

## 9. Legal Systems as Frameworks for Market Exchanges

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*We have learned about the importance of private property and the rule of law as a basis for economic freedom... It turns out that the rule of law is probably more basic than privatization. Privatization is meaningless if you don't have the rule of law.*

Milton Friedman (2002)

### 1. INTRODUCTION

The quotation from Milton Friedman heading this chapter summarizes the evolution of beliefs of many economists (including myself) following the collapse of the Soviet Union and its satellites. Initially, it was widely believed that creation of markets and the freeing of the economy would be enough to lead to economic growth and prosperity. The lesson of this episode in human history is that removal of restraints and creation of property rights is not sufficient. Rather, an economy needs a legal system in order to thrive and grow, and creation of such a legal system is a difficult task. Indeed, it is not obvious that it is always possible to succeed in this process.

One characteristic of legal institutions that pervades the empirical analysis is their persistence. Many of the papers cited below indicate that legal systems date back some hundreds of years. For example, in the empirical papers, whether the English, the Spanish, or the French colonized a country is quite important in explaining the legal system that exists today. Daron Acemoglu, Simon Johnson and James Robinson (2001a) further distinguish between types of colonies. In areas where weather and other conditions made settlement by residents of the colonizing country dangerous, institutions were developed that made exploitation by the home country of the colony easier, which meant little protection of property rights. Where residents of the home country were able to settle in large numbers, institutions that provided more protection to residents were put in place. They find that difference in mortality rates among colonizers can explain much of the difference in current incomes.

Bernard Black and Anna Tarassova (2003) discuss the tremendous difficulties in creating market-supporting institutions, including legal institutions, from

scratch. In particular, legal frameworks are interrelated in numerous dimensions, and so it is necessary to change many laws simultaneously to improve performance. In the case of Russia, Black and Tarassova identify 59 elements in six categories that must be changed to achieve reform. (For example, creation of a “Civil Code” is only one of fourteen elements of the category “Commercial Law Reform.”) There are numerous links between each of these elements. (The “Civil Code” element is linked to “Enterprise Privatization and Restructuring” and “Banking Reform.”) This difficulty may in part explain the persistence of a given set of institutions.

I first discuss the components of a legal system, so that the reader will have an idea of the sorts of institutions at issue. I then discuss the main economic functions of a legal system: creating, transferring, and protecting property rights, the functions of property, contract, and tort and criminal law. I present a simple transaction as an example of the use of these rules. The following section discusses the “Rule of Law” as a protector of property rights. I discuss the benefits of protecting property rights in terms of incentives for investment. I also discuss the historical and empirical evidence on the value of protection of property rights in order to show that the issue is economically significant and important. I then examine specific types of institutions that protect property rights, so that policy makers will have the basis for choosing efficient institutions. I first consider various forms of private ordering, including arbitration and the multilateral mechanisms available for enforcement of agreements. I then discuss common law and code (civil) law systems, the two main legal systems in the West. There is evidence that common law is more efficient than code law, perhaps because common law provides more independence from government control than does code law. This added protection may be particularly important in countries without a strong rule of law tradition, where predation by government is especially dangerous. This is relevant since much law throughout the world is transplanted from European countries. An important source of legal efficiency is competition between various forms of law. I conclude with a discussion of implications, both for future research and for policy makers. The most important policy implication is that decision makers should allow free choice of law, as in allowing arbitration in contracts. The analysis of legal institutions clearly indicates that they are important for economic growth, but it is perhaps less helpful in indicating how countries can be induced to adopt efficient institutions.

## 2. COMPONENTS OF A LEGAL SYSTEM

A legal system contains numerous institutions. There are mechanisms for the creation of rules and regulations. Some of these are legislatures, government agencies, private entities (such as trade associations), and, particularly in common law jurisdictions, judges and courts. There are entities that enforce rules and regulations, including courts, administrative tribunals, private arbitrators, and