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Rule of Law and Credibility: Lessons for the Forgetful

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Abstract

Although the institution of *Rule of Law* (ROL) and its counterpart, *Control of Corruption* (COC), are well known in economic development literature as being essential to economic growth and investment, policy makers in developed countries may be unaware of, or may have forgotten the lessons learned in the developing world. In this paper we argue that countries in different stages of development may seek to increase credibility and reduce uncertainty associated with economic transactions through either ROL or COC. Some developing economies, such as China, have achieved impressive economic growth through COC without relying on ROL. In the long run, however, all nations have to move toward the establishment of a ROL based economy. We demonstrate mathematically that lack of certainty, due to a lack of rule of law, the presence of corruption, or a lack of credibility of government, can increase the rent-seeking expenditures and thereby have a damaging effect on economic growth. Such evidence reconfirms the value of rule of law in safeguarding sustainable path of economic growth.

Although the institution of *Rule of Law* (ROL) and its counterpart, *Control of Corruption* (COC), are well known in economic development literature as being essential to economic growth and investment, policy makers in developed countries may be unaware of, or may have forgotten the lessons learned in the developing world. The United States of America, for example, used to have a strong tradition of ROL but has been moving away from this concept in the past few years. This shift has been documented by various agencies who rate countries for such things as perceived corruption and certainty of ROL.

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For example, the 2012 Index of Economic Freedom, an index produced by the Heritage Foundation, which measures such things as rule of law and other aspects of economic freedom, shows that the United States has been falling in economic freedom since 2008. Among the areas listed where the United States has suffered a decline are freedom from corruption, government spending, monetary freedom, and investment freedom. Since 2009, the United States fell out of the category of Free Economies, which have a score of 80-100, and by 2012 had a country score of 76.3 (Miller, Holmes and Feulner, 2012).

Likewise, in the 2012 *Global Competitiveness Report* published by the World Economic Forum, the United States has fallen by 6 notches since the 2008-2009 report, from # 1 to # 7, in terms of global competitiveness. This report covers a long list of factors, including good governance and rule of law. As a matter of fact, the United States has sunk the most among all countries covered by this report. Additionally, the *Corruption Perceptions Index*, which is produced by Transparency International, shows the USA falling from 18th to 24th in ranking, measured by relative lack of corruption, between the 2008 and the 2011 reports.

These indices provide some evidence that national and international research groups do indeed perceive a decline in the USA in the areas of ROL or COC. But why should this be important? Why would such things as corruption or rule of law matter to the economic growth or the condition of a developed economy?

The purpose of this paper is to answer these questions by exploring the importance of the institutions of ROL and COC in the process of economic development. We begin with a short summary of the history of economic development literature, focusing generally on institutions and more specifically on ROL and COC.

The Importance of Institutions to Economic Development

For decades economists have been intrigued by a general question: Why is the pace of economic development so uneven across different countries? There are basically three ways to explain why some countries have economies that grow faster than others. One can use an economic theory of growth, one can focus on climate and geography, or one can focus on institutions that exist and either support or resist the growth of markets (Gwartney, Holcombe and Lawson 2006).

This paper takes an institutional approach, starting with a definition of institutions. We argue that, although the ROL and COC are two closely-tied mechanisms to maintain fair and orderly transactions in any economic system, different countries do weigh them differently and the choice made by the government in this respect tends to lead to differing paths of economic growth. This is because the certainty and credibility of any transaction contract, which are crucial to ensuring the sustainability of all economic transactions, can be significantly affected by the dominant mode of governance for economic activities, knowingly or unknowingly chosen by the government of a nation. At the end of the paper, we will examine the cases of some emerging economies to demonstrate this phenomenon.

There is a difference between institutions and organizations. This was stressed by North (1990), who maintained that institutions are broader and include non-organizations such as *rule of law*, or *absence of corruption* in addition to traditional organizations, such as national banks.

