JUDICIAL REFORM AND ECONOMIC DEVELOPMENT: A SURVEY OF THE ISSUES

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The government of Bangladesh has launched a major initiative to improve the operation of the nation's judicial system. Its efforts are being supported by a loan from the World Bank, which will finance efforts to reform substantive law, overhaul procedural codes, upgrade facilities, train judges and support staff and otherwise modernise the courts and related institutions. Bangladesh thus joins a host of other developing countries that are undertaking judicial reform programmes of one kind or another.

Indeed, since 1994 the World Bank, the Inter-American Development Bank and the Asian Development Bank have either approved or initiated more than $500 million in loans for judicial reform projects in 26 countries. The U.S. Agency for International Development has spent close to $200 million in the past decade on similar projects, and other government and private groups are also funding programmes to modernise the judicial branch of government. Today, the majority of developing countries and former socialist states

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1 J.D. Georgetown University Law School, 1978. The author is a Senior Public Sector Specialist with the World Bank.

2 Lawyerc's Committee for Human Rights, Selected World Bank, Judicial and/or Legal Reform Projects, 1998.


are receiving assistance of some kind to help reform courts, prosecutors’ offices and the other institutions that together constitute the judicial system.

Although few now question the importance of judicial reform for development, little is known about the impact of the judicial system on economic performance. Nor is there any agreement on what makes for a successful judicial reform project. Some argue that reform cannot be achieved without a society-wide consensus, while others contend that the reform project can help create this consensus. Fears are also being expressed that judicial reform programmes will repeat the mistakes of the law and development movement, an earlier American-sponsored initiative that unsuccessfully sought to export the U.S. legal system wholesale to the developing world.

The design and implementation of judicial reform projects are complicated by a lack of knowledge about the relationship between formal enforcement of the laws through the courts and traditional extra-legal— or informal— means of enforcement. Coincident with the growing emphasis on judicial reform, a body of research has emerged showing that the formal legal system is just one way of ensuring compliance with society’s laws. A variety of studies, in settings as diverse as medieval Europe and contemporary Asia, show that informal mechanisms based on incentives provided by repeat dealings can ensure the performance of contracts that no court has the power to enforce. One early and surprising finding of this research is that in some instances the sudden introduction of a formal mechanism to resolve legal disputes can disrupt informal mechanisms without providing offsetting gains.
RATIONALES FOR JUDICIAL REFORM

Judicial reform is part of a larger effort to make the legal systems in developing countries and transition economies more market friendly. This broader legal reform movement encompasses everything from writing or revising commercial codes, bankruptcy statutes and company laws through overhauling regulatory agencies and teaching justice ministry officials how to draft legislation that fosters private investment. Although the line between judicial and legal reform blurs at the margin, the core of a judicial reform programme typically consists of measures to strengthen the judicial branch of government and such related entities as the public prosecutor and public defender offices, bar associations and law schools. These measures aim to:

Make the judicial branch independent. Included here are changes in the ways in which judges are selected, evaluated and disciplined to ensure that decisions are insulated from improper influences. In some cases, the budget for the judicial branch or the authority to administer the funds allocated for the judicial function is transferred from the ministry of justice or other executive branch agency to the judges themselves. Independence can also encompass giving judges the power to declare acts of the executive and legislative branches of government in violation of the country's constitution or some other higher law.

Speed the processing of cases. Providing management training, computers and other resources to judges and court personnel reduces case backlogs and accelerates the disposition of new disputes. Revising the procedures for filing and resolving lawsuits helps to weed out procedures that invite delay and raise costs.

Increase access to dispute resolution mechanisms. The creation of mediation and conciliation services and other alternatives to resolving disputes in the courts reduces court costs, as does introduction of small claims courts or justices of the peace and the establishment of legal aid

societies. Actions may also include transferring responsibility for non-contentious matters, such as name changes, the probate of uncontested wills and the registration of property, to administrative agencies so that the courts have more time for disputed cases.

Professionalise the bench and bar. In-service training for judges, lawyers and other legal professionals entails programmes to establish codes of ethics and disciplinary procedures. Increasing the number of law schools, ensuring that these schools have adequate resources and modifying the curriculum to reflect the demands of a market economy are also a part of this element.

The U.S. Agency for International Development funds judicial reform as part of its larger effort to strengthen newly emerging democracies around the globe. USAID’s projects originated in the early 1980s to assist the then fragile democratic government in El Salvador to bring individuals accused of human rights abuses to justice. A small programme was initiated to train judges and law enforcement personnel in investigative techniques. The programme was subsequently expanded and then extended, first to the rest of Latin America and later to the nations of Central and Eastern Europe and the newly independent states of the former Soviet Union.

