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The Rule of Law and Economic Growth: Where are We?

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Summary. — It is widely assumed that the rule of law is essential for economic growth. However, the rule of law is clearly a multidimensional concept, encompassing a variety of discrete components from security of person and property rights, to checks on government and control of corruption. We review the theory underlying these different causal mechanisms linking the rule of law to economic growth, and provide an introduction to some outstanding measurement issues. We find that the correlation among different components of the rule of law concept are not tight among developing countries and that some inferences about the effects of property rights protection may not be warranted.

Key words — rule of law, economic growth, institutions, economic volatility, developing countries

1. INTRODUCTION

The literature on the rule of law and economic growth has become one of the more dynamic areas of theoretical and empirical work in political science, economics, and law. We also now have more cross-national data purporting to measure the rule of law than we know what to do with. Yet even the very best work in the field has not been adequately attentive to the multidimensionality of the rule of law concept. What do we really mean by the rule of law? How are discrete components of the rule of law related to one another theoretically and empirically? To what extent are empirical findings based on one conception—and measure—of the rule of law robust to alternative specifications?

The first section of this paper enumerates four distinct causal mechanisms through which the rule of law has been associated with economic growth: through the provision of security of person; through security of property and enforcement of contract; through checks on government; and through checks on corruption and private capture. The second section considers issues of measurement, including ongoing debate about the merits of subjective and objective indicators and the difference between *de jure* and *de facto* measures. We then consider the empirical relationship between these distinct components of the rule of law in a sample of 74 developing and transition economies. We find that measures of property rights, checks on government and corruption are correlated much less tightly than is often thought. A cluster analysis suggests that developing countries exhibit somewhat different rule of law "syndromes" or "complexes" and that the level of violence is one of the more important factors in differentiating among them in this regard. For some significant group of developing countries, establishing "law and order" in the most traditional sense remains an ongoing challenge.

The looser-than-expected correlation across rule-of-law measures raises the question of whether empirical findings in the literature are robust to alternative specifications. In the third and fourth sections, we undertake replications of influential work. The well-known paper by Acemoglu, Johnson, and Robinson (2001) addresses the determinants of economic growth over the long-run, focusing on the role of institutions for the protection of property rights. Despite the care exercised by Acemoglu *et al.* in addressing endogeneity issues, their instrumental variables approach is incapable of distinguishing between competing institutional hypotheses and, therefore, cannot be taken as a demonstration of the primacy of a property rights story; as they themselves suggest, a complex or cluster of institutional shortcomings are likely responsible for continuing weak economic performance over the long run.

Building on a model developed by Barro (1997), we also consider the effects of the rule of law on both growth and the volatility of growth in the intermediate-run (1985–2004). Corruption performs better than measures of property rights or checks on government, suggesting private capture may be as damaging to economic performance as predatory governments. But we also find that the effective provision of security—"law and order" in the more traditional sense—has strong effects on the *volatility* of growth, an important—and damaging—feature of the developing country growth experience (Ramey & Ramey 1995).

The conclusion maps out some ideas for future work on the rule of law and economic growth. In particular, we emphasize the need for more research on the complementarity among different institutions. We also speculate on the implications of existing research for the appropriate sequencing of political, institutional, and legal reforms.

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2. THEORETICAL ISSUES: WHAT IS THE RULE OF LAW ANYWAY?

There remains some ambiguity about what we mean by the very concept of the rule of law. We start by reviewing four major theoretical routes from the rule of law to economic growth: through the mitigation of violence; through protection of property rights; through institutional checks on government; and through control of private capture and corruption.

(a) *Hobbes revisited: the rule of law as security of person*

For the early contract theorists, most notably Hobbes, the state of nature was characterized by continuing and ongoing threats to personal security as well as property. The rule of law meant in the first instance the provision of security. There is a deep logic in this view; it makes little sense to talk about security of property or the integrity of contract if economic agents are themselves not secure (Belton, 2005; Black, Kraakman, & Tarassova, 2000; Narayan, Patel, Schafft, Rademacher, & Koch-Schulte, 2000). With a few recent exceptions, however, the literature on the rule of law and economic growth has tended to ignore the fundamental issue of the control of violence (see, however, Bates, 2001 and North, Wallis, & Weingast, 2009). For example, we have no sustained tests of the extent to which weak property rights are a result of bad political institutions or much more fundamental problems of civil conflict and criminality.