Institutions can be defined as "sets of formal, rule-based constraints on the behavior of individual and collective actors." As such, this construct is different from just cultural norms or beliefs. It does include codes for behavior, however. These codes may descend from or be endogenous to cultural beliefs and norms (Dunning and Pop-Eleches, 2004).

Why do institutions matter? There is clear evidence showing that the quality of institutions significantly affects the pace of a nation's economic development. According to some research findings (Gwartney, Holcombe, and Lawson, 2006), countries with higher-quality institutions, as measured by the EFW index[i], both achieve more growth per unit of investment and attract a higher level of private investment as a share of GDP. Additionally, private investment was approximately 25% more productive.

Rule of Law vs. Control of Corruption

Although institutional quality can be measured in many different ways (Gwartney and Lawson, 2003), all measures are, by and large, geared to the purpose of keeping the uncertainty low and credibility high for economic transactions so that all parties involved would have sufficient confidence in their outcome.

In light of such a fundamental purpose, the most important function played by a national government is making sure that the rule of law is abided by all participants of the economic system, or at least ensuring that the level of corruption in the country is minimized.

According to Kaufmann, Kraay, and Mastruzzi (2010), the rule of law (ROL) indicator captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. All of these seem to be anchored to the presence of formal legal systems in a country.

By contrast, the control of corruption (COC) indicator captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests (Kaufmann, Kraay, & Mastruzzi, 2010).

Table 1 illustrates the differences between these two mechanisms that have been employed by governments of different countries to ensure fair and equitable transactions. Although they differ from each other in terms of dependence on written laws, uniformity of application, and methods of enforcement, both of them may help reduce uncertainty experienced by transaction partners and increase the credibility of the ruler or the government perceived by its people.

Table 1: A Comparison of Two Worldwide Governance Mechanisms

Rule of Law	Control of Corruption
• Typically linked to a sophisticated judicial system	• Typically coupled with a rudimentary judicial system
• Effect is more durable	• Effect is more transient
• More likely to be institutionalized by laws and regulations	• More likely to hinge on the leader' personal competence
• Locally enforced by a hierarchical structure of justice	• Centrally exercised by a dictator or a political party
• Commonly adopted by developed economies	• Commonly practiced in developing economies
• Consistently applied over time	• Applied by varied methods over time

Aixala' and Fabro (2008) determined that the most significant institutional variables for the achievement of high growth depended "on the income levels of countries." They found that for the wealthiest countries, "rule of law is fundamental while, for poor countries, it is control of corruption."

The results obtained by them show, firstly, that institutional infrastructure is a fundamental factor in explaining the economic growth of countries, as can be seen from the improvement in the explanatory capacity of a model of growth when institutional variables are included. As to which aspects of institutional quality are the most important, the answer differs according to the sample considered: "Rule of Law'" in the rich countries and "Control of Corruption" in the poor countries (Aixala' & Fabro, 2008).

Although the difference found between rich countries and poor countries by Aixala' and Fabro might be valid and substantial, we think the rich-poor dichotomy actually reflects different stages of economic development. Understandably, underdeveloped or emerging economies are more likely to be characterized by lower per capita income. As the economic development continues to progress, people in these countries also become richer.

To a certain extent, of course, these two options are similar and overlapped. When a ruler does not observe the rule of law with respect to all citizens, but instead gives exceptions to the law to friends and donors, or enforces the law differently depending upon whether the person of interest is a friend or donor, this is clearly a form of corruption. On the flip side, even the most sophisticated, well-developed laws would not function effectively to ensure orderly, equitable economic transactions in a country unless they were rigorously enforced under a strong governmental leadership.

Interestingly, the existence of one corrupt ruler does not imply that the ruler would encourage or tolerate other governmental officials to behave corruptly. Rather, the rulers of some countries may still crack down on bribery, nepotism, or cronyism when they detect such occurrences.

We can find numerous examples in recent human history when rulers or dictators took the responsibility of creating "clean politics" with their own hands, such as the former president of Philippines, Ferdinand Marcos, former president of Egypt, Hosni Mubarak, and former dictator of North Korea, Kim Jong-Il. With the self-serving behavior of these dictators being excluded, the governmental officers under their administrations were fairly clean of corrupt conducts due to the fear of being severely punished.

