

2023 May 11

4. Theories of law and development (1): Economic theory of law and development

Readings:

"Chapter 3: Institutional theories of development" and "Chapter 10: Property rights, contracts and development" in Michael J. Trebilcock and Mariana Mora Prado, Advanced introduction to law and development, 2nd edition, Edward Elgar, 2021.¹²

The E-Book is available on the Nagoya University Library website

(<https://ebookcentral.proquest.com/lib/nagoyauniv/detail.action?docID=6837135>)

Goal:

To understand the relationship between development paradigm and the legal reform strategy.

To understand how legal institution affects the market economy.

To understand relationship among market, transaction costs and law.

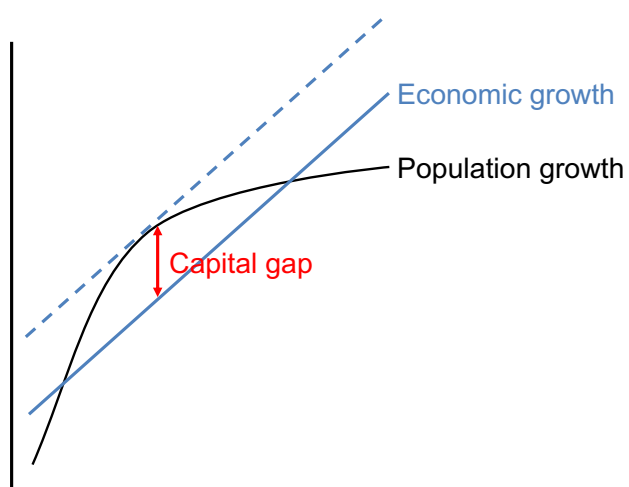
1. Development paradigm and the legal reform

From the economic perspective, the development paradigm (predominant development strategy in a particular period in post-WWII history) can be categorized into "capital fundamentalism" and "market fundamentalism."

(1) Capital fundamentalism: Capital input and the State's role in economic development based on rational planning

According to capital fundamentalism, the insufficiency of capital is assumed to be the cause of underdevelopment. Therefore, a developing country needs additional capital input from outside sources. If sufficient capital is available and the developing country's government can create a rational economic development plan with the support of the international community, development should be achievable. As a result, capital fundamentalism presupposes the government's ability to create a rational policy and implement it accordingly. In this context, capital fundamentalism assumes the government's active intervention in the economy.

¹² E-book is available on the Nagoya university library website



A common theory regarding the capital gap centers on the disparity between economic growth and population growth. When population growth surpasses economic growth, the GDP per capita decreases, and the population becomes poorer. Consequently, there must be a significant enough influx of external capital (the Big Push theory) to fill this gap. While this theory outlines the required amount of capital input, it

does not specify how the capital should be allocated.

Given the belief in rationality in the development of policymaking, several leading law schools in the United States and the United Kingdom sent law professors to developing nations, primarily in Latin America and Africa, to advance legal reforms aimed at modernizing society and politics. This initiative is known as the "law and development movement (LDM)." We will delve further into the LDM in subsequent sections¹³.

Nonetheless, in numerous developing nations, government-led development plans have failed to achieve their intended goals. As a result, economists began to view the government not as a catalyst for development but rather as a source of economic failure.

(2) Market Fundamentalism

In response to growing disillusionment with government-led development, market fundamentalism emerged as the new development paradigm in the late 1970s. Several Latin American countries transitioned from state-led economies to market economies during this period, including Chile in 1973, Uruguay in 1974, and Argentina in 1976. Additionally, in the 1980s, more countries, such as Vietnam, China, the former Soviet Union, and Eastern Europe, adopted market economies.

Todaro and Smith¹⁴, in their widely cited textbook on development economics, explain the shift towards free market policies as follows:

¹³ For the experience of the law and development movement in 1960s, see: Trubek "Toward a Social Theory of Law: An Essay on the Study of Law and Development" *Yale Law Journal* Vol.82, p.1, 1972.

