



## Judicial Reform in Developing Economies: Constraints and Opportunities

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*This essay focuses on three recurring problems that bedevil efforts to design and implement effective legal and judicial reform projects. The first problem is a straightforward resource constraint problem: Improving the capacity and quality of a judicial system requires material and human resources that are in short supply in developing economies. The second problem is an incentive compatibility problem: The ability of the judicial system to perform a positive role in promoting development depends on the willingness of affected parties to use the courts to resolve disputes and to abide by judicial decisions, and on the willingness of judges and other legal officers to behave in a manner that is consistent with the requirements of a well-functioning judicial system. The third problem is an institutional version of the General Theory of the Second Best: When a legal system is suboptimal in more than one respect, improving the law or the courts along one dimension may not improve overall institutional performance, and may even worsen it. Scholars and practitioners should pay greater attention to the inherent tradeoffs induced by resource scarcity; the importance of making sure that individual incentives are aligned with institutional objectives; and the dangers that particular institutional reforms that appear to be welfare-improving when considered in isolation may have counterproductive effects, if other institutional reforms are unachievable.*

Over the last decade, there has been an extraordinary increase in the attention paid to the role that public institutions play in promoting economic development.<sup>1</sup> Indeed, the assertion that “institutions matter” has become commonplace, perhaps even cliché. This institutionalist revival in the development community has included a resurgence of interest in the role that legal and judicial institutions play, or ought to play, in promoting material improvements in the quality of life of the world’s poor. Academics and policy analysts have sought to better understand the relationship between legal institutions and economic performance, while the development community has promoted legal and judicial reform projects that range from modest

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efforts to improve court administration to ambitious attempts to eliminate judicial corruption, promote judicial independence, and craft better, more equitable, and more market-friendly legal systems.

The diversity and complexity of the debate about legal and judicial reform, and of the myriad reform projects that have already been undertaken, put a comprehensive overview of the field beyond reach. My purpose here is a more modest one. First, I want to identify what I see as basic and recurring problems that bedevil efforts to design and implement effective legal and judicial reform projects. Second, I hope to suggest some conceptual tools that can be used to address these difficulties.

I have three particular problems in mind. The first is a straightforward resource constraint problem. Improving the capacity and quality of a judicial system requires material and human resources that are in short supply in developing economies. The second problem is what one might think of as an incentive compatibility problem. The judiciary's capacity to perform the economic and other functions assigned to it by law-and-development theorists depends in large part on the willingness of affected parties to use the courts to resolve disputes and to abide by judicial decisions, and on the willingness of judges and other legal officers to behave in a manner that is consistent with the requirements of a well-functioning judicial system. But creating appropriate incentives often proves difficult. The third problem is an institutional version of the General Theory of the Second Best: When a legal system is suboptimal in more than one respect, improving the law or the courts along one dimension may not improve, and may even worsen, overall institutional performance. Understanding this principle is important to understanding, and attempting to avoid, the pitfalls associated with the necessarily incremental and partial nature of virtually all legal and judicial reform efforts.

## Why Reform Judiciaries?

It may be useful to remind ourselves why reforming legal and judicial institutions in developing countries is thought to be important. In sketching an answer, I will glide over an even more basic set of conceptual questions. Simply defining "courts," "law," and "lawyers" in comparative or historical contexts can be a challenge, given the variation in institutional arrangements and functions. There is also the vexed question of whether certain qualities of the legal system ought to be considered constitutive of, not merely causally connected to, "development" properly understood (Sen 2000). Without disparaging the significance of these conceptual controversies, for reasons of brevity I will not engage them here. Instead, I use terms like "law," "courts," and "judicial" to refer to the set of institutional arrangements that conventionally carry those labels, even though I acknowledge that substantial institutional variation exists. As for "development," I will focus on the instrumental role of legal and judicial institutions in promoting social welfare, rather than on the intrinsic value of such institutions.

With these definitional preliminaries out of the way, what can we say about the appropriate role of the judicial system in promoting economic development? Generally,

the primary service provided by courts is thought to be reliable and efficient dispute resolution. This service is important to development for at least three reasons.

First, courts enforce contract and property rights, and secure property and contract rights are important for fostering productive investment and arms' length economic transactions (North 1990; World Bank 2005, ch. 4).

