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THE RULE OF LAW AND DEVELOPMENT

I. Introduction.

The object of this paper is to discuss the extent to which economic development and certain features of the rule of law are intimately related. This idea, as a general proposition, is not a novelty. In The Constitution of Liberty, F. A. Hayek takes us through the historical journey of the ideal of a "government of laws and not of men", which can be traced back to Antiquity.[1] However, the practical adoption of this ideal requires a rather detailed examination of the basic characteristics of each of the institutions, offices, and agencies that, for the most part, make or fail to make the rule of law a daily reality.

So much emphasis has been placed on the spontaneous orders of society, on the market, that the consideration of those organizations that can contribute to their most efficient operation has been left to scholars and professionals that, for the most part, are not concerned with the interrelation between the market and legal institutions.

In short, economic development is not only dependant on the rule of law, as an ideal to be widely embraced, but more concretely on the realization at every level of institutional life of the functions and actions that give actual meaning to this ideal. This might seem obvious now, but only fifteen years ago or so a private foundation, directed by very competent professionals, approached a former president of my university and asked him to prepare an economic plan for the transition to or instauration of a market economy system in a socialist country. His reply was basically that there is no way to "plan a market economy", that the market process emerges from the establishment of certain legal institutions that effectively limit or direct the decisions of public officials towards the realization of certain aims, the most important of which are, precisely, to enforce and protect property rights, contracts, and personal liberties. Together with him we ended up drafting a kind of "model constitution" for them.

Paradoxically, the rule of law has become a very powerful idea and, at the same time, a very vague one. It is probably a set of circumstances that is easier to miss than it is to actually experience. Partly this has to do with the fact that the ordinary citizen rarely has the opportunity to go through a situation where the obvious reflection would be: "thank God for the rule of law". Beyond a car accident or a claim for invalid telephone or credit card charges, the ordinary citizen rarely becomes familiar with governmental agencies or the court system in any substantial way.

I think this is true even in countries where the rule of law is one of the principles expressly declared to be the basis of the political and legal systems and is widely proclaimed in political discourse, although it might not be fully operative. However, in places where the rule of law is hardly more than a mere appearance or where it does not transcend from the formal to the substantial level, everyone, perhaps with the exception of the wealthy and powerful, suffers from the absence of the rule of law. They are frequently exposed to be the victims of arbitrary decisions on behalf of governmental

[1] *The Constitution of Liberty,* Routledge, London 1960.

agencies, or are likely to have to "bribe there way out" of situations that need not be a problem, but for a civil servant that chooses to make one, because he has sufficient discretionary power.

In order to move from the mainly rhetorical and formal promulgation of the rule of law to a more meaningful situation it is indispensable to adopt a series of measures, many of which are often unpopular. Thus, in what follows I will try to briefly discuss the specific areas where the ideal of the rule of law must become a concrete realization and, very succinctly, how this could come to happen. Unless developing countries in general move from the abstract adoption of the ideal of the rule of law to its concrete realization, their path to development will be longer and more complex. The twenty first century may or may not be "their century" depending largely on this question.

II. *Some of the issues.*

It is difficult to exaggerate the levels of frustration that the ordinary citizen faces in countries where the rule of law is mostly superficial formality or appearance. Even something as basic as getting a driver's license can become a nightmare. Should one be the victim of a robbery, the most practical and "safe" thing to do might be to just turn the page and forget about the incident. Getting a simple contract enforced may well take up to four or five years and property rights of all sorts are constantly vulnerable to unexpected threats or usurpations. Credit is, thus, expensive and banks have to hedge their risks demanding collateral in excess of what would be required but for the feebleness of the court system. In the informal sector the means of collection of debts are frequently associated with illegal coercion or outright violence.

The tax code is constantly undergoing amendments in order to cope with the creativity of tax lawyers and CPA firms. Tax inspectors are thus prone to question almost anything that might possibly be characterized as being subject to taxation. Time and time again the same matters are discussed before the tax courts. Loopholes generally hinge on formalistic interpretations partly because the court system is also used to perform Byzantine dissections that seldom go to the essence of the question.

In connection with this, medium and small size business firms are often faced with the choice of being competitive or paying taxes. Not only smuggled products or counterfeit merchandise, but the impossibility to meet the terms and conditions of their competitors that have opted partially or totally out of the system, coupled with the inability of tax authorities to bring latter back in, drags them in the same direction. The response of lawmakers is often times yet another amendment to the tax code, increasing the tax burden for the ever fewer firms that remain in the formal sector of the economy.

Public officials are frequently of the view that a "good idea" must be "legal". Thus, public procurement regulations and administrative procedures are considered an obstacle rather than the normal way to do things. Public procurement procedures usually take long and are frequently the object of administrative appeals based, again, on formalities of secondary importance. At the end of the day, the head of the department or agency involved comes to realize that his or her projects will most probably fail to even get started, should the legal proceedings be observed. Another quest for loopholes begins.

Once the fundamental decision to have a "government of laws and not of men" is adopted, the issues are basically three:

1. How to put the right incentives in place;
2. How to get and maintain a professional team; and
3. How to get the team to deal with the substance of each matter.

