

ECONOMIC UNCERTAINTY AND THE ROLE OF THE COURTS

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This Article addresses economic uncertainty and the role of institutions in securing property rights. We know a lot more about the former than we do about the latter. That is to say, we know about the effects of uncertainty, especially uncertainty about property rights, on the economy.¹ We know less about the extent to which institutional arrangements can guarantee security of property and less still about whether they can create secure property rights where such rights do not already exist.

There are very strong theoretical reasons to believe that property rights are a first-order determinant of the health of the economy. Adam Smith linked investment and growth to the security of property.² It also seems reasonably clear that the security of property rights is connected to the structure of government. When we compare societies around the world with despotic governments to those with limited governments, the latter usually have better property rights and are usually more prosperous.³ Examples include the Netherlands before and after independence from Spain in the seventeenth century⁴ and Zimbabwe and Botswana today.⁵

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1. See, e.g., Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. LEGAL STUD. 503 (2001); Stewart E. Stark, *Property Rules, Liability Rules, and Uncertainty About Property Rights*, 106 MICH. L. REV. 1285 (2008).

2. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 294–301 (Edwin Cannan ed., 1976) (1776).

3. See Manuel Vega-Gordillo & José L. Álvarez-Arce, *Economic Growth and Freedom: A Causality Study*, 23 CATO J. 199 (2003).

4. MAARTEN PRAK, *THE DUTCH REPUBLIC IN THE SEVENTEENTH CENTURY: THE GOLDEN AGE* 2, 4 (Diane Webb trans., 2005).

5. See, e.g., ATO KWAMENA ONOMA, *THE POLITICS OF PROPERTY RIGHTS INSTITUTIONS IN AFRICA* 1–60 (2010); John McClung Nading, *Property Under Siege: The Legality of Land Reform in Zimbabwe*, 16 EMORY INT'L L. REV. 737, 765–74 (2002) (discussing property rights in Zimbabwe).

We can look at the question more systematically, and many scholars have set out to do just that.⁶ I will accordingly draw on a large body of work to which many scholars have contributed.

A simple starting point is whether, in the world today, the security of property rights is associated with economic prosperity. We cannot answer that question, however, from the statute books alone. In general, non-Communist countries have formal protections for property rights. Even if the formal rules about property are the same in Luxembourg and Paraguay, however, most observers would share the intuition that property is more secure in Luxembourg.

In addition, I must use the term “property rights” loosely because there are many things a government can do to interfere with property rights besides outright theft. It can regulate to the extent that property can no longer be used profitably.⁷ It can devalue the currency to the point where paper assets become worthless. It can allow politically favored entities to play by different rules than everyone else. Thus, I will use the terms “property rights” and “economic freedom” to refer broadly to the absence of those forms of interference.

Various organizations and scholars try to measure the de facto security of property rights. Companies like Political Risk Services create survey-based measures for private sector clients who invest abroad.⁸ The Heritage Foundation calculates an index of economic freedom that incorporates some of the above forms of interference with property rights.⁹ In general, economic freedom scores correlate quite strongly with economic prosperity.¹⁰ Interestingly, the correlation between prosperity and economic freedom is even stronger than that between prosperity and measures of political freedoms.¹¹

6. *E.g.*, Stark, *supra* note 1.

7. *See* Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992).

8. Economists Stephen Knack and Philip Keefer popularized the use of the PRS measures. *See* Stephen Knack & Philip Keefer, *Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures*, 7 *ECON. & POL.* 207 (1995).

9. *See* TERRY MILLER & KIM R. HOLMES, HERITAGE FOUND., 2011 INDEX OF ECONOMIC FREEDOM (2011), *available at* www.heritage.org/index.

10. *Id.*

11. *See* ROBERT J. BARRO, DETERMINANTS OF ECONOMIC GROWTH: A CROSS-COUNTRY EMPIRICAL STUDY 49–61 (1997).