The case of the Philippines is particularly noteworthy. Before the "Four Little Tigers" (Taiwan, Hong Kong, Singapore, and South Korea) emerged in East Asia, the Republic of the Philippines was the envy of Asia in terms of economic prosperity. To be sure, under Marcos regime (1965 - 1986), the Philippines' external debt rose from $360 million in 1962 to $28.3 billion in 1986, making the Philippines one of the most indebted countries in Asia, and a sizable amount of this money went to Marcos family and friends in the form of behest loans (Boyce, 1993). However, during that period the economic development progressed and citizens of Philippines enjoyed higher standards of living than people in the neighboring countries.

Eventually, the lack of true democracy under Marcos administration and the general resentment of Marcos's dictatorship brought his regime to demise. The collapse of the Marcos regime marked the beginning of more prevalent democracy enjoyed by Filipinos, but it failed to bring a turnaround to the Philippine economy, which started to decline in last few years of Marcos administration.

In essence, after Marcos's loss of power had left a void in the control of corruption, the rule of law failed to take hold in the Philippines. An expert[ii] of Asian Political Economy interviewed by one of the authors of this paper put it bluntly: "When Ferdinand Marcos was still in charge, only the president and a few confidants could take bribery. After Marcos lost his power, almost every governmental official in Philippines felt free to take advantage of their authorities to enrich their own pockets." That may be an overstatement -- there are still many clean governmental officials in today's Philippines -- but it might be one of the reasons why the Philippines had missed the opportunity to become one of the Little Tigers of Asia.

We can also find numerous countries where pervasive application of the rule of law did not successfully prevent corruption from happening. In those cases, economic growth in the country was still curtailed or even reversed.

One piece of evidence is found in Mauro'S (1995) empirical studies, which confirmed that corruption could lower private investment, thereby reducing economic growth even in the sub-samples of countries in which bureaucratic regulations are very cumbersome.

The Puzzle of Uneven Economic Growth across Nations

Researchers of economic development are oftentimes puzzled by the uneven pace of economic recovery experienced by different countries in the same region. Using data from UNICEF (2001), for instance, Dunning and Pop-Eleches (2004) pointed out that "Economic performance in Poland, Slovenia and Hungary declined less and recovered much faster than in the former Soviet Republics, many of which suffered catastrophic declines in the early transition years and experienced only modest recoveries afterwards." Five of the former Soviet satellite countries had, by 1997, rebounded to levels that were less than 40% of their 1989 GDP. Traditional approaches, such as examining the speed of reform, or the differences between organizations, have failed to explain the differences in results.

Another, more recent example of uneven growth can be seen in the African Cheetahs[iii], countries where economic rates of growth are much higher than average. The term African Cheetahs also is used to describe the new generation of African leaders who are returning to their African countries with education and job experience from the United States, Canada and Europe with new ideas of good governance and rejection of the old and corrupt way of doing business. These countries, where the Cheetahs are having an impact, are experiencing rates of economic development that many of the more traditional predictors of success would not have foreseen, based upon the history of governance in these countries. The one seeming consistency in these countries is certainty -- certainty that the rule of law with respect to contracts will be enforced.[iv]

Additionally, Dunning and Pop-Eleches (2004) point out that "analysts might not have expected the one-party Chinese Communist state to be able to commit to respecting the property of private industry, which much current literature tends to see as the *sine qua non* of economic growth. Yet institutions for growth, based in part on private accumulation, seem nonetheless to have arisen."

They contend that what economists traditionally see as wrong institutions sometimes "engender growth," and that high-growth countries have widely varied formal institutions. This seeming conflict may be better explained as having occurred as a result of economic evolution, rather than formal developmental planning.

We believe that, if an evolutionary theory indeed explains the differential growth rates of various economies, it must be because different nations have gone through different paths of institutional evolution or are in different stages of the same path. In light of the similar political histories that characterized the aforementioned nations in the past half century, however, the first explanation seems to be more plausible than the second one.