The Inter-American Development Bank finances judicial reform projects for a combination of political and economic reasons. On one hand it sees judicial reform as an indispensable element in consolidating democratic institutions in Latin America by protecting basic human rights and promoting harmonious social relations. At the same time, it recognises that a well-functioning judicial system is important in the development of a successful market economy. Judicial reform is part of the Inter-American Development Bank's recent initiative to help borrower countries modernise the machinery of government. Since this initiative was launched, the Inter-American Development Bank has either approved or taken under consideration 16 separate reform projects.

Judicial reform projects sponsored by the World Bank aim solely at enhancing a nation’s economic performance. The Bank is enjoined by

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6 Modernisation of the State, Inter-American Development Bank, 1994.
7 Lawyer's Committee for Human Rights, supra note 1.
its Articles of Agreement from interfering in the political affairs of its members, a prohibition it interprets as preventing it from supporting judicial reform unless the project is relevant to the country’s economic development and to the success of the Bank’s lending strategy for the country.\textsuperscript{8} In practice this means that it does not provide assistance to reform criminal codes, train police or criminal court judges, or manage penal institutions.\textsuperscript{9} This focus on the economic consequences of judicial reform has led to complaints that such projects are ineffectual. Becker asserts that the emphasis on narrow, technical issues comes at the expense of more important, but arguably political, questions.\textsuperscript{10}

**JUDICIAL REFORM AND ECONOMIC DEVELOPMENT**

Whatever the rationale for judicial reform, it is widely believed that reform will significantly improve economic performance.\textsuperscript{11} One hypothesis focuses broadly on the importance of the judicial system in enforcing property rights, checking abuses of government power and otherwise upholding the rule of law. A second, narrower one casts the relationship solely in terms of the judiciary’s effect in enabling exchanges between private parties. Although neither hypothesis has been subjected to a rigorous empirical test, there is some indirect evidence, albeit tentative and inconclusive, supporting both.

The narrow hypothesis originates with the 16th century English philosopher Thomas Hobbes, who argued that without a judicial system, traders would be reluctant to enter into wealth-enhancing exchanges for fear that the bargain would not be honoured. In Hobbes’ words, when two parties enter into a contract, "he that performeth first

\textsuperscript{8} Shihata, supra note 4 at 132-33.

\textsuperscript{9} Legal Department, the World Bank, The World Bank and Legal Technical Assistance: Initial Lessons14, 1995.


has no assurance the other will perform after because the bonds of words are too weak to bridle men's ambitions, avarice, anger and other passions without the fear of some coercive power.\footnote{12}

Twentieth century development economists have revived Hobbes's thesis. North asserts that the absence of low-cost means of enforcing contracts is "the most important source of both historical stagnation and contemporary underdevelopment in the Third World.\footnote{13} In Williamson's view, a "high-performance economy" is one that is characterised by a significant number of long-term contracts — just the type of business relationship that is unlikely to thrive in the absence of a well-functioning judicial system.\footnote{14} When the judiciary is unable to enforce contract obligations, a disproportionately large number of transactions take place in the spot market where there is less opportunity for breaching contracts. Or, alternatively, firms circumvent the judicial system altogether by vertical and conglomerate integration, turning arms-length transactions into intra-firm ones. In either case, argues Williamson, the results are higher transaction costs and a "low-performance economy."

Survey evidence from Ghana supports Williamson's argument that the absence of a judicial system raises transaction costs — but not in the way he posited. As reported in Fafchamps, businesses in Ghana rely upon a network of traders to serve as go-betweens.\footnote{12} Rather than solicit a supply of lumber, say, from an unknown company directly, a firm will enlist a trader that it knows and that knows the lumber company. The personal relationships provide the buyer and seller with some assurance that the lumber will be delivered and payment received, but at a price: the creation of intermediaries raises the costs of doing business.

Constructing a direct empirical test of Hobbes's hypothesis is a formidable task. As Sherwood, Shephard and de Souza note, it would

\begin{footnotes}
\footnotetext[12]{Thomas Hobbes, Leviathan ([1651], 1962, at p. 76.}
\footnotetext[13]{North, D.C., Institutions, Institutional Change and Economic Performance, 1990, at p. 51.}
\end{footnotes}
require determining what transactions are not taking place and then quantifying the resulting losses.\textsuperscript{16} Clague and others proposed an indirect test instead, based on the assumption that the greater the percentage of money held in bank accounts and other financial assets, the more confidence citizens had in the judiciary and other institutions required to enforce bargains.\textsuperscript{17} Conversely, they reasoned that when a large percentage of the money supply was held outside banks and other financial institutions, the greater the likelihood that a substantial number of exchanges are consummated in simultaneous, spot market transactions.

