
3b. Economic Incentives in Legal Reform

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Introduction

From the time of Adam Smith, economists have sought the sources of economic development. Plausible development models emphasizing, in turn, savings, investment, technological change, best practices, trade, human capital, and geography have been proposed. From the time of Bretton Woods, a number of national and international donors and development agencies have labored to support development, spending hundreds of billions on the process. Yet poor nations, by and large, remain poor.

Recently attention has turned to “institutions,” particularly political democracy and the rule of law. Richer countries tend to have these things while poorer countries do not. Does this correlation result from a causative effect? If so, do the institutions cause economic growth or does growth make it possible for people to afford such institutions? And if it is indeed the institutions that cause the growth, are these institutions capable of being transplanted from one culture (historical context) to another?

Economic Benefits of Rule of Law

To begin to answer these questions we need to understand the links between institutions and economic behavior. Incentives are key to economic activity in any culture. People do not work, save or invest without the expectation of gain, although the expected gain may not be purely monetary. How do institutions affect incentives? How do institutions change the opportunities facing individual workers, consumers and investors? If we had models of these links, we could design institutional development strategies that are at least theoretically sound and build evaluation tools to judge the implementation of the strategies.

The rule of law is an institution which poor countries often are urged to adopt or to reform. However, the rule of law is not a well-defined concept. As lawyers use it, the chief meaning of the term is the supremacy of substantive and procedural rights, as administered by independent courts, over both arbitrary executive power and the might of powerful private individuals. At another level, it is the general acceptance, especially by losers, of a common system of dispute resolution. Relatedly, it is the mechanism by which the state’s monopoly of legitimate force is channeled to protect civil, property, and other rights. This “legal” view of the rule of law has much merit, but it tends to neglect the important economic benefits of the legal system.

How does the rule of law affect poverty? Income arises, to risk oversimplification, from three major and related sources: trade, production and capital investment, including investment in human capital. Income arises in trade because different people place different values on given commodities, so trade can make each trader better off. Income arises in production because the value of output may be greater than the cost of inputs. Income arises from investment because forbearance and risk taking each have economic value. All of these activities require transactions between different individuals in order to generate income, and each transaction is the result of economic incentives—specifically, the expectation of being better off (increasing one’s income, status, or self respect). National income increases (poverty is reduced) when the number and size of such transactions increase.

The rule of law affects the incentives to engage in trade, production and investment transactions. Indeed, we could define the rule of law for present purposes as the adoption and acceptance of legal institutions that optimize incentives to engage in economic transactions. It is very easy to think of examples.

- When the law establishes and secures well-defined land rights, landowners have much stronger incentives to trade in, or to invest in improving, property. This is so because in the absence of secure property rights there is no expectation that individuals will be able to retain the benefits of such transactions. Land becomes a more secure and liquid asset, enhancing its economic value. Wealth and income increase.
- When the law establishes and enforces effectively the right of women to own property and to retain income, women have much stronger incentives to engage in transactions that increase their incomes—including, for example, educational investments that improve their productivity. Wealth and income increase.
- When the law establishes a mechanism to enforce private contracts, a variety of trades and investments that were not previously possible (because of the risk of opportunistic behavior by a party) suddenly become profitable and take place, increasing economic welfare. Wealth and income increase.
- When the law protects individual liberty from private encroachment (as through criminal law enforcement) or official abuse (as though *habeas corpus*), the chance that any given person will be able to retain and enjoy the fruits of trade, production and investment increases. This enhances the incentive to engage in such activity. Wealth and income increase.

In each of these cases and many others, the economic effects of the rule of law are to change incentives, providing additional motivation to engage in income-producing and wealth-enhancing activities. The fact is that people everywhere respond to economic incentives. In principle, the mere addition or strengthening of the rule of law can greatly enhance the economic welfare of a nation, and begin the process of growth, even without an increase in economic resources, simply by enhancing allocative efficiency through incentive effects.

But what about the costs? Adoption of the rule of law has a number of costs. First, those who benefit from the lawlessness of a society must be compensated or otherwise convinced (coerced) to accept the losses they will incur under the rule of law. Second, citizens must be educated to understand what the rule of law is, how it works, and what changes it will bring about. The rule of law is meaningless if not widely understood and accepted. Third, the machinery of lawmaking, law enforcement and adjudication must be set up and maintained. These costs must be considered in deciding whether to attempt legal reform.