III. ***Consensus at a global level.***

It is only very recently that multilateral organizations and agencies such as the World Bank have looked at the specific institutions and processes that make the rule of law a "pedestrian reality". I am not aware of any other prior comprehensive study and publication made by them of the nature of the series *Doing Business in 2004 Understanding Regulation; Doing Business in 2005 Removing Obstacles to Growth; and Doing Business in 2006 Creating Jobs,* conducted by the World Bank, and I think that the width and depth of these projects reflect that public policy experts, economists, advisors, and so forth have only fairly recently arrived at a consensus that legal institutions of this sort are not a given and are critical in order to achieve economic development. [2]

I have reported elsewhere, to the *Association Henri Capitant des Amis de la Culture Juridique Française,* that, in my opinion, these studies do not grasp the essence of the so called *Civil Law* system in a number of ways, thereby criticizing a series of aspects that I would characterize as accidental, but not essential or connatural to this legal tradition. But the point that deserves attention here is that there is growing recognition that the efficient operation of the basic legal institutions related to the rule of law is as relevant to economic development as the establishment of sound macroeconomic policies. Moreover, the latter cannot possibly be successful in the absence of the former.

This should not be very difficult to demonstrate since, in general, monetary and fiscal stability require a number of legal sub-systems to work. If one considers, for example, the banking system of any country it is clear that the absence of adequate mechanisms to enforce regulations aimed at providing for transparency; on the one hand, and for the enforcement of contracts, on the other, will be inefficient. It is difficult to imagine a sound financial system where the banking community does not adhere to accounting practices that might allow economic agents to choose to do business with one bank or another. To achieve this it is not sufficient to mandate the use, on a consistent basis, of a certain set of accounting principles and periodic reporting of financial statements, prepared on the basis of such principles. Additionally, it is

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[2] A publication of *The International Bank for Reconstruction and Development / The World Bank*
As a matter of fact, in the preface to Understanding Regulation; (P. viii), it is noted that: "Although macro policies are unquestionably important, there is a growing consensus that the quality of business regulation and the institutions that enforce it are a major determinant of prosperity. Hong Kong (China)'s economic success, Botswana's stellar growth performance, and Hungary's smooth transition experience have all been stimulated by a good regulatory environment. But little research has measured specific aspects of regulation and analyzed their impact on economic outcomes such as productivity, investment, informality, corruption, unemployment, and poverty. The lack of systematic knowledge prevents policymakers from assessing how gook legal and regulatory systems are and determining what to reform.

necessary to make sure that in practice banks and other financial institutions actually observe their application. But in order to assess the real value of the assets of banks and other financial institutions, for example, it is necessary to consider whether those assets are supported by an efficient court system and other related agencies, if or when it might become necessary to take legal action against those liable to pay the loans.

Put in other words, things such as inflation may be under control at any given point in time, but the cost of getting a loan may be much higher than it should be for any entrepreneur in a situation where the banks in general need to incorporate in the rates of interest they charge for loans, the inefficiencies of the court system. Moreover, it is doubtful that an economy with high financial costs may be stable in the long run; much less successful.

Something similar may occur regarding budgetary stability. The ability to collect taxes depends on mainly two factors: (1) reasonable and realistic tax rates; and (2) efficient systems to collect them. When tax receipts diminish or fail to grow sufficiently to support pressing budgetary conditions, it is not realistic to just consider a further increase in tax rates. First, because of the political costs of doing so, but more importantly because those business firms that are operating at marginal levels would most probably be forced either to move to the informal sector of the economy or to close shop. Tax receipts would, in both cases, diminish even further. Thus, in this type of circumstances, the Government can only move in one of two directions: incurring more public debt (thereby potentially affecting fiscal and monetary stability), or becoming a better tax collector. This, again, requires a number of legal institutions to function professionally: tax inspectors, tax tribunals, and the court system in general.

The reasonableness and realism of tax rates is a simplified way to describe the characteristics that the tax code, or the tax legislation, requires in order to work well. We will touch on this later as well as on some of the elements that allow for the fruitful organization of functional institutions. For the time being it suffices to restate that the causal relationship between: (1) the sets of rules that, consistently applied, by serious institutions, make the ideal of the rule of law a day to day reality; and (2) economic development, has become clearer in several important ways.

IV. *The political arena.*

At the level of the political arena, there seems to be sometimes a sort of schizophrenia: although political leaders constantly proclaim their convictions that the rule of law must be observed as a general principle of public life, however, when it comes to choosing, for example, between the creation of ten more courts or building a new airport, they go for the airport.

This may be attributed to a combination of several factors, including a certain degree of ignorance of the interrelation between the operation of the market and the efficacy of certain institutions, such as the courts in this example. The causal relation between a more efficient apparatus in order to support the protection of property rights and contractual arrangements, on the one hand, and economic development, on the other, is not intuitive and not immediately noticeable.

But there is also the public choice side of the problem: in the time frame within which political agents need to compare the costs and benefits of giving their support for each option –the new courts or the airport— it is probable that the latter reports greater political profits (because the benefits to their constituencies are more immediate in time and do not depend on further future decisions and actions by still other political agents).

