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Turning cheap talk into economic growth: On the relationship between property rights and judicial independence

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ABSTRACT

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Among economists, the view that precisely defined and reliably enforced property rights are generally conducive to economic growth has been quasi-unanimous. But recently, some authors have argued that the relationship is more complex than previously acknowledged: property rights reforms might, for example, not per se lead to increases in observed growth rates. This paper contributes to the debate by emphasizing that the mere promise of secure property rights is unlikely to have any effects unless accompanied by some commitment to enforce these rights that is perceived as credible by private actors. An independent judiciary is interpreted as a tool that permits governments to make credible commitments to abide by the law. We provide empirical evidence for a positive growth effect of constitutional property rights, once the judicial system is independent enough to guarantee their enforcement. *Journal of Comparative Economics* **41** (1) (2013) 66–73. Institute of Law & Economics, University of Hamburg, Johnsallee 35, D-20148 Hamburg, Germany.

1. Introduction

Among economists in general and among adherents of the new institutional economics in particular, there has been quasi-unanimous consensus that securely defined and reliably enforced property rights are the single most important institution or, rather, group of institutions, conducive to economic growth and individuals' well-being (see e.g. Asoni, 2008).

The consensus has been so broad that both scholars and policy-makers were optimistic that growth in poor countries could be spurred by passing broad reforms improving property rights. Yet, the success of such reforms seems mixed at best. Martínez and King (2010), for example, do not find a positive association between improvements in property rights country rankings and economic growth. They suspect that this result is driven by "unacceptably low validity" of property rights indicators. Among the three indicators they used, they even find countries for which one indicator reports improvements over time whereas another indicates deteriorations. Other issues that have been raised include endogeneity (e.g. Haggard et al., 2008) and the substantial variation in fast growing countries concerning the degree to which they protect property rights (Melton, 2011).

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There are straightforward explanations for these counterintuitive results based on model misspecifications. The relationship between property rights and growth might be more complex than a simple positive linear relationship (e.g. Cooter and Edlin, 2011). First, one might have to differentiate the form of property that is protected, e.g. intellectual or other property.[2] Second, there might be an optimal intermediate level of property rights protection in the presence of transaction costs. Transaction costs, for example, inhibit both perfect price discrimination by monopolists and finding a negotiated solution to externalities or the tragedy of the anticommons. It is thus only in the presence of transaction costs that monopolies, externalities and overly segmented property rights yield inefficient market results. This might legitimize a limitation of property rights as a second-best solution.

A third potential explanation is that property rights require an efficient design of other complementary institutions to be growth-enhancing (Haggard and Tiede, 2011:682). A simple promise to secure property rights by ordinary law or even in the constitution is unlikely to be interpreted as a credible commitment. This insight leads Melton (2011) to argue that the interaction between the (formal) protection of property rights and a high degree of checks and balances in government affairs could do the trick. Justesen (2011) argues likewise for a critical role of veto players in making property rights credible. Weymouth (2011) argues that veto players alone can keep policy makers from pursuing policies that lead to indirect expropriation, e.g., via higher inflation.[3] In this paper, we propose a more specific hypothesis: Given that private property rights are promised in countries characterized by a judiciary that is independent from political pressure, this promise will be considered as credible by private actors. This should, in turn, lead to more investment and spur economic growth. Beyond the sheer investment level, we would expect a more efficient allocation of resources as investors need not evade investment opportunities that are more prone to expropriation.

In previous work (Feld and Voigt, 2003, 2006), it was shown that *de facto* judicial independence is conducive to economic growth. In this paper, we are interested in the interaction effect between *de jure* property rights on the one hand and *de facto* judicial independence on the other. The results confirm our priors. Taking into account that the effect of *de jure* property rights on economic growth should be conditional on the level of actual judicial independence, we find positive effects for property rights, once a country has established an above average level of judicial independence.

The rest of the paper is organized as follows: Section 2 contains a very brief sketch of the main arguments according to which secure property rights are the single most important determinant for long-run economic growth. In Section 3, the pros and cons of some commonly used property rights indicators are briefly discussed. Section 4 presents the data and explains our estimation approach. Section 5 is a discussion of the results and Section 6 concludes by pointing to a number of open questions.

2. Secure property rights and long-term growth: a survey of the main arguments

Seldon (2005) defines property rights as "the expectation of an individual, or group of individuals, that his/their exclusive use of resources will be assured [...]. The rights attach to the owner, not to the property and trade consists of an exchange of rights over property rather than of property itself, which would be useless if there was no power to use (or transfer, or hire, or sell) it."

Seldon's definition reminds us that representatives of the property rights school (e.g. Demsetz, 1967; Furubotn and Pejovich, 1972 or Alchian, 1977) proposed to think of property rights not as a relation between a person and a (physical) object but, rather, as legislation – or even broader: norms – defining the relationship between actors in relation to (physical) objects. The property rights school was to become part of the New Institutional Economics which proved to be very influential, especially among development organizations such as the World Bank.

The argument that private property rights are decisive for economic development can be traced back at least to Aristotle (1959) who dealt with the positive incentives of private property and the negative ones of common or public property. More recently, some of these arguments have been dealt with under headings such as the tragedy of the commons (Hardin, 1968; Ostrom, 2005), but also the incentive incompatibility of socialism (Kornai, 1992).

Buchanan (1975), echoing Hobbes (1982), develops a complementary argument in favor of secure private property rights. Absent a state that protects such rights, an anarchic equilibrium in which the marginal returns from producing, stealing and protecting one's own property will all be equal is expected to ensue. In such a situation, huge welfare gains can be reaped by creating a state that protects private property.

The simple existence of the state, however, is evidently not sufficient to ensure both the promise and the enforcement of secure property rights. North (1981:20) describes the existence of the state as both necessary for economic development but also as a potential source of man-made economic decline. Time and again, inadequately specified and insufficiently enforced property rights have been the root cause for economic demise. In order to fulfill its potential role as a catalyst for economic growth, the state must be strong enough to enforce efficient property rights. Yet, with this level of strength, it is also strong enough to attenuate them or to ignore them altogether. This problem has been succinctly described by Weingast (1997), and it could be termed the "dilemma of the strong state": A government which is strong enough to enforce its own promises – e.g., with regard to private property rights – is also strong enough to ignore them. The (physical) strength of the state embodies its greatest weakness, namely the inability to make credible promises.

[2] It might even be necessary to distinguish the concrete rights that are laid down for each form instead of creating an overall measure of property rights quality. Is it e.g. decisive that property rights are explicitly promised or is it more important how an expropriation is to be compensated?

[3] Prescribing a low level of inflation can be seen as one important component regarding the protection of property rights.