¹⁴ Todaro and Smith, *Economic Development*, 12th edition, Pearson, 2015, pp.556-557

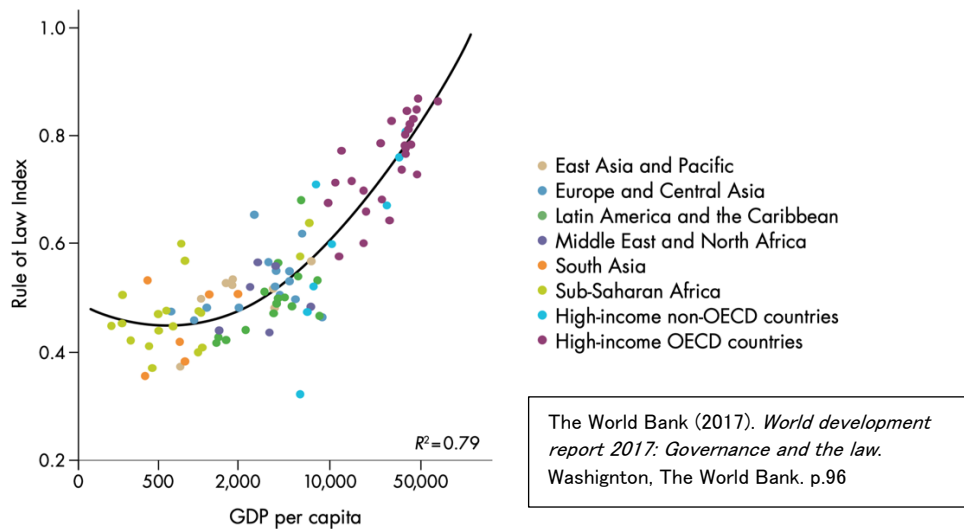
"As a result of the disenchantment with planning and the perceived failure of government intervention, many economists, some finance ministers in developing countries, and the heads of the major international development organizations advocated increased use of the market mechanism as a key instrument for promoting greater efficiency and more rapid economic growth. U.S. President Ronald Reagan made a famous reference to the "magic of the marketplace" in a 1981 speech at Cancun, Mexico. If the decade of the 1970s could be described as a period of increased public-sector activity in the pursuit of more equitable development, the 1980s and 1990s witnessed the reemergence of free-market economics."

Market fundamentalism posits that an independent market mechanism can lead to the most efficient allocation of resources, and any external intervention in this mechanism may negatively impact productivity. Consequently, market fundamentalism advocates for legal policies of deregulation and privatization. For the market mechanism, see section 2 "Market mechanism" of this lecture material.

(3) "Good governance" and the "rule of law."

During the 1990s, institutionalist economics, also known as New Institutional Economics (NIE), emerged as a development paradigm¹⁵. Institutional economics emphasized the government's role in creating institutions that could enhance market efficiency by establishing ownership and reducing transaction costs, or what is commonly referred to as "good governance" for the market. Moreover, good governance and the rule of law align with human development and have expanded its scope to encompass more inclusive development, such as participation and equity.

¹⁵ "Beginning in the early 1990s, an institutional perspective on development has become increasingly prominent in development thinking, captured in the mantra 'institutions matter,' or 'governance matters.' This perspective views the quality of a country's domestic institutions as a major determinant of its development prospects." (Trebilcock and Prado, p.34)



2. Market mechanism



In economics, the term "market" does not refer to a physical location where many sellers gather (such as a shopping center or bazaar). Rather, a market in economics refers to the process by which purchasers (called the "demand side") and sellers (called the "supply side") of a useful item

(called "goods") agree on the value of the goods and exchange them at a mutually satisfactory price (the agreed value is called the "price" of the goods).