Formation of Expectations

The second of the three costs—that of informing and educating citizens regarding the role of courts—deserves further comment, even in this brief treatment of the economic role of the rule of law. The resolution of a dispute or the enforcement of an entitlement by a court has only an inconsequential direct economic effect. This is so for two reasons. First, the action of the court often simply classifies (assigns property rights to the consequences of) past actions. It cannot change what has already occurred. Second, any given case is seldom in itself significant relative to the economy as a whole. Nevertheless, courts can and do have an enormous impact on future economic decisions through their effects on private expectations.

The microeconomics of the rule of law hinges chiefly on the expectations created by the existence of the legal system. Decisions regarding trade, production, or investment (and corresponding decisions regarding savings and consumption) are based on the anticipated outcomes of present or future actions. The future consequence of current actions is never certain. Instead (in classical probability theory) there is a range of possible consequences, each associated with some likelihood or probability. The net benefit of an action is the weighted sum of these possible outcomes—the “expected value” of an action or inaction. Higher positive expected values are better than smaller ones, and for a given expected value greater certainty is better than less certainty. This simple framework for modeling economic decision-making relies both on behavioral assumptions and logic, and it makes testable predictions about how people will behave. These predictions have generally been correct.

The rule of law can affect the expected values of economic decisions in two ways—by changing the expected value of an action or by changing its variance, or degree of certainty. The expected value of an action can be changed if certain outcomes (positive or negative in value) are made unlawful or compensable. The certainty of the expected value can be changed if the law simply clarifies the status of some of the possible outcomes, or if the law makes certain outcomes more or less probable. Further, by clarifying the status of certain outcomes, or merely by specifying the rules that will be used to determine the status of such outcomes, the rule of law enables additional transactions to take place by reducing the costs of negotiation among the parties.

These economic effects of the rule of law operate chiefly with respect to economic decisions that are taken in advance of any event that might give rise to adjudication and with respect to which there may very likely never be any adjudication. Indeed, the likelihood of future litigation is endogenous. In the criminal law this is the concept of deterrence. Some people decide not to commit potentially criminal acts because the existence of the legal system makes them believe that they will be worse off (in expected value terms) if they do so. Thus, most potential crimes are deterred, not by the action of any court or officer, but by the expectation of what the court or its officers will do. The same principle applies to many other areas of law, notably property, contracts and torts.

Because the key to the economic effects of the rule of law is expectations, the formation of expectations is a critical step in the process of installing or reforming a legal system. A legal system by itself, however well-designed, is not a sufficient condition to reap the economic benefits of the rule of law. Economic actors must understand, at least in general terms, what courts do and they must be prepared to accept what courts do as legitimate, even when they themselves are (narrowly) worse off as a result of a particular decision. In some circumstances, achieving this understanding through education and experience may take considerable time and resources, particularly if we consider the issue of access to justice. Developing countries usually have a huge under-provision of judicial services so that, for the poorest segments of society, legal proceedings are not an option. As may be obvious, no legal system can affect the behavior of non-litigants if non-litigants have no expectation of interaction with that system, whatever their behavior.

Economic Impact of Legal Reform: The Case of Ecuador

What makes establishment of the rule of law a potentially very powerful development strategy is that its major economic effects do not rely on the quantity of legal “output,” measured in conventional terms. The nature of a legal system permits it to encourage trade, production and investment decisions that are made outside the courtroom, and whose consequences never produce a lawsuit. One might think that the output of a legal system should be measured in terms

of cases tried, courtroom in use, judges appointed, backlogs reduced, and so on. But this is almost entirely incorrect. A highly effective legal system, in theory, might exist without a single case ever being tried.

To measure the impact of a legal reform project intended to increase income and wealth we must find a way to measure the effect of the reform either on income directly, or on expectations relevant to trade, production and investment decisions. This requires an explicit understanding of the relationship between the particular legal reform and the economic decisions it affects. It also requires a model of the mechanism by which economic actors form expectations about the law and its impact upon them.