A theoretical literature has explored the economic effects, in different formulations, of the absence of rule of law: as anarchy (Hirshleifer, 1995), as extortion (Konrad & Skaperdas, 1998), as private predation (Grossman & Kim, 1995), and simply as lawlessness (Dixit, 2004). But it has taken the empirical work of Collier (1999; 2007, chap. 2; Collier, Elliott, Hegre, Hoeffler, & Reynol-Querol, 2003; Collier, Hoeffler, & Soederbaum, 2006; Collier 2009) to show just how devastating the effects of civil conflict have been for economic growth. According to Collier, civil war tends to reduce growth by around 2.3% per year; with civil wars (in his dataset) averaging seven years in duration, the typical war leaves a country 15% poorer than it otherwise would have been (Collier, 2007, p. 27). Even in the absence of full-blown civil war or state failure, personal insecurity associated with criminal activity also affects development (Ayres, 1998; Buvinc & Morrison, 1999). The World Bank (2006) has estimated that decreasing the homicide rate by 10% increased *per capita* GDP by 0.7–2.9% over the subsequent five years even when controlling for a variety of other determinants.

It is one thing to document the economic costs of civil conflict and crime; it is quite another to reconstitute the rule of law in this most basic sense when it is lacking. Civil wars typically last a long time (Fearon & Laitin, 2003) and recidivism is high. On average, 39% of states emerging from conflict return to conflict in the first five years, and another 32% return to conflict in the following five years (Collier *et al.*, 2006). Ending the violence is a necessary but not sufficient condition for rebuilding the rule of law in post-conflict settings. This task is extraordinarily complex, involving a myriad of complementary institutional developments (Samuels, 2006): building a credible and neutral police force; training public prosecutors and defenders; reforming the criminal code; ensuring the competence and independence of judges; and guaranteeing the integrity of the penal system.

(b) *The canonical economic formulation: property and contracting rights*

Among economists, the core theoretical mechanism linking law to economic development runs through property rights and contract enforcement (Alchian, 1965; Alchian & Demsetz, 1973; Coase, 1960; Demsetz, 1967; Williamson, 1971, 1985; for reviews and syntheses, see Asoni, 2008; Barzel, 1997; Furubotn & Pejovich, 1972; on the so-called new economic history see Dam, 2007; Haber, Razo, & Maurer, 2003; North 1981, 1990; North & Thomas, 1973). There is a direct lineage from this earlier work to the strand of new growth theory that focuses on the role of institutions (Acemoglu, Johnson, & Robinson, 2001; Acemoglu, Johnson, & Robinson, 2005; Easterly & Levine, 2003; Rodrik, Subramanian, & Trebbi, 2002).

The link from property rights to growth runs through the incentives individuals have to invest and trade when such rights are secure. The capacity to contract is equally fundamental. Some trade can take place in the form of barter or "spot" exchanges but more complex inter-temporal transactions, including financial ones, require the ability to make and receive promises about future actions (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998).

The empirical literature is relatively easy to summarize as there are few dissenters. A broad literature has found that more robust property rights protection is associated with better long-run economic performance (Asoni, 2008; Barro, 1997; Clague, Keefer, Knack, & Olson, 1996; Keefer, 2007; Keefer & Knack, 2002, 1995; Scully, 1988; Zak & Knack, 2001; for micro level studies, see Alston & Schneider, 1996; Anderson & Hill, 1975; Bazzi, & Clemens 2009; Libecap, 1989; Kaufmann, 2004; Malesky & Taussig, 2008). In the new literature on institutions and long-run growth, either the conception of institutions or the proxy for them is the extent of property rights protection; similarly, these institutions are found significant for long-run economic performance (e.g., Acemoglu & Johnson, 2005; Acemoglu *et al.*, 2001).

(c) *The canonical political formulation: checks on government*

Among political scientists and legal scholars, institutional checks on executive discretion, including through independent judiciaries, are seen as integral to the very concept of the rule of law. Such checks and balances are economically important because of the classic time-inconsistency problem (Kydland & Prescott, 1977) that governments not only have the power to renege on their commitments but incentives to do so. As a result the rule of law, property rights, and contract enforcement cannot be credible unless there are effective limits on executive discretion (e.g., Buchanan & Tullock, 1962 and Hayek, 1973 on constitutions; Cass, 2001; Dicey, 1982; Hayek, 1978 on the role of courts).

Olson (1993) and Weingast (1995,1997) provide exemplary statements of this logic. In deciding whether to uphold property rights, the government or ruler faces both economic and political constraints. Olson shows that by credibly committing to restraints on their discretion, even autocrats can gain as a result of more robust economic activity and higher tax revenues (McGuire & Olson, 1996; Olson, 1993). Weingast (1997) introduces more realism by noting that sovereigns must also consider *political* constraints on the exercise of discretion; citizens can ultimately rise up and attempt to dispose of the sovereign. Even autocrats make institutional, legal, and policy concessions to guard against this threat; for example, North and Weingast (1989) detail the institutional changes that constrained royal