Cross-country regressions for a large sample of industrial and developing countries using a measure of the stock of money held in the financial system yielded the predicted results. The greater the percentage of the economy’s money in the system, the higher the level of investment and, to some extent, growth. But as Castellar Pinheiro observes, these results are problematic.\textsuperscript{18} A large portion of the money held in financial institutions consists of currency and other liquid assets available for immediate withdrawal. Hence, it cannot readily be assumed that a high ratio of funds held inside the system necessarily means that fewer spot or simultaneous transactions are taking place.

Surveys of Latin American entrepreneurs provide somewhat more, if also indirect, support for Hobbes’s thesis. In Peru almost a third of those responding to a World Bank poll said they would not switch from a trusted supplier to a new one — even if a lower price were offered — for fear the new supplier could not be held to the bargain.\textsuperscript{19} A similar survey in Ecuador found that businesses were hesitant to invest because of the uncertainty of and potential lack of timeliness in enforcing contract rights. In-depth interviews of Brazilian entrepreneurs suggest that domestic investment would increase 10


\textsuperscript{18} Pinheiro, A.C., Economic Costs of Judicial Inefficiency in Brazil in Final Report to the Tinker Foundation, 1998.

percent if the Brazilian judiciary were on a par with those in the advanced market economies.  

A second — far broader — hypothesis posits a more complex relationship between judicial reform and economic development. This view holds that economic development depends upon a legal system in which not only contracts between private parties are enforced, but the property rights of foreign and domestic investors are respected and the executive and legislative branches of government operate within a known framework of rules. This way of defining the rule of law assigns a prominent place to the judicial system: "[T]he judiciary [is] in a unique position to support sustainable development by holding the other two branches accountable for their decisions and underpinning the credibility of the overall business and political environment."  

The argument that the rule of law fosters economic development has been made many times. The 15th century jurist John Fortescue asserted that medieval England's prosperity was traceable to the quality of English legal institutions. Almost 300 years later Adam Smith observed that "a tolerable administration of justice," along with peace and low taxes, was all that was necessary to "carry a state to the highest degree of opulence." Max Weber, the 19th century German sociologist, was the first to look carefully at the relationship among the rule of law, a well-functioning judiciary and economic development, but according to Hayek, credit for recognizing the judiciary's importance in enforcing the rule of law belongs to the writers of the American constitution and the German philosophers who elaborated the concept of the Rechtsstaat. The former showed why judicial review

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20. Supra note 18.
of legislative actions was crucial, while the latter demonstrated the importance of subjecting the actions of the executive and its administrative agencies to judicial scrutiny.

Weber's comparative analysis of the role of law in China and the West was perhaps the first systematic effort to develop empirical support for the claim of a relationship. Most recently, in a survey of 3,600 firms in 69 countries, more than 70 percent of the respondents said that an unpredictable judiciary was a major problem "in their business operations." The report also found that the overall level of confidence in the institutions of the government, including the judicial system, correlated with the level of investment and measures of economic performance.

But rigorous econometric methods for verifying the rule-of-law hypothesis and the role played by the judicial system are still in their infancy. Castellar Pinheiro reviews three recent efforts using cross-country regression analysis: Knack and Keefer, Mauro and Brunetti and Weder. Each uses a proxy for judicial system performance, such as entrepreneurs' perception of the political risk involved in conducting business in a given country, to explore the correlation between a better judicial system and higher rates of investment, growth and other indicators of economic performance. All three studies report a

Although Rechtsstaat is frequently rendered into English as "rule of law," this translation can be highly misleading. The word "law" in the English phrase "rule of law" can mean either positive law, that is, any law enacted by a duly constituted government, or it can mean natural law, that is, precepts that meet some test of morality and justice. The German Recht is far closer in meaning to the latter than to the former and thus a more accurate translation of Rechtsstaat would be "state ordered or ruled by natural law or justice." Similar translation problems arise with other European languages that, like German, have different terms for positive and natural law. See Fletcher, G.P., Basic Concepts of Legal Thought, 1986, at p. 12.

relationship between the proxies selected and different indicators of economic development, but as Castells Pinheiro notes, each suffers from several methodological problems that make the results suggestive at best. The proxies for judicial system performance are often questionable and there are problems with the endogeneity of the independent variables. These studies also do not rule out competing explanations such as increases in trade and investment or even the effects of other institutional reforms such as the introduction of an independent central bank.

Nor do cross-country regressions settle the question of the direction of causality. It may be that higher levels of development permit the state to spend more on the judicial system. Or as Pistor observed in a review of judicial and economic reform in the transition economies, the same factors that contribute to economic reform and development may also be responsible for improvements in the judiciary. Both may be a result of pre-existing attitudes and beliefs in society at large, or what has recently been termed "social capital".

