by pragmatically finding out what works rather than by theorizing.

The same is true of substantive law. Paper money, debt instruments, draft laws, competition laws are all devices that can be useful in developing an economy. Whether they are in practice useful depends on how they are used. If too much money is printed, an inundation of the paper will make the “money” worthless. If debts are frequently unpaid or not reasonably enforceable, the best drafted instrument will not protect the lender. Draft laws are useful to raise an army and to determine whether the general population will support a particular war, but an amateur army of draftees may not be sufficient to protect a nation’s economy from a surprise invasion. A competition law can help protect and promote a market economy, but if it is not enforced or is enforced in a manner that stifles competition, the economy is likely to suffer. These lessons appear to be obvious, but they seem to get lost in sophistication of modern economic models and studies. Professor Dam’s book provides us with some of the tools and information needed to see what is important.