Second, state-funded courts may improve economic performance by correcting various market failures. For example, judicial imposition of legal liability for certain types of harm may induce private parties to internalize what would otherwise be negative externalities associated with their conduct. To put the same point in more Coasian terms, a well-functioning judicial system may allocate liability in such a way that total social costs (including the transaction costs associated with bargaining around the initial allocation of legal rights) are minimized (Coase 1960).

Third, judicial enforcement can make commitments—particularly commitments by government—more credible. The basic credible commitment problem identified by Finn Kydland and Edward Prescott (1977) has particular salience for the governments of developing economies, which need to convince both their citizens and international investors to invest in the long term without fear that the government will expropriate the value of these investments (Brunetti and Weder 1994; Henisz 2000). Because courts are supposed to resolve disputes according to pre-existing legal commitments—whether contained in contracts, statutes, or constitutions—judicial dispute resolution by independent, effective courts helps enable parties, including government, to bind themselves to take or forgo certain actions under specified circumstances.

To be sure, at least some of these functions can be performed by other institutions, or even by private parties. Thus the American Arbitration Association, the International Chamber of Commerce, the World Bank's International Center for the Settlement of Investment Disputes, and a host of other providers offer conflict resolution services that compete with state-backed courts. But, while competitive private provision of dispute resolution services can be both healthy and desirable (Benson 1990; Landes and Posner 1979), there are several reasons why public provision of dispute resolution services, in the form of effective courts, is superior to exclusive reliance on the private market. First, many forms of private dispute resolution are inherently limited in size or scope (Bueno de Mesquita and Stephenson 2006; Greif 1993). Second, many nongovernmental substitutes for judicial dispute resolution produce significant negative externalities. For example, Curtis Milhaupt and Mark West (2000) show that in the absence of effective state dispute resolution and contract enforcement in Japan, the Yakuza (the Japanese mafia) provides an unsavory substitute. Likewise, Diego Gambetta (1993) found that the Sicilian mafia arose to supply landowners with protection from predatory attacks in an environment where state-supplied law enforcement and dispute resolution was unavailable. Third, courts develop rules, doctrines, and principles that offer guidance for the resolution of future disputes. This is particularly so in common law countries, but it is increasingly the case in civil law countries as well (MacCormick, Summers, and Goodhart 1997). This body of judge-made (or judge-"discovered") law is a public good that benefits individuals

other than the parties to the dispute. It would therefore tend to be undersupplied in a private market for dispute resolution services (Landes and Posner 1979).

The preceding summary of the role of the judiciary in economic development is both abstract and general. Specifying the optimal set of judicial and legal institutions for any given country is a much more difficult and context-specific task, one that is well beyond the scope of this essay. The point I want to emphasize is that even if we could specify the optimal judicial and legal institutions for any given developing country, reformers who wanted to bring about progress toward that ideal could not escape three challenging problems: resource constraints, incentive compatibility, and the second best problem. It is to these three issues that I now turn.

### Three Dilemmas for Judicial Reformers

#### *Resource Constraints*

The first important limitation on the ability of legal and judicial reform to improve overall economic well-being in developing countries is the simple fact that material and human resources are limited. This observation is not especially interesting analytically, but it has great practical significance. After all, every dollar spent on judicial reform is a dollar that cannot be spent on other public goods or put toward economically productive private investment. Every hour spent by government officials drafting judicial reform legislation or investigating methods for improving judicial performance is an hour that could have been spent on other legislative activities. And every talented young man or woman in a developing country who decides to become a lawyer or a judge generally forgoes the possibility of becoming an engineer or a doctor or an entrepreneur (Murphy, Shleifer, and Vishney 1991). (For that matter, every academic paper about legal reform diverts time and attention from papers on other aspects of the development project.)

This is not to disparage the importance of legal and judicial reform as part of the larger project of economic reform. Clearly, legal and judicial reform has some role in the overall development project. The question, from a practical standpoint, is how much of a role it should have when resources are scarce. This is not a question that admits of easy or generic answers. My point, which may be obvious but is nonetheless worth restating, is that devoting development resources to judicial reform projects, and allocating those resources among various judicial reform projects, entails difficult trade-offs. It is therefore important to think more critically about the role of judicial reform as part of a larger development strategy, and about how to set institutional reform priorities.