Hirschman’s suggestion about the relationship between political and economic progress may apply equally to the relationship between judicial reform and development. He argues that political and economic progress are not tied together in any straightforward functional way. Rather, given the historical record, the relationship is probably better modelled as a series of on-and-off connections, or of couplings and decouplings. At some stages in the development process, the two may be interdependent, while at other stages they may be autonomous. There is no reason not to believe that a similar dynamic may be at work in the interplay between the evolution of the judiciary and economic growth and the legal transplant school of comparative

29 Supra note 18.
law has marshalled an enormous body of evidence showing that substantive law develops independent of economic and social variables.\textsuperscript{34}

In sum, while history and comparative analysis support the view that a better judicial system fosters economic growth, as Weder observes, there is no clear, empirical evidence showing the economic impact of a weak judicial system.\textsuperscript{35} The most that can be said at the moment is that the weight of opinion and evidence suggests the existence of some type of relationship.

THE PREREQUISITES OF SUCCESSFUL JUDICIAL REFORM

Judicial reform can threaten those with a stake in the status quo. As both Eyzaguirre and Blair and Hansen note, inefficiencies in court procedures and management often provide opportunities for rent-seeking by attorneys, judges and judicial support personnel.\textsuperscript{36} In Argentina, for example, the judicial clerks have protested a proposal by Fundacion de Investigaciones Economicas Latinoamericanas that they work more than the current 132 days a year.\textsuperscript{37} (The increase would raise the work year to at least 163 days, the average for executive branch personnel, if not to the 231 average for Argentine private sector employees.) The support staff is also challenging a recommendation to curb their power over case management and courtroom scheduling.

Reform may also engender opposition from the nation's organised bar. In Uruguay lawyers objected to the introduction of procedures that would speed up civil and criminal trials, fearing that speedier trials would mean less work for them.\textsuperscript{38} Reform can threaten lawyers' incomes in other ways as well. The practice of law is almost invariably a state-sanctioned guild or cartel, but as Posner explains, unlike an oil


\textsuperscript{37} "La Reforma del Poder Judicial en la Argentina", in Fundacion de Investigaciones Economicas Latinoamericanas, 1996.

or steel cartel, "legal services" are difficult to define. The state must therefore specify what tasks are for lawyers and what tasks can be performed just as well by non-lawyers. In Peru, for example, attorneys and public notaries vigorously opposed measures to cut the costs of registering land belonging to the urban poor because the measures would allow engineers, architects and other professionals to provide services that had once been the exclusive preserve of the legal profession.

Given the opposition that judicial reform is certain to generate, one view holds that no programme should be undertaken absent a broad consensus in the country on the need for significant change. Dakolas recommends extensive consultation with committees representing judges, members of the bar and other affected groups during the preparation and implementation of the project. Shihata adds that this consensus must include a long-term commitment on the part of the government to provide the resources required for an effective judiciary.

Blair and Hansen reached a similar conclusion in an evaluation of judicial reform projects in Argentina, Colombia, Honduras, the Philippines, Sri Lanka and Uruguay. Absent a high level of support from the ministry of justice, senior executive branch officials, legislators and judges, the authors argue that judicial reform is unlikely to succeed. When such support is lacking, they recommend that both public and private donors forgo judicial reform altogether. Instead, they suggest that donors concentrate on building a consensus for reform by opening a dialogue with the government and by encouraging bar associations, business groups and other non-governmental organisations to campaign publicly for reform.

In the six cases examined, Blair and Hansen found that training judges, improving management systems and supplying computers and other resources to the judiciary had little impact in countries where a consensus for judicial reform was lacking. The lesson they draw is that these traditional components of judicial reform, often termed "institutional strengthening," should not be initiated until more basic
reforms have been achieved. Legal changes permitting the use of alternative dispute resolution mechanisms, creating or broadening legal aid programmes and ensuring that judges are appointed on the basis of merit should come first. Only after such structural reforms and access-enhancing measures are in place, do they support institutional strengthening.

Several other evaluations of judicial reform in Latin America appeared to confirm Blair and Hansen's findings. Even before their results were published, the U.S. General Accounting Office, in an analysis of the USAID sponsored programmes in Central American and Colombia, concluded that providing computers, training and other technical assistance to the judiciary in countries where a strong commitment to reform was lacking had not been productive.41 Buscaglia, Dakolias and Ratliff report that Latin American judges often questioned the value of training in the absence of more fundamental reforms to the judicial system.42 In many cases once a judge had been trained, he or she quickly left the bench for a more lucrative position in the private bar.