Therefore, even where a number of political leaders have become knowledgeable about the mid to long term beneficial consequences that follow from the articulation of a sound set of rules and the establishment of strong and efficient public institutions that work to support the better operation of markets, it may still be rational for the political leaders to choose the courts over the airport. Of course, in real life all decisions are made marginally and thus, to the extent possible, this should be viewed in terms of the sacrifice of “x” units of courts for “y” units of airport.

In the same general context that I am discussing here, special interest groups (private or otherwise) often prefer to lobby for projects that purport more short term benefits for the political leadership (a new airport), rather than others whose benefits depend on a chain of future decisions or choices that may or may not be made as required.[3] The two options (the courts and the airport) might be of interest to a group of firms that export perishable products, understanding that, in the long run, their investments will be better protected by impartial and fair judges. At the same time, they cannot fail to consider the risk that once the courts are established, some five years down the road their powers might become restricted or their resources insufficient.

In addition to the kind of problems mentioned above, there is the issue of the conflicts of interest. This is that, in general, a professional police force, a well organized office for the prosecution of legal infringements, together with a good working court system, will result –among other things— in greater accountability on behalf of the political agents. Thus, a wide range of problems ranging from the negligent use of public money to plain acts of corruption and other related crimes, naturally come under closer scrutiny and stricter control. It is only logical that those potentially liable for these legal violations will not be prone to support the strengthening of the offices or agencies in charge of applying the law.

Therefore, the facts that (a) the causal relation between good working basic legal institutions, indispensable in order to support the appropriate operation of a market economy, and economic development are not immediately apparent or intuitive; and (b) that even where the connection has been understood, it is often times not profitable for the political agents or for special interest groups to use resources to favor this type of institutions –or perhaps even contrary to their short term interests. This calls for considering the role of constitutional rules in order to sort these problems out.

Where the rules of the constitution effectively constrain the ability of political agents to maximize their political profits (in terms of votes or support for future votes) in the short term, at the cost of long term projects or objectives, the risks of excessive strategic behavior on their behalf diminish.

[3] Brennan, Geoffrey and Buchanan, James M., *The Reason of Rules,* The Collected Works of James M. Buchanan, Chapter 5: “Time, Temptation, and the Constrained Future”. Liberty Fund Inc., 2000; Cambridge University Press, 1985.

In this connection there are two aspects that require specific attention: 1) priority; and 2) substantive powers. Constitutional rules must require that, in the process of allocating resources through the preparation and approval of the budget (at every level of government), those in charge must determine that the institutions that make the rule of law a living reality have been assigned the necessary resources in order to operate independently and effectively, before resources are allocated for other programs and agencies. Which are these institutions? This obviously depends on certain characteristics of the constitution since, for example, large federal states will and need not replicate at every level of government the same type of departments and agencies. However, one can think of a matrix where there are basically three sets of rules that could be the object of infringement, namely: Civil/Commercial Law; Criminal Law; and Constitutional/Administrative Law. Further, there can be two types of actions, depending on the nature of the infringement and the rules infringed: Private Action; and Public Action. This refers to whether one or more single individuals or private organizations can or should promote the appropriate legal proceedings. Since this is generally costly, it is clear that, as a general rule, a private party will only undertake the exercise of a legal action where it expects that, one way or another, it will recover these costs.

This matrix can be made more complex in order to show whether any legal action may be exercised both by a private party and a governmental official or whether it is exclusive of either. It can also be made to show aspects such as the nature of the consequences of the infringement, namely: mainly punitive (time in prison; prohibition to practice a profession, etc.) and/or compensatory (redress for damages, a contractual indemnification, etc.). However, it is important to understand that any and every aspect of a matrix like this does not necessarily imply that, in general, the legal system is structured such that property rights can be clearly defined, easily exchanged, and effectively protected. The substance of the rules may leave more or less room for the definition of private property rights and yet the matrix would look much the same. Thus, most of the time if underground minerals and hydrocarbons belong to the state and cannot be privatized, because of a constitutional provision or so, infringements of the rules that regulate the exploration and exploitation of those resources will generally be exercised by a public official on behalf of the state or any particular agency thereof.

The matrix would, then, look like this:

Area of the law	*Civil/Commercial*	*Criminal Law*	*Constitutional/Public Administrative Law*
Type of action			
Private Action	**X**	**X**	**X**
Public Action		**X**	**X**

Although there are few cases where it is necessary that the state exercises a legal action where the rights or interests at stake are mainly private, such as on behalf of people that lack mental capacity, for example, it is fair to say that there are many more cases where some sort of public interest is involved that, notwithstanding, may be sufficiently connected with the rights or interests of a specific individual or organization such that there are enough incentives to take on the costs of pursuing legal action. Private victims of several kinds of crimes are often sufficiently motivated to do that, although it is not uncommon that the law may impose certain limits or restrictions to

this. This is, fundamentally, a mistake. Where there are sufficient common objectives as between the interests of certain specific individuals and those of the community and the means to achieve those objectives are equally applicable to private and public action efforts, it is unwise to prevent or deter those specific individuals from taking on the corresponding costs for themselves and pursue whatever action as may be appropriate.