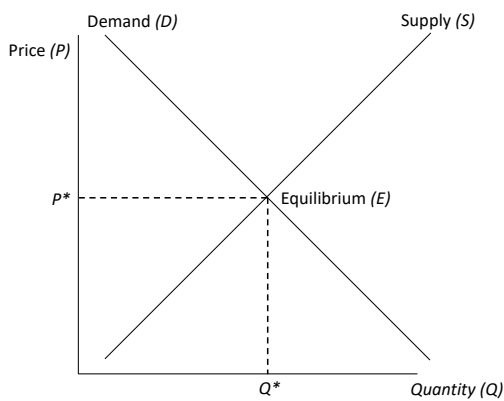
To simplify the concept, let us consider the scenario where there is only one type of good being sold in a limited location, such as a small town where you want to buy an ice cream.

- Purchasers know well the taste (*quality*) and price of all ice cream shops in the town.
- Sellers know that other shops are selling similar ice cream. A seller can decide the ice cream price and knows the ice cream price of other shops.
- There is no reason for a seller to sell ice cream at a lower price than others, and if a seller sells ice cream at a higher price, purchasers will buy it at another shop.

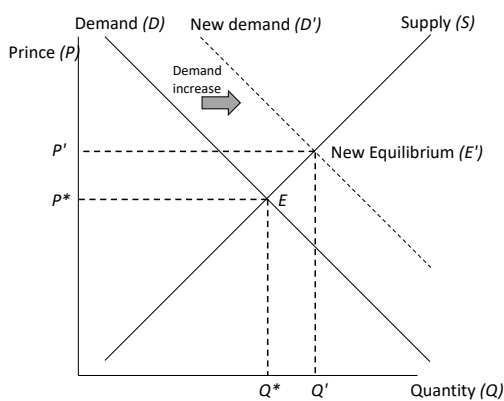
- As a result, the ice cream price of the town will be the price that purchasers are willing to buy, and sellers are willing to sell it for.
- Furthermore, if purchasers feel the ice cream price of the town is too high, they will not buy ice cream (they may buy hot tapioca milk tea instead of ice cream).
- If more purchasers want to buy ice cream (for instance, due to hot weather), more ice cream will be sold even if the price is high.

In this case, the market is the process by which you, as the buyer, and the seller of the ice cream agree on a price that is satisfactory for both parties based on their perceived value of the ice cream.

The process described above can be represented using a **Supply-Demand Curve (S-D Curve)**:



Price is determined by the quantity of demand and the quantity of supply (or the quantities of demand and supply are determined by the price) at an equilibrium point E (price P^* and quantity Q^*). The figure below shows that the intersection E (Equilibrium) moves toward the upper-right (from E to E') when the demand curve shifts rightward (from D to D'). This means that as a result of increasing demand, the quantity of supply increases (moves toward the positive side of the x-axis, $Q' > Q^*$), and the price of goods in the market rises (moves toward the positive side of the y-axis, $P' > P^*$). For example, more people will buy ice cream due to hot weather (increased demand for ice cream), and ice cream shops do not have to discount the ice cream price (the ice cream price rises).



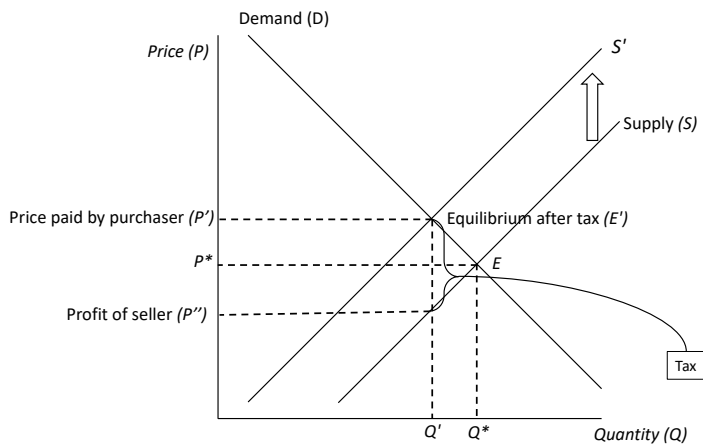
From another perspective, we can interpret the same figure as the demand curve shifts upward. In this case, the figure explains that because people are willing to pay a higher price, supply increases.