Indeed, there is a school of development thought based in economic geography that has its roots in Darwinian Evolution. In this vein of thought, countries develop their own evolutionary path based on past inheritances. They are dependent on this path, with its habits, rules, norms, heredity and continuity. New paths spring forth either from crisis or innovation (Boschma & Lambooy, 1999; Martin & Sunley, 2006; Hodgson, 2004; MacKinnon *et al,* 2009).

Based on this school of thought, different economies might have fared differently in recovering from a recession or catastrophic decline, not necessarily because they were in different stages of the common type of institutional evolution but because each country has followed a unique path defined by its own habits, rules, norms, heredity and continuity.

Continuous Evolution or Disruptive Evolution?

Even if we grant that each country would follow a unique path to develop its institutions, there is no guarantee that such an evolution process would be smooth and continuous. Disruption could be caused by a nation-specific or regional financial crisis (e.g. the Asian Financial Crisis in 1997), a major economic downturn (e.g. the Great Depression in 1930s), a major war between two countries (e.g. the eight-year war between China and Japan in 1937-1945), or a catastrophic terrorist action (e.g. the 9/11 attacks). Although the scope of the disruption caused by different events might vary widely, inevitably a nation's economic institutions would feel the pressure for change.

If institutions are globally imposed and exogenous to a country's own development path, social choices are preempted, which might have developed more effective ones. This mono-cropping of institutions "reduces incentives for states and citizens to build choice-making institutions, and therefore diminishes the likelihood that such institutions will emerge." (Dunning and Pop-Eleches, 2004; Evans, 1995) As the pace of globalization accelerated in early 21st century, this seems to be increasingly the case.

We posit that, so long as a nation can maintain steady economic growth, the government is likely to stick to the dominant mode of governance currently used, whether it is the rule of law or control of corruption. Nevertheless, when an economy suffers from a decline due to the failure of its current mode of governance in weathering a local or global disruption, it is likely to shift to the other direction in order to restore the trajectory of growth.

The next question is: Which way is likely to be the direction of the shift when the economic growth is disrupted? Theoretically, the shift could occur either way. When a country is already depending on the rule of law to maintain the economic order, a major crisis could force the government to temporarily take unorthodox measures to control the problem. Conversely, when a sophisticated formal system of laws is not in place yet and the nation has relied on one or a few strong leaders to reduce corruption, an economic downturn could push the government toward the development of a more comprehensive and enforceable formal legal system to contain corruption.

In the long run, however, the rule of law will more likely ensure more sustainable economic stability if not economic growth. That is the reason why all the developed economies in the world today are relying on the rule of law to maintain equitable and fair economic transactions.

The Role of Credibility in Moderating Uncertainty

Whether we consider the rule of law or control of corruption as a means to reduce uncertainty for market transactions, credibility of the government is always a key denominator.

Although uncertainty is universally present in every country or region, the level of governmental credibility has never been uniform across different nations. In other words, despite the fundamental mission of every government to help reduce uncertainty for its constituents, how effective a government is in accomplishing such a mission depends heavily upon its creditability in the eyes of its people.

Obviously, an honest government gains more credibility, thereby reducing the uncertainty experienced by all participants of the economy. Nonetheless, what if we are certain the government always lies? Can the certainty of a dishonest government lead to more uncertainty? Indeed, if the rule of law is not followed and the government plays favoritism, we are reduced to guessing who will be the favored or disfavored instead of being certain of outcomes. Then, the economic act becomes a greater gamble for all players in the market. In this section we will discuss the dynamics of the interplay of credibility and uncertainty.

Informed by decades of researchers[v], both Henisz (2000) and Sumner and Williams (2010) remind us that uncertainty can have profoundly negative impacts on markets. Henisz focused on economic reforms in developing economies, specifically on the idea of "credible and non-credible reforms." Sumner and Williams focused on the importance of "hard" as opposed to "fuzzy" contracts in the context of a developed country which was taking a step backwards institutionally, to a lower level of legal certainty. Both described the impact of arbitrariness as leading to higher hurdle rates in investment, which leads to decreased investment, and derivatively, to lower GDP or GDP growth.

