

Law and economy

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Summary:

Economic development is not a sure thing. A strong institutional and legal framework is required for the development of economic activity. Indeed, the creator of wealth will only undertake a project if he is certain to achieve returns on his investment.

Some economic history theorists focus on the role that institutions play in economic development. Their analyses show that institutions can have an influence on the costs and the benefits of thievery or cooperation. For example, when the law punishes theft, the thief's gain expectancy decreases, thus increasing the attractiveness of production. So economic development is closely related to institutions protecting private property. The institutions' evolution differences on an international scale make some economist historians suggest that the cause for the industrial revolution was a more stable institutional framework for some countries compared to others and thus guaranteeing well-defined legal rights to entrepreneurs.

The study of development differences permits a deeper comprehension of the link between institutions and economic growth. Institutions' credibility is fundamental to keep mistrust and transaction costs low. For example, a title deed issued by a recognized and credible administration will save the buyer time and money to check the seller's integrity. Thus, credible institutions are not only guaranteeing an outcome to the entrepreneurs' efforts, but also facilitating trades, loans or investments.

In this context, the lawyer plays a major role. He interlinks law and institutions to the creators of wealth. In case of a dispute, he represents his client in Court, which enables the latter to spend his time in his specialty field. More importantly, when the lawyer draws up contracts or gives advices to the entrepreneurs, he establishes the transition from a general legal framework to the smaller contractual one, which is more adapted to the individual cases. Thus, by being the link between entrepreneurs and institutions, the lawyer takes part in the institutional environment's stability required by the development of new projects.

Institutions and development

As it will be shown below, law is fundamental to the economic prosperity of a country. Thus, the institutional framework, which ensures the compliance with law, is a central topic when it comes to studies about economic growth. Even if the lawyer does not necessarily seem to be in a position to influence the institutions, his activity is however important for the prosperity of business as he creates the junction between law and entrepreneurs.

Some economic historians, such as Nobel Prize Laureate Douglass North, suggest a strong correlation between the level of development and the quality of institutions.¹ Only institutions guaranteeing the cooperation between the individuals and ensuring the compliance with their respective rights can create a climate of confidence leading to new projects and contributing to economic growth.

“Game theory” analyzes the strictly rational behavior of individuals facing situations where several strategies can be chosen. It can illustrate how institutions have an influence on economic activity. Imagine that two individuals are able to produce two units of goods per day; this means one unit per half a day. At noon, they can decide whether to produce an additional unit or to prepare the theft of the daily production of their neighbor.

The different options that the two individuals are facing and their results are shown in table 1. For example, if A chooses to rob B, while B takes advantage of his afternoon to increase his production, the thief gets three units (the one he produced in the morning and the two additional stolen ones) and the entrepreneur gets nothing. The result is shown in the top right box.

Individual B Individual A	Theft	Production
Theft	1 \ 1	3 \ 0
Production	0 \ 3	2 \ 2

Table 1: without punishment of theft

When analyzing the chart, one realizes that theft is the best choice to make whatever decision the other individual takes. If B prepares a theft, A should do the same, if he doesn't want to end up with nothing. If B chooses to produce one more unit, A should still privilege the robbery, so that he ends up with three units instead of two. Bottom line, both individuals would steal from each other and get only one unit, instead of producing two each. Obviously, the chosen time frame of half a day for this example is somehow arbitrary. Nevertheless, this is the kind of calculation of risk and of profit expectancy that thieves make when deciding what to do.

Now let's imagine a situation where theft is punished by law. The thief has to give back the loot and is forced to pay the proceeding costs. In this case, the table of benefits would change and each one would be better off producing two units a day. Both individuals would be in a more comfortable situation and global production would increase.

¹ Douglass C. North, *Prize Lecture*, December 9th, 1993. Available online under this link:

http://nobelprize.org/nobel_prizes/economics/laureates/1993/north-lecture.html

According to North, the Western institutions have evolved faster than elsewhere, in a way that changed the costs and benefits ratio and encouraged the individuals to cooperate with each other. This way, he explains why the industrial revolution remained geographically limited.

Individual B Individual A	Theft	Production
Theft	0 \ 0	0 \ 2
Production	2 \ 0	2 \ 2

Table 2: With punishment of theft

The relevance of the institutions is still being studied today, particularly with regards to development gaps between the various regions worldwide. According to the Peruvian economist Hernando de Soto, the lack of recognition and protection of property rights in the Southern countries is one of the reasons for the scarce development in this part of the world.²

De Soto explains that in addition to the guarantee of being able to keep and control his production, the entrepreneur also needs to have enough capital to finance his projects, or he needs to get approval for a loan to start his business. However, loans can only be made in a stable environment, where institutions are credible and efficient. Indeed, it is important that the laws, that give rights and protection to the entrepreneurs, be also credibly guaranteed and formalized by institutions. As an example, a real property can only be mortgaged when a proper certificate is issued by a credible administration, recognized by Courts and protected by the police forces.

A country therefore needs good quality institutions in order to grow its savings by granting loans and making investments.

The major role of the lawyer

At first glance the lawyer may appear far removed from questions about institutions and regulations. Indeed, even if lawyers often belong to Commissions charged of drafting the law, they are, after all, neither responsible for their enactment nor for their aims.

However, their knowledge of the law and regulations provides non-specialists a way to save time and to get the best available protection. The lawyer takes care of legal research, judicial proceedings or represents his clients in Court, which enables the entrepreneur to have time to manage his own business.

But lawyers, especially the Legal Counsel have a more important function: they prevent conflicts by drafting agreements for individuals, which anticipate and thus solve possible disputes, which avoids time consuming proceedings and costs. Indeed, some lawyers who gather experience through trade litigation cases are able to anticipate potential disputes and they know how to prevent them more easily. Thus, these tailor-made drafted agreements provide the customer with a customized contractual framework, which the law as such cannot supply.

² Hernando De Soto, *Why Capitalism Works in the West but Not Elsewhere*, *International Herald Tribune*, January 5th, 2001. Available online under this link: http://www.cato.org/pub_display.php?pub_id=5182

Therefore, even if the lawyer cannot change the law, his knowledge of the latter and his experience make him a major player in the resolution or prevention of conflicts. He enables the entrepreneurs to assert their rights and establishes the fundamental link between them and the institutions. He thus contributes to the stability of the institutional environment, on which entrepreneurs rely to develop their projects.