For example, when the ice cream in the town is recognized as a high-end brand, people will buy it regardless of the price.

This process indicates that each person allocates their limited resources most efficiently (to maximize their satisfaction with goods).

Government intervention in the market (e.g., tax and subsidy)

Guess what would happen if the government intervenes in the ice cream market in the town by imposing a tax to increase its revenue. The effect of the tax on the market can be described as follows:



The government imposes a tax on the selling price of good X (ice cream).

Because sellers must increase the price of X by the amount of the tax, the supply curve shifts upward (S to S'). As a result, a new price and quantity are determined after the tax (P' , Q').

If we compare the price before and after the tax, the burden of the tax is the same for both sellers and purchasers ($PP' = PP''$).

Originally, there is a demand for the goods (Q^*).

However, because purchasers have to pay a higher price due to the tax, the quantity of supply decreases to Q' (thus, the tax has a negative effect on the ice cream economy in the town, $Q' < Q^*$). Sellers might want to supply ice cream at the price of P'' . However, if they do so, ice cream cannot be sold, and there would be a surplus of stock. If we consider another market of goods Y (such as hot tapioca milk tea) that uses the same material (milk) as X, the milk for X will be transferred and over-supplied to other goods (Y), and the price of Y will decrease (sellers of Y will suffer a loss).

As explained above, according to the market mechanism, interventions from outside the market distort the price-quantity balance and have a negative effect on productivity. There are various types of interventions to consider (please draw D-S curves yourself):

Subsidy: the price of supply side decrease (S curve moves downwards) and the good will be overly supplied due to artificially padded up demand.

Restricting participation (limited permission given for doing the business): Quantity from supply side will be set lower level than unrestricted participation to market, therefore the price will continue increasing.

Price limit (controlling upper most of the price): Demands continue increasing, while the goods is insufficiently supplied.

In summary, a free-market economy does not generally welcome state intervention. The market requires government legal regulations only to maintain social safety (such as policing and



minimum welfare) and to correct market failures (such as monopolies, inadequate supply of public goods, etc.).

3. Institutional Theory: Transaction cost and economic performance

"Institution"

In this section, we will examine Institutional economics, which is a predominant theory in current development strategies. According to Douglas North, who won the Nobel Prize in Economics in 1993, Institutional economics aims to explain the reasons for the differences in economic performance among countries. While market economic theory suggests that economies should converge, in reality, they diverge. North believes that differences in institutions are the cause of this phenomenon. As Trebilcock and Prado quote, North defines institutions as "the rules of the game of a society, or, more formally, the humanly devised constraints that structure human interactions. They are composed of formal rules (statute law, common law, regulation), informal constraints (conventions, norms of behavior, and self-imposed codes of conduct), and the enforcement characteristics of both" (Trebilcock and Prado, p.35).

The metaphor of "the rule of the game" implies that each market actor plays in the market to maximize their own benefit within the rules. Therefore, the output of economic activity under a particular institution might be less than the output under another institution¹⁶. According to NIE, the economic performance of a country may be worse than that of others because of bad institutions.

"Transaction cost"

NIE complements the economic theory of the market mechanism rather than rejecting it. As explained earlier, market fundamentalism assumes that market mechanisms can allocate resources most effectively and increase productivity. However, this assumption is based on the concept of a "perfect competition market (perfect market)" in which:

- Everyone can produce goods without restrictions.
- Everyone can participate in the market as either a seller or buyer.
- Everyone has access to the same full information on the demand, supply, price, and quality of goods.
- Resources can be instantly moved to produce other goods.