The prioritization issue relates to a more general set of debates in the academic and policy communities about the degree to which high-quality institutions—including but not limited to judicial institutions—are primarily a cause or a consequence of economic growth (Acemoglu, Johnson, and Robinson 2001; Chong and Calderon 2000). The short, simple, and not very helpful answer to this question is “both.” But we need to know more about the nature of the causal relationships in order to make intelligent decisions about how to allocate scarce human and material resources in

developing countries. If, for example, a well-functioning judicial system is a necessary precondition for large-scale economic activity, then it might make sense to devote substantial resources up front to improving the court system. If, on the other hand, a great deal of economic progress and social welfare can be generated with a more modest court system, then it may make sense to devote relatively fewer government resources to the court system early on, targeting these resources instead at other things—such as health care, basic education, and infrastructure—thought to be more important for priming the pump of economic growth. Of course, the productivity of these other sorts of reforms may depend on a well-functioning system for regulating service delivery and resolving disputes, which may require a reasonably effective judicial system. The point is not that judicial reform should be postponed entirely, but rather that resource constraints mean that the allocation of scarce resources to different types of reform efforts involves difficult questions of prioritization.

A similar resource constraint problem, and a similar set of hard choices, appears when we think about how to allocate resources among different types of judicial reform projects. There are, to be sure, some low-hanging fruit: straightforward, inexpensive reforms that yield a very high payoff. Thus, for example, the simple introduction of a computerized list of the jail population can significantly reduce the time those suspected of a crime are held before trial (Hammergren forthcoming). In most instances, however, such low-cost, easy reforms were embraced long ago, leaving the more complex, expensive, and politically controversial ones to be taken up. But usually it is simply impossible, in light of limited resources, for developing country governments or the donor community to tackle all of these at once, and it therefore becomes necessary to pick and choose among different projects.

In that situation, how should priorities be set? Is it more important to train judges or to computerize the case filing and tracking system? Is it more important to invest in fighting judicial corruption or in educating the poor about their legal rights? Does it make more sense to concentrate resources on creating a few highly capable specialized tribunals—say, to deal with disputes involving foreign investors or major business transactions—or to spread resources more widely to improve the average local court? Again, all these things may be valuable, and these choices are “more-less” choices, not “either-or” choices. But they are choices nonetheless, and as Linn Hammergren’s forthcoming review of the Latin American experience with judicial reform over the past 25 years shows, there has not been sufficient attention in the field to issues of prioritization and sequencing of judicial reform efforts (ch. 7).

The lack of attention to prioritization and sequencing reflects what Thomas Carothers (2006) has dubbed “the problem of knowledge.” Despite more than a decade of experience with programs of all types, knowledge about what factors are conducive to success, and why, remains scarce. This knowledge gap itself reflects a resource problem: the unwillingness of donor agencies and developing country governments to invest in better up-front analysis and more thorough post-reform evaluation (Carothers 2006; Hammergren 2002; Messick 2000). Yet without more robust data on judicial systems and reform experiences, analyzed in the context of the ongoing research on the role of institutions in development, the ability to set appropriate reform priorities is unlikely to improve.

### *Incentive Compatibility*

In order for the judiciary to perform the functions generally assigned to it by law and development theorists, the relevant parties must have appropriate incentives. Individuals must have an incentive to rely on the courts to adjudicate their disputes rather than relying on alternative, socially undesirable dispute resolution mechanisms or forgoing certain transactions altogether. Those with the power to disregard judicial decisions or to subvert judicial independence must have an incentive to refrain from such activities. And the judges themselves must have an incentive to carry out the functions assigned to them.

Consider first the private parties who we would like to encourage to use the courts rather than on other mechanisms to resolve their disputes. Of course, it is manifestly not the case that a society or an economy is better off if all potentially justiciable controversies are litigated, as that would entail an enormous social cost (Shavell 1997). Many nonjudicial dispute resolution mechanisms may often be more efficient (from both a private and a social perspective) than the court system, and therefore decisions to forgo judicial adjudication may often reflect a market success rather than a market failure (Bueno de Mesquita and Stephenson 2006). But, we might reasonably suppose that, in an ideal world, the judiciary would be the best forum for the resolution of some nontrivial subset of private disputes, either because alternatives are unavailable or because they are too socially costly. In this subset of cases, the private parties to a dispute must have incentives to rely on the court system. There are a number of reasons, however, why such incentives may not be present.