However, there is a sort of gray area in this matter and it has to do with the use of coercion or physical force. Although it is not uncommon for private companies to provide services in terms of preventive/defensive security, the opposite is generally believed to be subject to more efficient checks under the power of the state. Not so much that the repressive private security would be less efficient, but that it would not operate in the pursuit of public interests if basically driven by profit. For our purposes here we will consider this to be a valid proposition.

Thus, the matrix above can be expanded to distinguish between preventive/defensive actions and repressive ones, where coercion or violence can be legally used:

<u>*Area of the law*</u>	*Civil/Commercial Law*	*Criminal Law*	*Constitutional/Public/ Administrative Law*
<u>Type of action</u>			
Private Action Preventive/defensive Repressive	**X**	**X**	**X**
Public Action Preventive/defensive Repressive		**X** **X**	**X** **X**

Again, depending on the size and structure of any state (small and unitary versus large and federal, for example) the specific individuals, agencies or officials in charge of each kind of action will vary. However, using the matrix above it is possible to get a glance at the "core rule of law institutions" whose functionality will mostly determine whether the rule of law remains a mere ideal or a daily reality. In Annex I to this paper there is an extended version of the matrix that, although not reflecting the actual system of any particular jurisdiction, does show in more detail the core institutions.

It is important to note that the rich countries succeeded in good part because, through relatively long periods of time, their rule of law institutions were reasonably strong. Moreover, these institutions grew solid and independent before the time when governments in general grew bigger and became involved in many more activities and programs.[4]

But the focus regarding resource allocation is more of a qualitative than a quantitative nature. Constitutional rules must require those public bodies in charge of preparing, discussing, and approving the annual budget of the nation, the state or the province, to follow the principle that funds are available to be allocated elsewhere once the offices, agencies or institutions that conform the backbone of any system that

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[4] *The Constitution of Liberty,* Chap. 11, "The Origins of the Rule of Law".

pretends to abide by the rule of law, have been adequately supplied. To this end it is important that the constitutional rules provide for appropriate participation of the political opposition.

As to the substantive powers of the core institutions, in order that through ordinary legislation or other means their powers do not become restricted, it is important that the constitutional rules define these powers with sufficient specificity. For example, the rules that grant the courts and the courts only, the power to deprive any individual of any right or to declare a contract null and void, following due process of law, are crucial. Political agents should not be allowed to tinker with the power of courts to review the constitutionality of their legal enactments or the legality of their administrative decisions, nor with the powers to try public officials, in accordance with law, for their actions or omissions. It is very important, also, that the rules of the constitution prevent the creation of extremely complex procedures or excessive appeals.[5]

Last but not least, constitutional rules must ensure that courts and offices such as the Prosecutor's Office, be independent both in terms of the stability of judges and prosecutors in their jobs, and sufficient isolation from political influence in the exercise of their functions. To the extent possible, their appointment, removal, and the determination of their remuneration should be based on their professional performance and unrelated to partisan politics.

V. *Protection of the person and her rights against illegal coercion and violence.*

One way to look at the different manners in which individuals and organizations interact in society is to distinguish between (1) coordination phenomena; (2) supra/sub-ordination systems; and (3) illegal coercion, violence, usurpation, etcetera.

In general, voluntary coordination brings about the market process, as well as other spontaneous orders of society.[6] From this perspective, where the rights of the several individuals and organizations that interact in society are sufficiently defined and exclusive (which does not mean absolute) it is possible for each and everyone to have reasonably certain expectations as to the behavior of other individuals and organizations. It is feasible to anticipate with reasonable certainty that certain rights will be exchanged under certain conditions. This allows for individual teleological behavior; meaning that each person can devise certain objectives and the means to achieve them coordinating with others.

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[5] See *Doing Business in 2004, Understanding Regulation,(2004, The International Bank for Reconstruction and Development / The World Bank) P. 48:* "Among civil-law countries, Latin American jurisdictions have the most onerous contract enforcement, in the number of procedures and time. It takes a median of one year, 30 procedures, and 17 percent of income per capita to resolve a dispute. Only Sub-Saharan Africa has higher median costs –at 46 percent. OECD (high income) countries take the shortest time (median of 200 days), have the lowest cost (6.2 percent of income per capita) and the fewest procedures (18)."

[6] F. A. Hayek, Law, Legislation, and Liberty, The University of Chicago Press, 1983. Vol. I, Pages 43 – 48.

However, as Ronald H. Coase has explained[7], the efficiency of the process depends, in addition to clearly specified rights and the possibility to exchange them freely, on the relative insignificance of transaction costs.

In other words, coordination phenomena can be very efficient but require the participants to assume the opportunity and transaction costs every time they exchange something. Person Λ will simply not give anything to person Ω in exchange for nothing.