In a study of judicial reform projects in 15 Latin American countries, Martínez Neira found there had been too much emphasis on increasing the number of judges, courts, buildings and computers at the expense of more fundamental changes to the legal system.43 He contends that this imbalance resulted from a lack of consensus on the scope of reform. Without such a consensus, judges, clerks, attorneys and other actors in the legal system are free to pursue their own agendas. Pérez Perdomo makes a similar point, arguing that too many Latin American reform programmes reflect only the needs and perspectives of judges and others with an institutional role in the judicial system.44

41 GAO, supra note 2; USAID, "Comments on the GAO Draft Report—Foreign Assistance: Promoting Judicial Reform to Strengthen Democracies", in id.
Not everyone agrees with these criticisms, however. In a response to the General Accounting Office’s critique, USAID contended that such programmes can be seen as the vehicles for developing a consensus.48 The collaboration between outside experts and judges and others within the country and the ensuing public discussion can help to generate the necessary political commitment, the agency maintained.

Hammergren, who subscribes to this view as well, also takes issue with Blair and Hansen’s recommendation that institutional strengthening should always follow structural reforms and measures to increase access to the judicial system.49 She observes that institutional strengthening can pave the way for broader reforms that, if attempted first, may engender such strong opposition that reform will be stalled. She argues that institutional strengthening measures do not have to end up simply serving the needs of judges, lawyers and others with a stake in the status quo. Such measures can include ways of making the judicial system more accountable to the public and, as Maclean has stressed, give it a public service orientation.50 Hammergren also cautions that non-governmental organisations also have their own interests that may be at odds with a broader reform agenda.51 Business groups may, for example, be interested solely in the creation of commercial courts or steps that reduce legal fees.

THE LAW AND DEVELOPMENT MOVEMENT

Are the legal technical assistance programmes sponsored by the World Bank ignoring the lessons learned in earlier attempts to foster development through law?52 In the 1960s USAID, the Ford Foundation and other private American donors underwrote an ambitious effort to

48 GAO, supra note 2; also, USAID, supra note 11.
reform the judicial systems and substantive laws of countries in Asia, Africa and Latin America. This "law and development" movement engaged professors from Harvard, Yale, Stanford, Wisconsin and other leading law schools and within a few years had generated hundreds of reports on the contribution of law reform to economic development. Yet after little more than a decade, both key academic participants and a former Ford Foundation official declared the programme a failure and support quickly evaporated.

The guiding assumption of the law and development movement was that law is central to the development process. A related belief was that law was an instrument that could be used to reform society and that lawyers and judges could serve as social engineers. As Merryman notes, not everyone subscribed to this view. A few participants in the movement argued that only minor changes could be effected through legal reforms and others contended that law reform should follow broader changes in society, that is, that the proper aim of reform was to adjust the legal system to social and economic changes that had already taken place. But the dominant view of law and development practitioners and theorists alike, although still unproven, was that law reform could lead social change, that law itself was an engine of change.

A second important belief was that educating the bench and bar in developing countries would advance reform efforts. The gap between the law on the books and the law in action in developing countries was widely appreciated and one of the solutions advanced was professional education. It was thought that if lawyers and judges were properly educated about law's role in development, they could be enlisted to


55 Gardner, supra at note 54.


close the gap. The idea was to turn members of both professions into legal activists through education. Yet as one sympathetic chronicler of the movement observed, this idea was supported by nothing more than "hopeful speculation" that education could overcome values instilled by family, class, religion and other social forces.58

The post-mortems on law and development identify a number of pitfalls that advocates of judicial reform ought to bear in mind.59 One is that the movement lacked any theory of the impact of law on development. Practitioners thus had no way to prioritise reforms or predict the effects of various measures. A second failing was too little participation by the lawyers and others in the target country who would either have to carry out the reforms or who would be affected by them. Foreign legal consultants, through a combination of expertise and access to funding, were often able to dictate the content and pace of reform. A third problem was that the movement focused on the formal legal system to the exclusion of customary law and the other informal ways in which many in developing nations order their lives.60

But perhaps the most significant reason for its failure was the naive belief that the American legal system (and the legal culture generally), which Trubek and Galanter refer to as "liberal legalism," could be easily transplanted to developing countries.61 In the United States judges play a significant role in policymaking and as a result, lawyers are often able to engineer significant changes in policy through litigation. This is not true in civil law systems or indeed even in the United Kingdom and other nations that share the same common law background as the United States. As Merryman put it, the law and development movement reflected the American "legal style," and this was a style that those in other cultures did not find particularly attractive.62

At a 1995 conference hosted by the British Council, participants debated whether the mistakes of the law and development movement are likely to be repeated. Faundez argued that although the old programmes and the Bank's new initiatives appear to be quite similar

58 Lowenstein, S., Lawyers, Legal Education and Development: An Examination of the Process of Reform in Chile, 1970.
59 Trubek and Galanter, supra note 54; Merryman, supra note 53; Gardner, supra note 54; Burg, supra note 57.
60 Trubek and Galanter, supra note 54 at p. 1062.
61 Id.
62 Merryman, supra note 53 at p. 479.
on the surface, the context in which the Bank's current programmes are being carried out is significantly different.\textsuperscript{63} Behind the law and development movement was the premise that the state "would initiate and promote the process of economic development." By contrast, today the Bank sees law as facilitating market transactions by defining property rights, guaranteeing the enforcement of contracts and maintaining law and order. Because the state is no longer the protagonist of social change, as in the law and development model, there is less room for error.