The first and most obvious reason is that the court system may fail to provide dispute resolution services of acceptable quality. Judges or court administrators may be incompetent, venal, or corrupt, and the law itself may be inefficient or unfair. Or, the private costs to litigants of using the court system—attorneys' fees, filing fees, and other court costs—may be inefficiently high (Shavell 1997). Perhaps there are too few courts or is too much delay in hearing or deciding cases. Redressing these and similar failings is the bread and butter of most judicial reform efforts.

There are also more subtle disincentives to reliance on judicial dispute resolution. Katharina Pistor's (1996) examination of Russian businesses' use of the courts to resolve commercial arbitration in the early 1990s provides an interesting illustration. Numerous observers claimed that during this period Russian businesses tended not to use the courts to resolve commercial disputes; instead, firms relied on nonlegal (or illegal) enforcement mechanisms. Contrary to this prevailing conventional wisdom, Pistor suggests that the reluctance of many Russian businesses to use the courts to resolve contractual disputes was not because the courts were inefficient or because enforcement was unreliable. Rather, the reason had to do with the gross inefficiencies of the Russian legal system, particularly the tax system, which induced most businesses to engage in numerous illegal or semilegal transactions. Going to court would risk disclosing these transactions—even if they were only peripherally related to the dispute at issue—which would often result in undesirable consequences for the firm.

The upshot, for legal and judicial reformers, is that bad law, or other bad collateral effects of invoking the judicial process, can deter use of otherwise efficient and effective judicial institutions. The point may seem obvious in the abstract, but the

more significant lesson here is that, when private parties are not using the courts, it is important to understand why. Improving the law may be of little relevance if judicial institutions are dysfunctional, but improving judicial institutions may likewise prove futile if private parties have strong incentives to avoid the courts for other reasons.

Another hypothesized deterrent to socially efficient use of the court system is “legal culture.” It is often claimed, particularly but not exclusively in the context of developing countries, that the use of courts to resolve disputes is considered culturally taboo or otherwise inappropriate, and therefore the use of the courts is inefficiently low and reliance on nonjudicial dispute resolution mechanisms is inefficiently high (Bierbrauer 1994). There are at least two problems with this hypothesis, however. First, it is difficult to specify in advance those cultural norms that pose a socially undesirable impediment to judicial adjudication. Indeed there are several counterexamples in which reliance on judicial dispute resolution became widespread, despite what one might have supposed were adverse cultural norms.<sup>2</sup> Second, many of the examples cited in support of the proposition that cultural predispositions deter use of the courts may actually be examples of the more mundane—though important—type of problem described earlier: the courts simply are not working well, and therefore they are not an efficient alternative to nonjudicial dispute resolution mechanisms (Bueno de Mesquita and Stephenson 2006). A cultural aversion to relying on the formal court system may be an effect, rather than a cause, of a poorly functioning judicial system.

Despite these concerns, however, the question whether specific cultural characteristics deter (or encourage) reliance on judicial dispute resolution is clearly important. If such effects do exist and can be identified, then cultural norms may be both an important constraint on reform and themselves an object of reform. If not, then judicial reformers should be wary of cultural determinist arguments about what sorts of judicial systems will or will not “take” in a particular cultural context.

Up to now, the discussion has focused on the incentives of private parties to rely on the judiciary for the resolution of disputes. An equally significant incentive compatibility question concerns the government. The government must have incentives both to abide by adverse judicial decisions to which it is a party and to enforce against other parties judicial decisions with which the government disagrees. The problem of creating adequate incentives for the government to respect judicial independence and authority is particularly salient if we believe that one of the most important functions of the judiciary is to enable the government to make credible commitments. Appropriate government incentives are important for private dispute resolution as well, since most judicial rulings rely on the government’s willingness to enforce them in order to be effective.