But in a certain way there are cases where, using his legal powers, person Ω may decide to take person Λ's rights, as in the case of a Prime Minister who decides to remove from office a subordinate official. True, in this instance it would not be Λ's personal rights, but in her capacity as a public official. This is the area where supra/sub-ordination interactions take place.

There is yet another set of circumstances where one person Ω may take Λ's rights without incurring the full costs of a coordinated exchange. This is in the cases of theft, usurpation, illegal coercion, fraud, and the like. In all these cases the gains for Ω and the losses for Λ can be substantial and, obviously, Λ does not voluntarily consent to the exchange.

In general, there are two types of reasons why the Ω types will not try to take Λ's rights without her consent: those intrinsic to Ω and those extrinsic to Ω. The first are related with his own convictions as to the nature of violent or fraudulent behavior –it is bad—and the latter refer to the resistance that Λ will most probably exert, in addition to the consequences that may derive for Ω from other sources. In modern societies this is the action of the State preventing and/or punishing his violent or fraudulent actions.

Thus, to the extent that the institutions in charge of preventing any kind of violence or fraud from one person against other persons operate adequately, even if those reasons intrinsic to potential offenders are not sufficient to deter their violent or fraudulent actions, coordination phenomena –the market process— will thrive.

This requires that the police, the court system, the prosecutors, and the penitentiary system operate adequately. Although the mix between privately organized and publicly supplied prevention, defense, and/or repressive mechanisms may vary substantially from one place to the other, it is indispensable that potential offenders will take due notice of the costs to them of resorting to violence or fraud. In this context, the role of the police preventing violent or fraudulent actions is most important and cost effective, but requires a decisive investment in the training and equipping of police forces, as well as in the adequate remuneration of their ranks. Generally, where there is scarce investment in this area, it becomes very difficult (costly) to curve violent or fraudulent actions by mere defensive or repressive mechanisms. Additionally, for the most part these two latter mechanisms require the active intervention of the police as well.

But in any system that could be considered based on the notion of the rule of law, it is not sufficient that violence and fraud be prevented, repelled or repressed "at any cost". It is necessary to recognize and guarantee certain rights to everyone, such as

[7] R. H Coase, *The Firm the Market and the Law;* Chapter 6: Notes on he Problem of Social Cost; The University of Chicago Press, Chicago and London 1990.

the protection against unwarranted detention or arrest, unreasonable search and seizure, the presumption of innocence, adequate defense, and an impartial and speedy trial. Thus police officers need to be capable of performing tasks that become much more complex than merely opposing violence to violence. I would venture to maintain that the main difference between the police forces in a jurisdiction where the rule of law prevails and one where it does not, or not sufficiently, is directly related to the specific fact that the police have not been adequately trained to perform their duties in general, with a view to effectively guarantee all these rights, at the same time that violence and fraud are deterred or repressed. This should not be a surprise since, again, much too often the notion of the rule of law is debated at a level very distant from the discussion of what should be the professional profile of a police officer and, therefore, the costs that must necessarily be incurred.

It follows logically that detectives, prosecutors, etcetera must be trained and equipped to achieve the same results within the same framework. It follows, also, that even if they were adequately prepared to stand up to the challenge, there is little they could do unless the police, always at the frontline of violence and crime, do what they are supposed to do and in a manner consistent with the notion of the rule of law.

The court system becomes, from this perspective, the ultimate judge or the ultimate victim of the system. In circumstances where the police, the detectives, the prosecutors are professionally capable and reasonably equipped to perform their duties appropriately, the courts will normally have little trouble exercising control over unavoidable excesses or negligent misconduct on behalf of the police or other officials involved in the process. However, where the contrary takes place, the court system will be the victim of a set of circumstances that it cannot effectively control or reform. Additionally, it is not uncommon that in jurisdictions where the police, the prosecutor's office, the bureau of investigation are not organized with the necessary human and material resources, the court system will not be either.

When one puts all of what has been discussed above in the context of corruption, it becomes clear that it is extremely dangerous not to invest in the right institutions all the necessary resources.

By way of synthesis, the market process will never flourish to the optimal point possible where the rules and institutions in charge of preventing, repelling, or repressing violence and fraud lack professionalism and/or sufficient resources to perform their duties. "Professionalism" in this context designates the clear understanding of the conditions and limits within which these functions are compatible with the ideal of the rule of law and the ability of the officials in charge and the courts to operate within that framework. Although there is ample room for the operation of private services connected with the prevention of violence and fraud, developing economies (where transaction costs are usually higher) generally need a basic apparatus for the protection of the population at large against violence and fraud, within de boundaries of the rule of law. Absent this, the market process will remain suboptimal.

VI. *The protection against the negligent behavior of others.*

This is not very different from what we have discussed above, although there is one essential difference. This is the difference between deliberate actions and negligent

behavior. Both can hurt people, create losses, and even death. But negligent behavior – the source of accidents— is easier to deal with from the perspective of the rules and the institutions that operate in most contemporaneous societies because the deliberate will of the agent, directed to causing damages to others, is absent. It is his lack of prudence, of expertise or diligence that needs to be dealt with.