Compare, for instance, Morocco and Singapore. Both have parliamentary governments,¹² and both governments are somewhat intolerant of dissent.¹³ The two countries have identical scores on Freedom House's Indexes of Political Rights and Civil Liberties, two of the most common measures of political freedom.¹⁴ Singapore, however, scores much higher than Morocco on the Heritage Foundation's index of economic freedom.¹⁵ Singapore is a much wealthier country. Indeed, its per capita GDP is more than ten times that of Morocco.¹⁶

But why does Singapore, which has a similar level of political freedom, have more secure property rights than Morocco, or, for that matter, Italy?¹⁷ More importantly, could Morocco become as wealthy as Singapore by altering its governmental structure in a way that would limit its ability to interfere with property and other economic rights?

One traditional answer, given by Montesquieu, is to constrain governmental power through institutions such as federalism or an independent judiciary.¹⁸ Governments always are tempted to interfere with property rights and other economic freedoms for temporary political advantage, even at the cost of long-term harm to the economy. Greater constraints on the government make such interference less feasible and reduce

12. See CIA, *Morocco*, WORLD FACTBOOK (Oct. 24, 2011), <https://www.cia.gov/library/publications/the-world-factbook/geos/mo.html>; CIA, *Singapore*, WORLD FACTBOOK (Oct. 21, 2011), <https://www.cia.gov/library/publications/the-world-factbook/geos/sn.html>.

13. See, e.g., Susan Waltz & Lindsay Benstead, *When the Time is Ripe: The Struggle to Create an Institutional Culture of Human Rights in Morocco*, in HUMAN RIGHTS IN THE ARAB WORLD: INDEPENDENT VOICES 174 (Anthony Chase & Amr Mzawy eds., 2006); Seth Mydans, *Outspoken Singapore Dissident Dies*, N.Y. TIMES, Sept. 30, 2008, <http://www.nytimes.com/2008/09/30/world/asia/30iht-obits.2.16585582.html>.

14. See FREEDOM HOUSE, FREEDOM IN THE WORLD 2011 14–15, http://www.freedomhouse.org/images/File/fiw/FIW_2011_Booklet.pdf (last visited Nov. 17, 2011).

15. See 2011 *Index of Economic Freedom World Rankings: Ranking the Countries*, HERITAGE FOUND., <http://www.heritage.org/index/ranking> (last visited Nov. 1, 2011) (ranking Singapore the second and Morocco the ninety-third most free countries in the world).

16. See, *GDP per Capita*, WORLD BANK, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD> (last visited Nov. 1, 2011).

17. See 2011 *Index of Economic Freedom*, *supra* note 15 (ranking Italy the eighty-seventh most free country).

18. See CHARLES DE SECONDAT, BARON DE MONTESQUIEU, *THE SPIRIT OF LAWS* 80 (Anne M. Cohler et al. eds., 1989) (1748).

the likelihood of government capture.¹⁹ Broadly speaking, that is the story we tell ourselves about the Framers. They wisely set up a government with many checks and balances that limit the federal government's ability to interfere with property and contract rights.²⁰

A piece of anecdotal evidence for the governmental constraint theory is the difference between England and France in the early eighteenth century. After the Glorious Revolution, England's monarchy was considerably more constrained than the monarchy of the Sun King and his Bourbon successors in France.²¹ During that period, England developed robust financial markets, improved its commercial markets, and moved ahead economically while France fell behind.²²

There is, however, an alternative view of the history which holds that the causation runs the other way. Societies do not respect property rights and become rich because they have constrained government; rather, they constrain government and secure property rights because they are rich.²³ Once people accumulate property and insist on a less intrusive and predatory government, their growing prosperity makes it possible for them to get their way.²⁴

A piece of anecdotal evidence for the theory that prosperity leads to constrained government is the Korean Peninsula.²⁵ Before the partition of Korea, when the country was under a single government, the North and South had similar levels of economic development.²⁶ After the Korean War, the country was

19. See J. Bradford De Long & Andrei Shleifer, *Princes and Merchants: European City Growth Before the Industrial Revolution*, 36 J.L. & ECON. 673–74 (1993) (considering evidence from pre-industrial Europe and finding that economic development, proxied by the growth of cities, where large-scale exchange took place, was greater in areas with less absolutist government).