Yet as his analysis proceeded, Faundez seemed to be less sure that the mistakes of the law and development movement would be avoided. He recognised that current development theories, inspired by the work of Douglas North and other neo-institutional economists, still contemplate a role for the state. It is, to be sure, a different one from the activist theory implicit in the law and development movement and it is one that is informed by economic analysis. "But it is unlikely that by shifting the focus of attention from legal institutions to economic analysis this new approach will manage to avoid the problems which so frustrated and disappointed members of the law and development movement".\textsuperscript{64} His concern is that all the unanswered questions that lurked behind the law and development movement—the role of law and the formal legal system in development, the relationship between law and politics and among democracy, authoritarianism and development—still remain.

If Faundez is ultimately uncertain that the Bank will not repeat the mistakes of the law and development movement, both McAuslan and Thome have no doubts that it will.\textsuperscript{65} McAuslan advances a series of reasons why this is likely to happen. Like Faundez, McAuslan underlines the absence of any empirical data connecting reform with development and the consequent disagreement even among reformers over priorities and strategy. In a commentary on McAuslan's article, Thome goes a step further. He believes the problem is not so much a lack of empirical data as the failure to reflect the data that is available.

\textsuperscript{63} Faundez, supra note 52, at p 14.
\textsuperscript{64} Id.
\textsuperscript{65} McAuslan, P., "Law, Governance and the Development of the Market: Practical Problems and Possible Solutions", in Faundez, supra note 52; Thome, J.R., "Comment on McAuslan's 'Law, Governance and the Development of the Market: Practical Problems and Possible Solutions" in id.
He asserts that all law reform and judicial reform in particular, rests on three premises: first, that development requires a modern legal framework resembling that in the United States; second, that this model establishes clear and predictable rules; and third, that the model can be easily transferred. Yet, he says, empirical research has refuted all three assumptions.

McAuslan is also critical of what he argues is the Bank’s focus on law reform to facilitate market transactions. The emphasis should be on promoting good governance and alleviating poverty. An efficient and equitable market economy requires well-functioning state-run institutions that can curb the abuses likely to arise as the market economy develops. He fears that in emphasising the role of the judiciary in fostering economic growth these considerations will be pushed aside. He cites as an example land-grabbing by elite as property rights are defined and allocated by the state. Without judicial and administrative bodies capable of curbing such behaviour, income inequalities will be exacerbated and political instability may result.

McAuslan and Thorne are not entirely negative. They do note that some Bank projects reflect the lessons of the law and development movement. The Financial and Legal Management Upgrading Project in Tanzania, for instance, has involved local lawyers from the beginning, both in studying the legal system and in developing proposals for change. Even the legislative drafting project for China, which they say is premised on an extreme view of the importance of law in the development process, is training local lawyers in the skills necessary for market reform. But even though the failings of the earlier law and development programmes may be clear, both critics assert that pressures to produce results quickly will work against the gradual and incremental approach to law reform warranted by our current state of knowledge about the relationship between law and development.

INTEGRATING JUDICIAL REFORM WITH INFORMAL ENFORCEMENT MECHANISMS

Judicial reform aims to buttress the rule of law and assure entrepreneurs that contracts will be enforced. Yet other institutions within society perform these same functions. Accountants and auditors issue standards and render judgements evaluating the performance of various economic actors. Credit bureaus provide an incentive to consumers and businesses alike to observe contracts by disseminating information about those who have failed to perform. And the media
and non-governmental organisations are often the first to detect and publicise arbitrary or illegal actions by government officials. Judicial reform projects that build upon or enhance the operation of such informal enforcement mechanisms will yield greater returns than those that do not. At the least, designers of reform projects must take the presence of these informal mechanisms into account. Otherwise, as Greif warns, the projects could backfire.  

A forthcoming study by Kranton and Swamy of the effect that the introduction of formal courts had on rural credit markets in India illustrates just how a judicial reform project can go awry. Before there were formal courts, moneylenders relied on informal enforcement mechanisms to ensure that clients paid their debts. Resort to these mechanisms was costly and usually required the acquiescence of local leaders. Entry into the money-lending business was thus retarded and competition lessens. Although lack of competition meant that interest rates remained high, it also gave lenders a cushion that allowed them to extend payment terms and otherwise accommodate debtors experiencing difficulties in meeting their obligations.