Again, coordination phenomena become severely affected when Λ suffers a loss imposed by the negligent behavior of Ω. Planning on the basis of reasonable expectations becomes less certain where those losses cannot be efficiently recovered. The costs of products and services go up and consequently do the prices with the obvious result that economic activity diminishes.

Here the main debate has been whether the government, through regulations and *ex ante* licensing of whatever economic activities or the creation of the right kind of incentives through the court system should prevail to achieve the most efficient levels of prudence, expertise, and diligence of behalf of the members of society. Of course, it is not a question of absolutes and again there is ample room for privately organized action through firms that specialize in certifying standards of safety.

However, in developing countries where resources are scarce and investment is much needed, the role of the individual in becoming the main agent of prevention of accidents derived from negligent behavior is fundamental. For this, the possibility of having expedite recourse to court proceedings in order to recover for damages suffered is extremely important.

The rationale is that, to the extent that those who have suffered damages at the negligent behavior of others will only incur the costs of seeking recovery when it is economic to do so. This is to say when the benefits of undergoing legal proceedings, in order to be adequately indemnified, exceed the costs. Thus, it becomes clear that access to efficient proceedings handled by professional courts of law, is a necessary condition in order to achieve reasonable levels of prudent behavior.

Where the courts issue awards expeditiously and reflecting the actual losses for the victims of the negligent behavior of others, the members of society in general are subject to the right set of incentives in order to act and behave prudently, at the right level. Excessive prudence is a waste and thus costly to society.

The truth, however, is that in general in those jurisdictions where the court system does not operate efficiently, there are uneconomic losses derived from the negligent behavior of individuals and public entities as well. Lives are unnecessarily lost, productive people become handicapped or totally disabled to work and produce, capital becomes destroyed, and consumers and business firms suffer substantial losses.

Last but not least is the difficult question of damages caused to "society" or "the community", as in the case of environmental damages. Here there are two different problems: one, to what extent it is impossible to create pseudo private rights that would allow specific individuals to seek damages for them and the conglomerate at large (through techniques such as class actions, for example); the other, the former being impracticable, what are the best mechanisms in order to set reasonable standards and to efficiently police their application. In general, it is preferable to deal with this kind of

problems through the court system rather than the political process, with a view to create solid criteria on the basis of real life cases, rather than pursuing the instauration of ideal situations through legislation or regulations.

In synthesis, in order for the market process to flourish it is indispensable that the court system function as a source of sound criteria that, through the issuing of awards that, timely and exactly, allow for the recovery of losses incurred from the negligent behavior of others such that the members of society may be subject to the right incentives to act and behave prudently, but only to the point that it is economic to do so.

VII. *The protection of real property and the enforcement of contracts.*

The protection of real property is a very similar matter as the protection against violence and fraud and against negligent actions on behalf of third parties, which cause damages and losses. This is so because real property rights, which can be defined in respect of tangible and intangible assets, are supposed to be respected *erga omnes*, by everyone. Thus, both the unauthorized use of intellectual property rights and the unauthorized occupation of a farm give rise to the exercise of legal actions. Their owners may sue to stop the infringement and to seek damages. It is very clear how this kind of protection is essential to allow for coordination phenomena to prosper. The market process is not conceivable unless rights are clearly specified and effectively protected. This is a precondition to coordination on the basis of rational expectations.

In this context it is indispensable that the court system and the police operate adequately, since it is insufficient that the law defines in the abstract the boundaries to which real property rights extend. Economic agents need that case laws, the rulings of the courts of the jurisdiction, consistently and coherently assert those boundaries, case after case. Moreover, where the law defines real property rights in any way that is not reflected in the rulings of the courts, the effects are devastating as the prices of the underlying assets have to reflect the uncertainty created by the incoherence between the statutory law and the rulings.

Additionally to real property rights and the need for their effective protection, so that coordination phenomena through the market process may flourish, there are the personal rights. Personal rights derive largely from promises exchanged by economic agents through contracts. In a very important way, the law on contract determines the dynamics of any market process. In jurisdictions where it is not costly to enter into a contract and where it is clear that the parties will be brought to court when their contractual obligations are not timely and adequately fulfilled, the market will function smoothly. But on the contrary, where the enforcement of a simple contract may take up to four or five years, transaction costs will rise and the whole system will tend to be less efficient.

This requires clear and simple legal procedures and very professional courts. Professionalism here means the capacity to send consistent and coherent signals to the market place as to the consequences of a breach of contract. Courts have to make it costly, to an economic level, to breach a contract and this requires a body of case law that can be pointed to for guidance. Lawyers and judges have to work to get simple questions out of the way –they have to be settled early on— so that only those cases in a

real gray area make it to the courts, and when they do, it is very important that they get resolved in consonance with the preexisting principles. Efficient jurisdictions in this area are those where it does not make sense to breach a contract, because it will turn out to be more costly at the end of the day.

In summary, real property and personal rights as defined in the statutes, in the law, in the contracts, have to be backed up coherently and consistently through the rulings of the courts, through an expedite and transparent procedure. In the absence of this, the market prices of all the underlying assets will be lower and they will not be assigned where they are economically demanded because one of the most significant transaction costs is the inability to enforce real and contractual rights at a reasonable cost and timely.