20. See Barry R. Weingast, *The Constitutional Dilemma of Economic Liberty*, J. ECON. PERSPECTIVES 2005, at 89, 89–91.

21. See DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 138–39 (1990).

22. *Id.*

23. A careful statement of this hypothesis with supporting empirical results is Edward L. Glaeser et al., *Do Institutions Cause Growth?*, 9 J. ECON. GROWTH 271 (2004).

24. In political science, this theory is commonly known as modernization theory. See, e.g., Seymour Martin Lipset, *Some Social Requisites of Democracy: Economic Development and Political Legitimacy*, 53 AM. POL. SCI. REV. 69, 81–82 (1959)

25. See Glaeser et al., *supra* note 23, at 272–73.

26. *Id.*

partitioned into North and South Korea, and both initially were ruled by autocrats.²⁷ But the North's autocrat decided to pursue socialism, while the South's autocrat chose to pursue a market economy.²⁸ The South grew prosperous and the North grew impoverished.²⁹ Eventually, the citizens of South Korea no longer accepted autocratic rule and created a more limited form of democratic government.³⁰

Those two stories have different implications for how a country can go from low to high security of property and from poverty to wealth. The first suggests that you must tie Leviathan down to create prosperity. The second suggests that you must be lucky enough to have the right Leviathan, or at least persuade Leviathan to adopt pro-growth policies, and eventually you will get limited government in the bargain.

My argument so far has relied on anecdotal evidence. Scholars have looked hard for systematic evidence, but unfortunately it is not conclusive. There is an important body of evidence to support the "constraining government causes prosperity" hypothesis. If we compare countries around the world, there are quite systematic differences between those that were colonized by England and those that were colonized by France, Spain, or other continental powers.³¹

In particular, former English colonies tend to have larger and more liquid financial markets and their economies grew faster in the post-colonial period, from the 1960s to the 1990s, after controlling for the initial level of development.³² This divergence is important for two reasons. First, the English theory of government, which it transported to its colonies, stressed limited power and robust property rights.³³ The French and Spanish theory, by con-

27. *Id.*

28. *Id.*

29. *Id.*

30. *See id.*

31. *See* Mahoney, *supra* note 1.

32. *See id.*; *see also* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); *Legal Determinants of External Finance*, 52 J. Fin. 1131, 1137–38 (1997) (providing data set).

33. *See* John McLaren et al., *Property Rights in the Colonial Imagination and Experience*, in *DESPOTIC DOMINION: PROPERTY RIGHTS IN BRITISH SETTLER SOCIETIES* 1–21 (John McLaren et al. eds., 2005).

trast, stressed a strong central state in which the government was not so constrained in pursuing collective ends.³⁴

Second and equally important, we do not have to worry about the possibility of reverse causation. The fact that Australia is a wealthy country today did not cause England, rather than Spain or France, to colonize it.³⁵ Wealth, in those results, does not cause good institutions because it did not cause colonization. Thus, the link between past colonization and present economic success is evidence in favor of the proposition that institutional constraints cause wealth.

But a piece of evidence in favor of the “prosperity causes constraints on government” hypothesis is that many poor countries in the middle of the past century had more-or-less despotic governments. In some, like South Korea, Taiwan, and Chile, the despot chose pro-growth policies and the country became prosperous relative to its neighbors and later developed more constraints on governmental power.³⁶

In my view, the evidence itself shows that there are two common packages consisting of institutions, policy choices, and economic outcomes. One package includes constrained government, generally pro-growth policies, secure property rights, and prosperity. The other includes unconstrained government, generally anti-growth policies, low protections for property rights, and poverty. Each package is common, and in each one the institutions, policy choices, and economic outcomes are mutually reinforcing.