The introduction of courts by the colonial authorities brought new entrants into the market. Interest rates declined, robbing lenders of the financial cushion that had allowed them to carry borrowers in bad times. When drought hit, lenders went to court to foreclose on farmers' land. Riots and widespread social unrest followed.

As Kranton and Swamy note, the lesson is not that judicial reform is never appropriate, but that where other markets, such as those for insurance and futures, are missing, care must be taken to ensure that judicial reform does not have unintended consequences. Fafchamps' study of contracting in Africa supports this view. He found that rigid compliance with the terms of a written contract was difficult, if not impossible, in developing countries. Their economies are simply subject

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to too many exogenous shocks for contracts to be strictly enforced, which is why informal contract enforcement mechanisms build in such flexibility.

The problem in every case comes in determining how judicial reform will affect informal enforcement mechanisms, for a general theory of informal mechanisms and their interplay with formal mechanisms has yet to be advanced.69 What is known is that when formal systems are deemed illegitimate, as they were in Moslem Central Asia after the Soviet take-over in the 1920s, disputes will be directed away from the formal system.70 Ellickson submits too that the division of labour between formal and informal mechanisms is affected by the technical complexity of the issues involved.71 He found, for example, that in northern California disputes between neighbouring ranchers about the cost of a fence, which raised simple questions of fact and technology, tended to be resolved informally. By contrast, disputes involving the allocation of groundwater supply, where the facts were difficult to ascertain and resolution of the contested issues involved complex technical questions of return flow and allocation during shortages, were more likely to be presented to a court for adjudication.

The informal enforcement mechanisms that have drawn the most attention are reputation-based systems that permit merchants to carry on extensive trading relations over time and space in the absence of a court system that could ensure contract performance. Greif describes a system used by traders in North Africa and the Mediterranean in the 11th century and in a later paper (1997), he shows similar reputation mechanisms at work in settings as diverse as the Wisconsin lumber industry, the New York diamond trading business, long-distance commerce in medieval Europe and parts of contemporary Asia, Africa and Latin America.72 The common denominator in all these examples is that the gains from repeat dealings provide the incentive necessary to ensure performance. That is, the discounted present value of the earnings stream that can be realised from future transactions exceeds

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71 Ellickson, supra note 69.
72 Greif, supra note 66.
the one-time wealth increase realisable from breaching the current
agreement.73

The incentive to maintain a good reputation operates in other
settings besides merchant-to-merchant relations. Credit bureaus,
business associations that exchange information about the payment
history of their customers, count on consumers’ desire to buy on credit
in the future to assure payment of current obligations.74 A similar
principle is behind consumer testing laboratories, better business
bureaus and other groups that market seals of approval or provide
quality guarantees.75 When these groups certify that a product or
business meets a certain standard, they are providing a visible sign of
good reputation that can be used to generate future sales.

Development itself can affect the mix of formal and informal
mechanisms in an economy. According to Besley, one of the reasons
informal financial institutions such as rotating savings and credit
associations continue to operate in the developing world is that they
spend far less than do banks and other formal financial institutions to
ensure that borrowers repay their debts.76 Because their borrowers
typically come from the same village, these institutions can rely on
group pressure and other informal methods to see that the loans are
repaid. Besley predicts that these institutions will lose their
comparative advantage as the number of close-knit communities
declines with the changes brought by economic development and that
they will ultimately be supplanted by formal firms.

Milgrom, North and Weingast too stress how increases in the costs
of operating an informal enforcement mechanism lead users to turn to
the formal legal system.77 They model a reputation-based system that

Theoretical Economics, 594.

74 Klein, D.B., Promise Keeping in the Great Society: A Model of Credit Information

Conduct, 1997.

76 Besley, J., “Non-market Institutions for Credit and Risk Sharing in Low-

77 Milgrom, P.R., North, D.C. and Weingast, B.R., “The Role of Institutions in
the Revival of Trade: The Law Merchants, Private Judges and the
note 75.
resembles the one devised by long-distance traders in medieval Europe. Enforcement depends upon each trader determining if the other party to the contemplated exchange has failed to honour a contract, or cheated, in the past. If the other party is a cheater, the honest trader refuses to exchange with him. The threat of a boycott deters cheating.

But traders incur costs in ascertaining the past history of those with whom they contemplate exchanging, costs that increase as the economy grows. The number of potential trading partners on which information must be gathered expands and the number of queries rises as the number of potential exchanges increases. Accordingly, Milgrom, North and Weingast argue that eventually the costs to traders will exceed the costs of operating a formal judicial system. Rising transaction costs, they note, explain why national courts replaced the Law Merchant system of informal enforcement in Europe during the late Middle Ages.