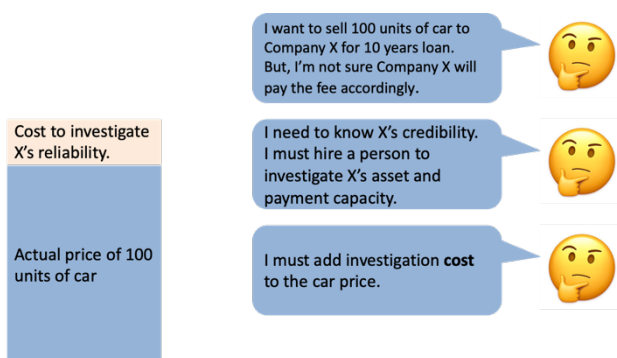
¹⁶ For example, soccer players behave in order to maximize goal points within the rule that prohibit using hands. As a result, amount of goal points in a soccer game might be fewer than goal points of handball game that allows using hand.

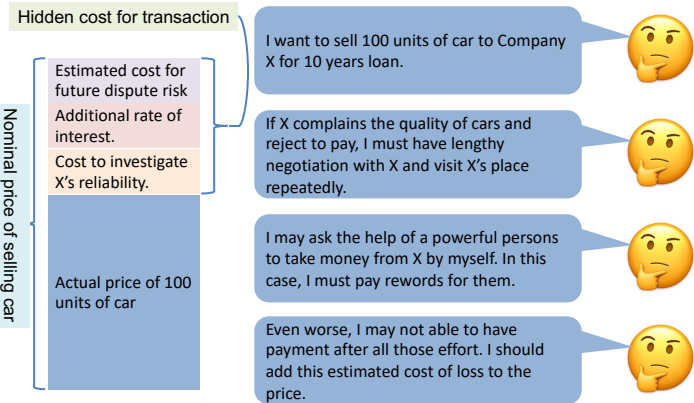
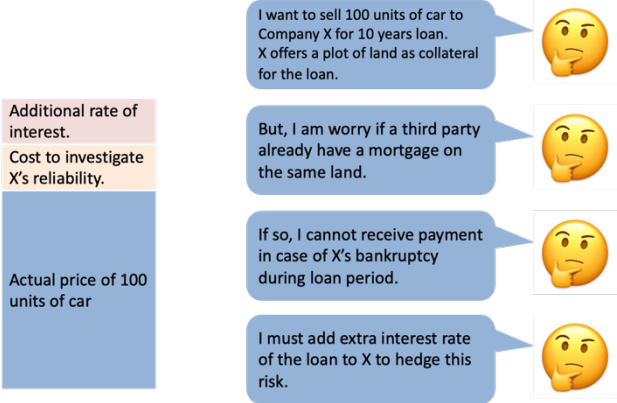
In reality, a perfect market that allows for the optimal allocation of resources does not exist. Therefore, it is important to consider how the price and quantity of goods are determined in an imperfect market.

North asserts that an imperfect market requires transaction costs, which in turn determine the economic outcome of the market. Furthermore, North argues that institutions largely determine transaction costs. As institutions establish the rules of the game, market participants repeatedly act to maximize their benefit within the institution. This creates increasing returns and self-enhancing institutions, leading to a path-dependent and persistent development process in a country. Therefore, differences in institutions between countries can explain the development gap among them.

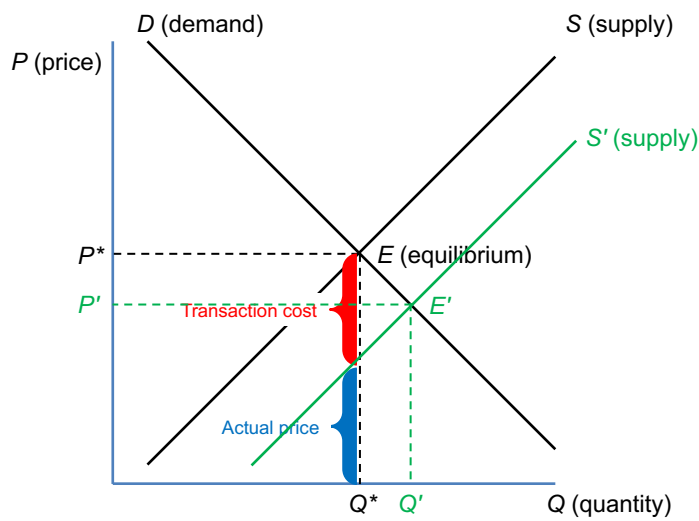
Transaction costs are made up of measurement costs and enforcement costs. Examples of measurement costs include the costs of obtaining information on goods and counterparties. Enforcement costs include the costs of protecting rights, settling disputes, and ensuring that other parties implement contracts accordingly (monitoring costs). These transaction costs are added to the price of goods as hidden costs, resulting in a difference between the nominal price (which includes hidden transaction costs) and the actual value of the goods.