VIII. *Taxation and mandatory contributions.*

The question of the optimal level of taxation and the kind of taxes that maximize revenue is very important for any economy, developed or developing, to prosper. However, it is frequently neglected that any tax system requires a rather complex set of procedures and agencies to function appropriately. This is true even where the level of taxation is sound from an economic point of view.

Just as it is less costly to take something from a private person for nothing, it is also less costly to let the others contribute to the common lot and thus take a free ride at their expense. In both cases, unless the potential offender has any solid moral scruples or can anticipate consequences more costly than it is to abide by the rules of the game, he or she will resort to violence or fraud to avoid the costs of compliance.

There are few factors that have worse effects regarding the efficiency of a tax system, than its inability to make most every one bear the same burdens and comply with tax obligations on mostly the same basis. The fastest way to make the informal sector of the economy grow is to allow for some players to get away with evading or eluding tax obligations, thereby gaining a bigger market share.

Here again, within the context of the ideal of the rule of law, it should not be permissible to resort to any mechanism in order to achieve compliance. Taxpayers should be protected against unwarranted inspections or what are commonly termed "fishing expeditions". Their proprietary information, books, and correspondence should be protected against leaks or outright dissemination. Proceedings have to be transparent and orderly and tax obligations cannot be outstanding forever. It should not be possible to terrorize taxpayers through arbitrary actions.

All this requires that the tax administration and the tax courts be, once more, professional and capable of making most everyone abide by the rules on an equal basis. This requires, also, consistency and coherence in the application of the Tax Code on behalf of the administration and adequate access to judicial review at reasonable costs and in a timely fashion.

No market process can tend to optimality where tax burdens can make the difference in terms of outperforming competitors, be it because the rules are biased in favor of any particular individuals or groups, or because the tax administration and the

courts lack the capability or professionalism to make everyone subject to most the same rules and procedures.

IX. *Conclusions.*

The rule of law is a powerful idea. It calls for the substitution of the arbitrary imposition of the will of any individual or group of individuals, for the Law. The notion of Law, in this context, refers to what Hayek defined as abstract rules of just conduct.[8]

But the adoption of the rule of law as a principle of constitutional and political organization requires the implementation of numerous measures, including the establishment of agencies and court systems capable of protecting the lives and rights of the members of society through transparent and expedite procedures. This requires a more or less complex set of legal rules and the ability to enforce them professionally in a number of areas that include protection against violence and fraud; against negligent behavior; against abuses of the rights of others; against free riders; and in order to enforce contracts.

The market process can only prosper sufficiently in order to improve the conditions of the majority of the people where it is backed by the “backbone institutions” that can make a daily reality the ideal of the rule of law. Rather than investing or spending in other areas, developing countries require, as a precondition to their development, that these backbone institutions be appropriately equipped and, more than anything, staffed with professionals capable of performing a long series of tasks that require a deep understanding of the difference between just ruling and ruling under the law.

Eduardo A. Mayora.
Guatemala, September 2006.

[8] F. A. Hayek, Law, Legislation, and Liberty, The University of Chicago Press, 1983. Vol. I, Pages 48 – 52

ANNEX I

Area of the law	*Civil/Commercial Law*	*Criminal Law*	*Constitutional/Public Administrative Law*
Type of action[9]			
Private Action			
Preventive/defensive:			
• Civil liberties> individual affected		X	X
• Conduct of public officials > individual affected	X	X	X
• Contracts > Right holder	X		
• Peace and order > individual affected		X	X
• Real Property > Owner	X	X	X
• Tax obligations > taxpayer	X	X	X
• Torts > Victim	X		X
• Use of public money > the individual citizen	X	X	X
Repressive			
• Civil liberties > individual affected			
• Conduct of public officials > the individual affected			
• Contracts > Right holder			
• Peace and order > individual affected			
• Real Property > Owner			
• Tax obligations > taxpayer			
• Torts > Victim			
• Use of public money > the individual citizen			
Public Action[10]			
Preventive/defensive			
• Civil liberties >			
➢ The Attorney General			X
➢ The Bureau of			

[9] In alphabetical order.
[10] In alphabetical order
[11] There are several instances where the state or a public entity do not act in there official capacity, but as an ordinary contracting party.
[12] It is not uncommon that the state and other public entities own real property for different purposes related with their function.
[13] Both the state and other public entities can be affected by third parties' tortful action.