It is important to the conclusions of this paper to understand the logic that increased uncertainty is a mathematically provable cause of slowed economic investment and growth. This fact is not up for debate. The logic for arriving at this conclusion rests in asset valuation methodologies whereby future cash flows are discounted using a hurdle rate, or required rate of return. To further illustrate, suppose we have two possible institutional extremes:

Credible and Certain = Hereinafter referenced as "CC, " this is an institutional environment wherein market participants have strong degree of certainty in institutional outcomes, such as promises made by the government as to future institutional reforms or the solidity of the rule of law.

Non-credible and Uncertain = Hereinafter referenced as "NCU," this is an institutional environment wherein market participants face a strong degree of uncertainty in institutional outcomes, such as promises made by the government as to future institutional reforms or the solidity of the rule of law.

The present value of an individual contract in assuming *CC* institutions is found to be:

$$PV = \sum_{i=1}^{n} \eta_i \, / \, (1 + r)^i$$

where ηi = the payment received in time period i

r = hurdle rate or required rate of return on an investment with CC institutions

n = the total number of payments

PV = the value today of the contract.

Finding the value of a contract (PV_{ncu}) when institutional conditions are *NCU* would follow a similar logic, but would additionally involve a risk premium (ϱ), which is added to the hurdle rate

$$PV_{ncu} = \sum_{i=1}^{n} \eta_i \, / \, (1 + (r + \varrho))^i$$

Logically (r + ϱ) is greater than (r) when $\varrho > 0$, therefore the individual contract PV_{ncu} is worth less than the individual contract PV.

Summing all contracts in the economy, we can show

$$\sum_{j=1}^{q} \sum_{i=1}^{n} \eta_{ij} \, / \, (1 + (r + \varrho))^i < \sum_{j=1}^{q} \sum_{i=1}^{n} \eta_{ij} \, / \, (1 + r)^i$$

simplified to be

$$\sum_{j=1}^{q} (PV_{ncu})_j < \sum_{j=1}^{q} PV_j$$

where q = quantity of contracts in the country's economy.

Thus, NCU institutions result in a lower total present value today than CC institutions. Since in Net Present Value analysis the total value of the future cash inflows from a contract is compared with the original cost of the investment, lower valued contracts have a lower likelihood of being accepted for investment.

According to Henisz (2000), "these effects will be strongest for large sunk investments whose returns are spread over an extended period such as infrastructure or new technology. These are precisely the types of investments typically identified by economists and policy makers as central to the economic development or growth process."

The Role of Credibility in Moderating Rent-Seeking

In addition to the above impact of uncertainty on investment, Giertz and Feldman (2012) point out in a study of uncertain tax policy that whenever there is uncertainty as to outcomes, market participants engage in rent-seeking.

Exactly why increased rent-seeking should be an problem for society has been and could be the subject for much discussion (and indeed, further research) in the areas of ethics, sustainability (wherein rent-seeking represents an unproductive use of resources), or temporal resource allocation study (where such behaviors could possibly result in sequential stages of greater and greater inefficiency). But our focus here is on the impact of uncertainty on development and investment.

In keeping with this focus, we show that rent-seeking is costly and by inference slows the rate of growth of participants. This can be demonstrated by using simple and inelegant mathematics, as illustrated below.

To begin, this connection between rent seeking and economic growth can be shown, *ceteris paribus*, by remembering that after tax profit (π) is equal to the difference between revenues (r) and costs (c), which by our definition include the cost of taxes, or

$$\pi = r - c$$

and

$$p = \pi / r$$

where p is the profit margin.

Company growth can be shown to be a function of both profit and profit margin as follows:

Let C_a = costs to a market enterprise with the absence of necessary rent seeking
C_b = costs to a market enterprise with the presence of necessary rent seeking
$C_b = c + s$
where s = the cost of rent seeking.