Although the value of their analysis is its explicit focus on transaction costs and how changes in these costs dictate the choice between an informal and formal enforcement mechanism, to the extent that their work implies that development always makes informal mechanisms more costly than formal mechanisms it is misleading. Development lowers at least some of the costs involved in operating an informal enforcement mechanism. The use of faxes, computers and other technologies, for example, reduces the costs of compiling and disseminating information about the credit history of consumers and businesses. How these increases and decreases net out, however, remains to be explored.

The line between formal and informal mechanisms may be fuzzy, however. In some cases a hybrid system appears. For example, the courts may enforce social customs or practices sanctioned by merchants. Or bankers may hold titles to farmers' land while their loans are outstanding, as in Thailand and Honduras. Although actual

78 Id.
79 Ellickson, supra note 69.
81 Siamwalla, A. and others, "The Thai Rural Credit System and Elements of a Theory: Public Subsidies, Private Information and Segmented Markets", in Hoff, K., Braverman, A. and Stiglitz, J.E. (eds), The Economics of Rural Organisation: Theory, Practice and Policy, 1993; Stanfield, D., Nesman, E.
possession gives the banks no formal legal right to foreclose on the land in case of default, bankers consider the leverage from holding the title to be a sufficient guarantee of repayment.

Much remains to be learned about the working of informal enforcement mechanisms and their relationship to the formal legal system. But at least some of the ways in which judicial reform can build upon or complement informal systems are already apparent. Some are obvious. Projects should capitalise on the power of the media to police reform efforts by providing as much information about the judicial system as possible. In Argentina, for example, it has been proposed to release information regularly about judicial caseloads, case backlogs and other indicators of judicial productivity.82

At a minimum, reform measures should try to bolster or complement informal enforcement mechanisms. In the case of reputation mechanisms, this could mean disclosing the identity of the parties to lawsuits, the status of cases in litigation and the disposition of closed cases, including the amount of any damages awarded. Going further, current laws need to be reviewed to be sure they pose no obstacles to the easy and inexpensive dissemination of truthful public information about firms and individuals.

Whenever reputation information circulates, there is the possibility for abuse. False and defamatory material may be disseminated, jeopardising privacy interests and compromising opportunities to make a fresh start. There are, however, many ways to strike a balance between these interests and the interests served by a well-functioning reputation system. In the United States, the Federal Fair Credit Reporting Act provides one model for balancing debtor and creditor interests. Another is Brazil’s juridically sanctioned process for publicising information about those who have failed to pay their debts.83

Often, enforcing reputation mechanisms depends upon an agreement among the participants to boycott anyone who has a history of breaching an agreement.84 But some U.S. courts have ruled that a boycott is illegal when one or more of the firms participating in the

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82 Supra note 37.

83 The World Bank, supra note 27;

84 Milgrom, North and Weingast, supra note 77.
boycott is a competitor of the party boycotted. These rulings have been sharply criticised for misapprehending the nature of anti-competitive agreements, but their influence may still be reflected in competition law. Accordingly, a programme to foster informal contract enforcement mechanisms should also encompass a review of the applicable competition law.

Based on research in Ghana, Fafchamps recommends helping local business communities develop systems to share information about the reliability of suppliers and customers. Klein’s analysis of credit bureaus shows that free-rider problems and other market failures are endemic in the start-up phase and can prevent the formation of credit reporting entities. In the United States credit bureaus began as small, nonprofit associations, often run as an adjunct to the local chamber of commerce. Members were drawn from a tight-knit group of local merchants and social ties supplied the incentives to overcome the problems of market failure. Where such incentives are missing, alternative ways of fostering the growth of credit reporting agencies should be considered. In Taiwan, the government’s check clearinghouse serves as a substitute for a private credit bureau, charging a small fee for information about individuals who have bounced checks.

Several other measures can be included in judicial reform projects to complement informal enforcement. One possibility is to transfer the responsibility for matters such as the registration of property rights to administrative agencies. This transfer can foster hybrid enforcement mechanisms. For example, technology now permits the creation of essentially paperless registries for land and other types of property. But paper titles may serve a purpose by permitting the development of a

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87 Fafchamps, supra note 68.

(American spellings have been changed into British ones. Editor)
type of informal mortgage based on physical possession of the certificate.

CONCLUSION

Although judicial reform projects are an accepted part of the development landscape, policymakers in Bangladesh face a number of challenges in crafting an effective project. As the discussion above shows, questions about how judicial reform affects the economy and society generally, remain to be answered. Nor is there any consensus on the ingredients for a successful project. Thus, those responsible for the judicial reform project in Bangladesh have no ready models to turn to. What they must do is proceed carefully and cautiously, starting with an in-depth analysis of the nation’s needs, an analysis that must be continually reviewed as the project proceeds.