The figures below illustrate how transaction costs affect the price of transacted goods.





By using a D-S curve, we can express the transaction costs as follows:



"S" represents supply based on the nominal price that includes hidden transaction costs. In the market, price and quantity are determined by this nominal price. However, the actual benefit of the seller is lower than the nominal price (i.e., nominal price minus transaction cost). If we can significantly reduce the transaction costs, the supply curve moves downward (S'). In

this situation, the nominal price of the goods decreases, and the quantity increases (positive effect on the economy). Furthermore, the actual gain of the supply side also increases. Thus, reducing transaction costs benefits both the demand and supply sides equally.

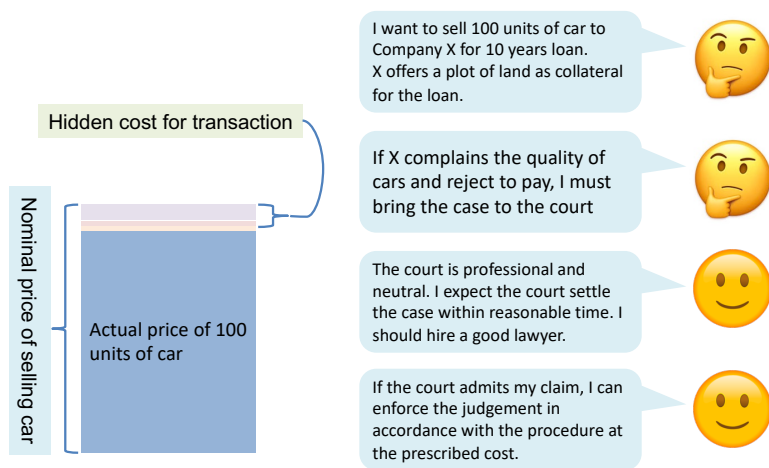
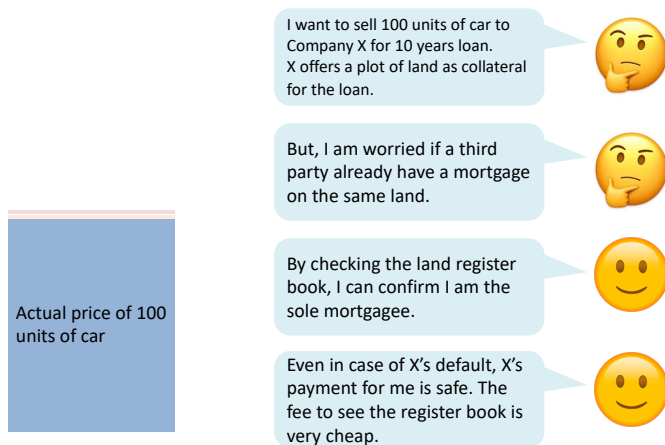
Now, we understood that transaction costs affect the economic performance of a market, and reducing transaction costs has a positive effect on the economy. Next, we should consider how to reduce transaction costs. Some examples are shown below:

Actual price of 100 units of car

I want to sell 100 units of car to Company X for 10 years loan. But, I'm not sure Company X will pay the fee accordingly.

I can access to X's mandatory disclosed financial report easily.

I can get information on X's asset and payment capacity with ignorable cost.



As explained above, information disclosure, clearly defined property rights (including information about ownership) and, not least, functioning dispute settlement system may reduce transaction cost (including measurement costs and enforcement costs). In this context, legal institutions play significant role in reducing transaction costs.