Recently we were asked to assist the World Bank in conducting an economic evaluation of the effectiveness of a program to support legal aid clinics for poor women in Ecuador. The legal aid clinics are a small part of a project intended to promote legal and judicial reform in Ecuador, and in turn part of a World Bank initiative to promote such reforms throughout the developing world. Measuring the effectiveness of the clinics presents two main challenges. First, one must decide what to measure. Second, one must find a practical way to measure performance *ex post*, given that the legal aid clinics did not collect or preserve ideal data and that an evaluation component was not built into the project.

In principle, the ultimate goal of such an evaluation is to measure the impact of the legal aid program on the living standards of those receiving counseling and legal representation. Nevertheless, these benefits may take a long time to fully materialize. In addition, the legal aid program may have a positive effect that goes beyond those directly involved. Specifically, those receiving improved access to legal entitlements may serve as disseminators of information and, at the same time, create a precedent that may induce changes in the behavior of non-litigants. This indirect benefit, or spillover effect, on non-litigants is perhaps the major impact of effective legal and judicial reform.

In order to simplify the analysis, we focused our attention to one legal issue (child support entitlements) and confine the fieldwork to one city (Guayaquil). A key question is whether, holding legally relevant facts constant, there is a statistically significant improvement in outcome associated with the use of the legal aid clinic or the judicial system.

Most of our data was derived from a survey instrument designed for this purpose and administered in coordination with personnel from local non-government organizations (NGOs). Specifically, the survey instrument collected information on the legally relevant circumstances defining the existence and amount of the entitlement, the mother's use of the judicial system and the legal aid clinics, and the extent of financial support from the absent father. In addition, we conducted focus groups that explore the mothers' motivations for using (or not using) the judicial system, as well as their subjective valuation of the assistance provided by the legal aid clinics. The purpose of this two-front strategy was to cover both the quantitative and qualitative dimensions associated with the program under study.

A primary consideration in selecting the sample design and planning the fieldwork was gaining access to the relevant mothers. During a pilot test conducted in October 2001, we found that eligible mothers were reluctant to participate in the interviews unless the initial contact was made through somebody they already knew and trusted, like the personnel from the legal aid clinic. In addition, we found that the mother's home was not the most appropriate place to conduct the interview due to concerns about confidentiality and safety, particularly for women subject to

domestic violence. Thus, it was necessary to adapt the scope of our survey to the limited reach of local NGOs.

During the period under study (1998-2001), the program in Guayaquil provided legal advice specifically on child support to over 700 mothers. From this roster, we drew a simple random sample of 181 mothers. We also selected a comparable sample of 181 mothers who have never received legal help from the legal aid clinics. Although the sample size is quite modest, it falls within the range used by comparable surveys.

Using the survey results, we found that, holding relevant characteristics constant, former clients of the legal aid clinics are better off than non-clients. Specifically, participation in the legal aid clinics increases the probability of both having a child support award and actually receiving a transfer, decreases the incidence of domestic violence after separation, and is associated with a more positive outlook towards the judicial system.

In addition, the focus group results indicate that there are important non-monetary gains from the legal aid clinic's intervention. Participants cited improved self-esteem and help in coping with the aftermath of domestic violence. Due in part to the stigma carried by illegitimate children, the primary concern for some mothers was to prove paternity, even if at the end they did not get child support payments.

There is also some evidence of the leverage spillover effect of legal intervention. Some focus group participants used the threat of legal action as a way to reach an out-of-court settlement with the absent father. In fact, some participants believe that the amount of child support fixed by the court is smaller than what could be received via an out-of-court settlement. In two instances, the mother indicated that, beyond any personal gain, standing up for her rights was a way to improve the conditions of all women.

Despite the many difficulties encountered, the study shows that empirical evaluation of the contributions of legal and judicial reform to economic development is possible. We were not able to measure more than a hint of the most important benefits of the clinics—their spillover impact on non-participants. But even without this potentially very large positive effect, the clinics appear to have made a contribution to the economic well-being of poor women in Ecuador.

Concluding Remarks

The establishment of rule of law leads to many economic benefits. These benefits are achieved through changing people's expectations and incentives to engage in desired economic activities. In the future, legal and judicial reform projects should be undertaken not merely to achieve abstract procedural norms derived from western legal experience, but to promote economic development by capitalizing on the law's potential leverage or spillover effects on the incentives of economic agents.

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