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The Path to Development: When Does the Legal Environment Become Critical?

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In many ways, a market economy is like a telephone or Internet system. In the case of those network goods, the value to the individual users increases as more people have telephones or Internet hookups. Markets have this same characteristic—the more people integrated into the system, the greater the benefits to each participant. The market network generates almost unbelievable benefits as the result of gains from trade, specialization, expansion in the size of the market, and the application of techniques of mass production.

Most of the consumer goods enjoyed by households in North America, Western Europe, and other parts of the developed world result from what Nobel laureate Douglass C. North calls “depersonalized exchange,” that is, trade between parties that do not know each other and will probably never meet. Those exchanges are coordinated by what Nobel laureate Friedrich Hayek refers to as the “extension of the market” from the local town or village to the region, nation, and indeed the far corners of the world. Without the market network, high levels of per capita income and modern living standards would be impossible.

However, the enormous benefits of the market network cannot be achieved without a sound legal system. People who live in countries where property rights are insecure, contracts poorly enforced, and legal and regulatory verdicts auctioned off to the highest bidder will not be integrated into the worldwide market network. Without rule of law, the benefits from trade will be limited to those derived from personalized exchange, trade among family members and persons in the local neighborhood or village who know each other or at least know about each other. Here, trade is based on personal knowledge, and contract enforcement is achieved through family ties and social pressures. However, the benefits derived from personalized exchange will be small compared with those available through a depersonalized market network based on enforceable contracts and rule of law.

The empirical evidence is consistent with this view. In the *Economic Freedom of the World* report, published annually by the Fraser Institute, we measure the level of economic freedom in more than 120 countries by looking at 38 policy and institutional variables in five general areas: size of government, access to sound money, international exchange, regulation, and legal structure and protection of property rights. Countries that are more economically free receive higher scores on a scale of 1 to 10.[1]

The Legal Structure and Protection of Property Rights area of the economic freedom index indicates the consistency of a nation’s legal structure with the protection of property rights, unbiased enforcement of contracts, independence of the judiciary, and rule of law principles. Among the approximately 100 countries for which data were available throughout the 1980–2000 period, 24 countries had an average legal system area rating of 7 or higher. Table 1 shows that these 24 countries had an average per capita GDP in 2000 of $25,716 and an average annual real growth rate of

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Table 1
Sound Legal Systems, Income, and Growth

Countries with Average Legal Rating > 7.0 during 1980–2000	Legal System Rating	Per Capita GDP 2000	Growth of per Capita GDP, 1980–2000, %
Switzerland	8.65	$27,780	0.82
United States	8.61	$33,960	2.12
Netherlands	8.58	$26,910	1.98
New Zealand	8.51	$17,840	1.29
Austria	8.49	$26,420	1.99
Luxembourg	8.45	$53,410	4.26
Denmark	8.41	$28,680	1.74
Finland	8.36	$24,160	2.27
Germany	8.36	$25,100	1.70
Canada	8.32	$26,840	1.69
Norway	8.31	$29,200	2.42
Australia	8.29	$24,550	1.96
Iceland	8.08	$28,910	1.67
Sweden	8.05	$23,650	1.66
Belgium	7.97	$25,220	1.91
United Kingdom	7.91	$23,580	2.29
Ireland	7.91	$30,380	4.91
Singapore	7.89	$23,700	4.92
Japan	7.84	$25,280	2.34
Portugal	7.50	$17,710	2.91
France	7.48	$23,490	1.72
Hungary	7.16	$11,960	1.31
Hong Kong	7.16	$25,180	4.07
Taiwan	7.03	$13,279	6.00
Average	**8.05**	**$25,716**	**2.50**

2.5 percent over the two-decade period. The lowest per capita income among these 24 countries was approximately $12,000. Perhaps even more important, all 24 of the countries with sound legal systems achieved positive real growth of per capita GDP over the two decades.

At the other end of the spectrum, there were 21 countries with an average rating of less than 4 in the legal system area during the period from 1980 to 2000. Table 2 indicates the income levels and growth rates of these countries. Their average 2000 per capita GDP was $3,094, and their growth rates averaged 0.33 percent over the two decades. Both of these figures were approximately one-eighth of the comparable figures for the countries with sound legal systems. The highest per capita GDP in 2000 among the 21 countries with low-quality legal systems was Colombia's $7,010. None of the 21 countries with low-quality legal systems was able to achieve both a 2000 per capita income of more than $3,400 and a growth rate during 1980–2000 of more than 1.1 percent. *Thus, none of the countries with unsound legal systems was able to sustain a solid rate of growth once income levels rose above $3,400.*

The gains derived from depersonalized exchange and expansion of the market provide the underpinnings for our modern living standards, and a sound legal system is essential for the realization of those gains. Without a legal system capable of enforcing contracts and protecting property rights, trade will occur mostly among parties who know each other, and it will cover only a relatively small geographic or market area. The gains from depersonalized trade and an expanded market will continue to go unrealized. Without the realization of those potential gains, it will be virtually impossible for countries to move up to even lower-middle-income status. Tragically, they will continue to stagnate at relatively low levels of income.

Table 2
Weak Legal Systems, Income, and Growth

Countries with Average Legal Rating < 4.0 during 1980–2000	Legal System Rating	Per Capita GDP 2000	Growth of per Capita GDP, 1980–2000, %
Indonesia	3.90	$2,970	3.69
Senegal	3.84	$1,450	0.57
Sri Lanka	3.67	$3,400	3.49
Pakistan	3.66	$1,870	2.46
Honduras	3.62	$2,830	-0.13
Syria	3.56	$3,280	0.64
Iran	3.55	$5,720	1.09
Nicaragua	3.54	$2,450	-2.26
Peru	3.52	$4,630	-0.24
Philippines	3.49	$3,790	-0.02
Algeria	3.47	$6,150	-0.20
Colombia	3.43	$7,010	1.04
Uganda	3.42	$1,450	2.23
Nigeria	3.34	$860	-0.93
El Salvador	3.27	$5,240	0.57
Congo, Rep. of	3.27	$950	0.37
Bolivia	3.20	$2,310	-0.28
Bangladesh	3.19	$1,540	2.57
Guatemala	3.02	$4,430	-0.08
Haiti	2.98	$1,920	-2.39
Congo, Dem. R.	2.38	$730	-5.31
Average	**3.40**	**$3,094**	**0.33**

Notes

This text is based on James Gwartney and Robert Lawson, *Economic Freedom of the World: 2004 Annual Report* (Vancouver: Fraser Institute, 2004), pp. 35–37.

1. For country rankings and ratings and for a detailed description of the methodology and sources, see James Gwartney and Robert Lawson, *Economic Freedom of the World: 2005 Annual Report* (Vancouver: Fraser Institute, 2005). For more evidence that institutions play a key role in development, see International Monetary Fund, *World Economic Outlook* (Washington: IMF, September 2005), pp. 125–60.