However, legal regulations are not enough. Those legal regulations must be observed and enforced. For that purpose, simple and transparent procedures, impartiality in public administration, and, but not least, credible commitments from the government are essential. Therefore, recently, "good governance" and the "rule of law" projects have become mainstream in economic development strategy¹⁷.

¹⁷ "The World Bank estimates to have supported 330 'rule of law' projects dealing with legal and judicial reform in over 100 countries."

Alvaro Santos, "The World Bank's uses of the 'rule of law' promise in economic development," in *The new law and economic development: A critical appraisal*, ed. David M. Trubek and Alvaro Santos (Cambridge University Press, 2006), 253.

So far, I explained the role of legal institution in making the market mechanism effective. Regarding the relationship between law and development since the 1990s, the following two points cannot be overlooked:

The first point is the political dimension of good governance and the rule of law, which are more than just tools for the development of the market economy. International cooperation for legal reform was triggered by regime changes in socialist countries in the late 1980s, and thus inevitably involved the promotion of democracy and human rights.

The second point relates to the outcome of legal reform projects in non-Western countries. These projects have mainly focused on safeguarding property rights and contracts for economic development. However, it has become apparent that merely replicating Western laws cannot ensure their successful implementation. Therefore, the significance of legal reforms that consider preexisting local institutions is being acknowledged.

These matters concern the definition of development, which encompasses more than just economic growth. We will explore them in the following session, taking into account access to justice and the local context.

Next session:

Law and Development other than economic development: Local context and the Access to Justice

Reading:

"Chapter 4: The Rule of Law and Development" in Trebilcock and Prado, pp.48-66.

Further readings:

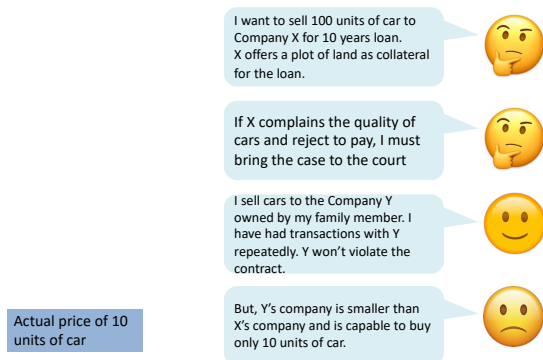
T.A. Benjaminsen et al., "Formalisation of land rights: Some empirical evidence from Mali, Niger and South Africa" *Land Use Policy* 26 (2008) 28–35

<https://www.sciencedirect.com/science/article/pii/S0264837708000781> *Accessible only from university network

van Rooij, B. and van de Meene, I., Access to Justice and Legal Empowerment. Making the Poor Central in Legal Development Co-operation, 2008, Leiden University Press

<https://library.oapen.org/handle/20.500.12657/32868>

Appendix: Plan B to reduce transaction cost = relying traditional personal relation



– Measurement cost

Plan A

- Develop formal, credible and widely accessible information system (clearly defined property rights, system, cadaster and land registration, public accounting etc.)

OR

Plan B

- Having transaction only with familiar persons (family members, small community members, long-time business partners)
- The endless repeated game can avoid "prisoners' dilemma"

– Enforcement cost

Plan A

- Creating formal reliable a third-party dispute settlement or enforcement institution.

OR

Plan B

- Relying self-enforcement mechanism (risk of losing reputation, risk of exclusion from small community)
- Avoiding long term contract and limiting to instant exchange by cash.

	Plan A	Plan B
Formality	Formal	Informal
Party's relation	Impersonal	Personal
Transaction size	Large	Small
Dispute settlement	Third-party decision	Self-enforcement
Institution forming cost	High*	Low
Economies of scale	Yes**	No

*As for judicial system, the cost for hiring experts and staffs, constructing court building etc.

**If a country hires one judge at a salary of \$100,000 a year, and that judge rules one case a year, the cost of dispute resolution would be \$100,000 a case. If the judge rules 50 cases a year, cost per a case would be reduced to 200\$.