Therefore
$C_a < C_b$ where $s > 0$.

It then follows that
$\pi_a > \pi_b$
and
$p_a > p_b$.

The value of an enterprise can be represented by the present value of the sum of all future after-tax cash flows[vi]. The sum of all future after tax cash flows (SFCF):

$$SFCF = \sum_{i=1}^{n} CF_i$$

and

$$\sum_{i=1}^{n} CF_i = \sum_{i=1}^{n} (\pi_i + ncc_i)$$

where
CF_i = cash flows in year i
ncc_i = non-cash charges in year i
Since
$\pi_a > \pi_b$
it then follows that
$SFCF_a > SFCF_b$

The sum of these future cash flows (SFCF) must eventually either end up as payments to ownership (d) or to development/expansion (x) of the business entity. And since we assume that, *ceteris paribus*, the amount that is required by owners as payments in the form of dividends or withdrawals would be the same under either condition a or b[vii], we can conclude that there will be more business expansion or development under condition a (a state of greater certainty, requiring less rent seeking expenditure) as shown:

$$x_a = SFCF_a - d$$

and

$$x_b = SFCF_b - d$$

Logically, therefore

$$x_a > x_b.$$

Additionally, the greater the profit margin (p), the greater the probability that owners or lenders will provide funds for future expansion.

Conclusion

Perfect certainty in economic decision-making is impossible, due to the random nature of the world where business is transacted. Due to the mathematical relationship between the level of risk and the NPV of an investment, however, anything that reduces uncertainty provides a greater possibility of economic expansion and investment, *ceteris paribus*. Additionally, economic actors may engage in rent-seeking behavior, which also has deleterious effects on economic growth.

Rule of law has value because it lowers uncertainty. Economic actors know the legal consequences of their actions and can therefore plan with certainty in at least this one aspect of their existence. The reverse is also true. Lack of certainty, due to a lack of rule of law, or due to the presence of corruption, or due to a lack of credibility of government, can have a damaging effect on economic growth.

A quick glance at the history of economic development in many countries seems to indicate that the transition to an economy fully governed by the rule of law is rarely smooth.

Catastrophic disruptions, caused by political turmoil or financial crises, may either create an opportunity for the national leaders to seize extraordinary power for their personal gains or force the government to temporarily take unconstitutional actions in order to bring things back under control. What happened in the Philippines, China, and other developing economies suggests that it is indeed possible for a country where the rule of law has not taken root to enjoy some economic growth for a number of years. In the long run, however, sustainable economic growth can be achieved only through the credibility and certainty ensured by the rule of law.

This fact has long had acceptance in the economic development literature, but it is important for policy-makers in developed countries to remember this as well. Inasmuch as economic growth may stall in developing countries where there is corruption, a developed country where there is a rise in corruption or a failure of the rule of law may also face serious consequences in its economic outlook, as economic actors cut back investment and increase rent-seeking activity.

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[i]SeeGwartney and Lawson (2003).

[ii]Special thanks to K.S. Yeh, former Minister of Transportation and Communications for Taiwan, and former professor at National Sun Yat-sen University for sharing his expertise in this area.

[iii]SeeRadelet (2010) for furtherreading on thissubject.

[iv] The authorswouldlike to thank Sandra Feustel Koch for valuablecomments and contributions to this discussion.

[v] It is standard fare of financialanalysistextsthat the economicactorseeks to reduceuncertainty and thatuncertaintyreducesinvestment….For additional background reading, a few recenttexts out of manysuitableincludeGitman (2012), Madura (2012).

[vi]The fact that an enterprise can valued by finding the present value of all future after-tax cash flows is standard reading for students of Business Finance. For additional background reading, see Gitman (2012), Madura (2012) or many other current texts in the field.

[vii] If wewere to assume thatdividendrequirements of ownersdifferedbetween the two states, itcouldbearguedthatownerswouldrequiregreaterpayouts, not lesserones, whenthereis a higher state of uncertainty. This wouldalso have the effect of limiting the fundsavailable for expansion for the firm.