Mixing and matching pieces from both packages creates some tensions. China, for example, has unconstrained government but relatively pro-market policies, low but improving property rights, and increasing prosperity, starting, of course, from a very

34. See Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285, 286 (2008) (contrasting a “strategy of social control that seeks to support private market outcomes” with one that “seeks to replace such outcomes with state-desired allocations” and assigning English common law to the first and continental civil law to the second category).

35. Although it makes sense to assume for our purposes that legal origin was exogenously determined, we should recognize that colonizers did not select colonies at random. The selection was determined by the strategies of the European colonizers and the opportunities available to them. See Daniel M. Klerman et al., *Legal Origin or Colonial History?* (Univ. S. Cal. Law Sch. Law & Econ. Working Paper Series, Paper 132, 2011), available at <http://law.bepress.com/usclwps/lewp/132/>.

36. See Glaeser et al., *supra* note 23.

low level.³⁷ This package is not mutually reinforcing, and China is likely to face ongoing political conflicts despite the best efforts of its rulers to hold on to unconstrained power.

Similarly, the American system of checks and balances, federalism, and an independent judiciary does not prevent episodic interference with property rights in the United States. In recent years, the federal government has pressured creditors in the Chrysler and General Motors bankruptcies to accept less than their pre-bankruptcy entitlements,³⁸ enacted a healthcare law that requires citizens to buy insurance whether they want to at prevailing prices or not,³⁹ and played favorites with certain industry sectors or individual companies.⁴⁰ But the recent outbreaks of such interference produced a powerful popular backlash that might operate as a more potent constraint than federalism, bicameralism, or other structural barriers.

Because the literature on economic development is concerned primarily with how to help poor nations out of poverty,⁴¹ it has tended to see the demand for good policies and good institutions as always rising with the level of wealth. History certainly suggests that a country with a middle class is more likely to demand good institutions than one without it. The experience of Europe and America over the past century, however, suggests that the relation between wealth and the desire for limited government may not be linear at all portions of the graph.

In particular, once a country reaches a stage of development in which the marginal voter owns a house, a car, and a flat

37. See Eva Pils, *Waste No Land: Property, Dignity, and Growth in Urbanizing China*, 11 *ASIAN-PAC. L. & POL'Y J.* 1, 2–6 (2010).

38. Douglas Baird argues that given the federal government's role as funder of a buyer of Chrysler's assets, a secured creditor of General Motors, and a party with great leverage over other creditors because of their receipt of TARP funds, the way the bankruptcy proceedings played out was unsurprising and procedurally unobjectionable. See Douglas G. Baird, *Car Trouble* (Univ. of Chicago Law & Economics Olin Working Paper, No. 551, 2011). I do not disagree that the government exercised its leverage the way a private creditor would and in that limited, procedural sense the bankruptcies were not unusual. But it seems equally true, as David Skeel argues, that the government's decision to create and then exercise that leverage has created additional risk for private creditors in any politically sensitive industry. See David Skeel, *The Real Cost of the Auto Bailouts*, *WALL ST. J.*, June 6, 2011, at A19.

39. Patient Protection and Affordable Care Act, Pub. L. 111–148, 124 Stat. 119 (2010).

40. See Skeel, *supra* note 38.

41. See, e.g., JEFFREY SACHS, *THE END OF POVERTY* (2006).

screen TV, the marginal voter may become less interested in growth and more interested in stability. And of course, the eternal justification for larger and more powerful government is stability. Perhaps, then, paradoxically, limited government may be very popular until it produces an extremely high level of success for its society.⁴²

⁴² Hayek similarly suggests that “the very success of liberalism became the cause of its decline.” FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 23 (Univ. of Chi. Press, 1994) (1944).