Investigation		X	
➢ The Comptroller			
➢ The Judiciary			X
➢ The Penitentiary System		X	X
➢ The Police			
➢ The Prosecutor's Office		X	X
➢ The Public Defense Office		X	X
➢ The Tax Administration		X	X
• Conduct of public officials>			X
➢ The Attorney General	X	X	X
➢ The Bureau of Investigation		X	
➢ The Comptroller			
➢ The Judiciary	X	X	X
➢ The Penitentiary System			
➢ The Police			
➢ The Prosecutor's Office		X	X
➢ The Public Defense Office	X	X	X
➢ The Tax Administration			
• Contracts > Right holder[11]			X
➢ The Attorney General			X
➢ The Bureau of Investigation	X		
➢ The Comptroller			X
➢ The Judiciary	X		X
➢ The Penitentiary System	X		
➢ The Police			
➢ The Prosecutor's Office			
➢ The Public Defense Office			X
➢ The Tax Administration	X		X
• Peace and order			
➢ The Attorney General			
➢ The Bureau of Investigation			X
➢ The Comptroller		X	
➢ The Judiciary			
➢ The Penitentiary System		X	X
➢ The Police		X	X
➢ The Prosecutor's Office			
➢ The Public Defense		X	X

Office		X	X
➢ The Tax Administration			
• Real Property > Owner[12]			
➢ The Attorney General	X		X
➢ The Bureau of Investigation		X	
➢ The Comptroller		X	X
➢ The Judiciary	X	X	X
➢ The Penitentiary System			
➢ The Police		X	X
➢ The Prosecutor's Office		X	
➢ The Public Defense Office		X	X
➢ The Tax Administration			X
• Tax obligations			
➢ The Attorney General			X
➢ The Bureau of Investigation		X	
➢ The Comptroller		X	X
➢ The Judiciary		X	X
➢ The Penitentiary System			
➢ The Police		X	X
➢ The Prosecutor's Office		X	X
➢ The Public Defense Office		X	X
➢ The Tax Administration			X
• Torts > Victim[13]			
➢ The Attorney General			
➢ The Bureau of Investigation	X		X
➢ The Comptroller			
➢ The Judiciary			X
➢ The Penitentiary System		X	X
➢ The Police			
➢ The Prosecutor's Office		X	X
➢ The Public Defense Office		X	
➢ The Tax Administration	X	X	X
• Use of public money			
➢ The Attorney General	X		X
➢ The Bureau of Investigation		X	
➢ The Comptroller			X

➢ The Judiciary		X	X
➢ The Penitentiary	X	X	X
System			
➢ The Police			
➢ The Prosecutor's		X	X
Office		X	
➢ The Public Defense			
Office			
➢ The Tax	X	X	X
Administration			
Repressive			X
• Civil liberties >			
➢ The Attorney			
General			X
➢ The Bureau of			
Investigation		X	
➢ The Comptroller			X
➢ The Judiciary			
➢ The Penitentiary		X	X
System		X	X
➢ The Police			
➢ The Prosecutor's		X	X
Office			
➢ The Public Defense		X	X
Office			
➢ The Tax		X	X
Administration			
• Conduct of			X
public officials>			
➢ The Attorney			
General			X
➢ The Bureau of			
Investigation		X	X
➢ The Comptroller			X
➢ The Judiciary	X	X	X
➢ The Penitentiary			
System		X	
➢ The Police			
➢ The Prosecutor's		X	
Office		X	X
➢ The Public Defense			
Office	X	X	X
➢ The Tax			
Administration			X
• Contracts >			
Right holder			
➢ The Attorney			
General	X		
➢ The Bureau of			X
Investigation			
➢ The Comptroller		X	
➢ The Judiciary	X		
➢ The Penitentiary		X	X
System			
➢ The Police			
➢ The Prosecutor's		X	X
Office		X	X
➢ The Public Defense	X		
Office		X	X

➢ The Tax			
Administration			X
• Peace and order			
➢ The Attorney			
General			
➢ The Bureau of			X
Investigation			
➢ The Comptroller		X	
➢ The Judiciary			
➢ The Penitentiary		X	X
System		X	X
➢ The Police			
➢ The Prosecutor's		X	X
Office		X	X
➢ The Public Defense	X		
Office		X	X
➢ The Tax			
Administration			
• Real Property >			
Owner			
➢ The Attorney			
General	X		
➢ The Bureau of			X
Investigation			
➢ The Comptroller		X	
➢ The Judiciary			X
➢ The Penitentiary			
System		X	X
➢ The Police		X	X
➢ The Prosecutor's		X	X
Office			
➢ The Public Defense		X	X
Office	X	X	X
➢ The Tax			
Administration			X
• Tax obligations			
➢ The Attorney			
General			X
➢ The Bureau of			
Investigation			
➢ The Comptroller		X	
➢ The Judiciary	X	X	X
➢ The Penitentiary		X	X
System			
➢ The Police		X	X
➢ The Prosecutor's		X	X
Office		X	X
➢ The Public Defense			
Office	X		
➢ The Tax		X	X
Administration			
• Torts > Victim			X
➢ The Attorney	X		
General			X
➢ The Bureau of			
Investigation			
➢ The Comptroller			X
➢ The Judiciary	X		X
➢ The Penitentiary			X

<table>
<tr>
<td>System
➢ The Police
➢ The Prosecutor’s Office
➢ The Public Defense Office
➢ The Tax Administration
• Use of public money
➢ The Attorney General
➢ The Bureau of Investigation
➢ The Comptroller
➢ The Judiciary
➢ The Penitentiary System
➢ The Police
➢ The Prosecutor’s Office
➢ The Public Defense Office
➢ The Tax Administration</td>
<td>X
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