There is now a sizable literature on the political and economic factors that may induce governments to respect the rulings of an independent judiciary even when the government dislikes a given decision.<sup>3</sup> One of the most interesting and persuasive explanations for why governments may have an incentive to respect adverse judicial decisions involves the role of long-term political competition between rivals for legislative and executive power. The hypothesis is that, when political competition is robust and the competitors tend to be long-lived political parties, then holders of

political power may prefer to respect the limits imposed by independent courts so long as their rivals do the same when they are in power. Mark Ramseyer (1994) developed this hypothesis to explain why courts in the United States exhibited so much more independence than courts in Japan under LDP rule. I have formalized Ramseyer's hypothesis and provided cross-country statistical evidence of a correlation between stable political competition and judicial independence (Stephenson 2003). The hypothesis finds further support in Thomas Ginsburg's (2003) study of judicial politics in East Asia and Andrew Hanssen's (2004) analysis of the variation in judicial independence across U.S. states. If the findings of this research prove robust, it will put to rest the claim that rule of law reforms can and should precede democratic reform (Zakaria 2003). If an independent judicial constraint on the government depends on robust and stable democratic competition, then attempts to promote judicial independence, or to implement legal or institutional reforms that presume an independent judiciary, are likely to founder in the absence of such competition. The scathing critique of the World Bank's efforts to promote judicial reform in Peru under President Fujimori may lend some case-specific support to this general conclusion (Lawyers' Committee on Human Rights 2000).

Another political mechanism that is sometimes thought to provide the government in power with sufficient incentives to respect independent courts is public support for the judiciary. On this account, because judicial independence improves social welfare—for instance, by ensuring that the government respects welfare-enhancing limits on its own power—attempts by the government to subvert judicial independence or to defy judicial decrees would be detected by public watchdogs and punished by public opinion (Sutter 1997; Vanberg 2001). Anecdotal support for this view is occasionally drawn from instances in U.S. political history in which perceived attempts to defy the courts have triggered political punishment. The negative public reaction to President Roosevelt's plan to "pack" the Supreme Court and to President Nixon's hints that he might defy a Supreme Court order to turn over incriminating evidence during the Watergate investigation are the most prominent examples. President Johnson's willingness to call out the National Guard to enforce the Supreme Court's school desegregation decisions and the negative public reaction to congressional attempts to meddle in the recent Terry Schiavo fiasco in Florida may also illustrate the political support for insulating judicial decisions from government interference.

The implication of this hypothesis, if it proves correct, may be that it is important for judicial reformers to promote a "rule of law culture" in which defiance or manipulation of courts engenders political opposition. But figuring out exactly what that entails is not easy. Moreover, there are reasons to doubt whether a "rule of law culture" is really an independent factor that causes the public to rise to the defense of independent courts. Indeed, there are a number of troubling cases in which an apparent "rule of law culture" proved transient or powerless in the face of determined government hostility to the courts. For instance, Malaysia in the late 1970s and the early to mid-1980s was generally seen as having a greater public commitment to judicial independence and the rule of law than most developing countries. Malaysia also boasted a relatively sophisticated and organized bench and bar. Despite this, after a series of politically controversial rulings provoked a constitutional crisis in 1988, Prime Minister



Mahatir forced out the Lord President of the Supreme Court and cowed the Court into submission (Harding 1990).

It may be that public willingness to defend the courts from political interference arises not because of some general, abstract political commitment to judicial independence, but rather because in certain circumstances, the public is rationally distrustful of government decisions that fail to obtain judicial approval (Stephenson 2004). If that is so, it is not at all clear that the general public would have sufficient incentives to protect the courts from government action that clearly benefited large and powerful political constituencies. The policy implications of this perspective on public support for the courts may differ from those of the “rule of law culture” perspective, in that the key to ensuring an effective judicial check in this view may be developing institutions and practices in which politically relevant constituencies rationally place a high value on the signal sent by judicial decisions, rather than attempting to promote a more general cultural change in affective attitudes toward the courts.

A final incentive compatibility issue concerns the incentives of the judges themselves. If the judges do not have incentives to decide cases in an appropriate manner, the judicial system will cease to function effectively as a forum for dispute resolution or as a source of new or improved law. One source of bad judicial incentives, already discussed, are threats and promises offered by the government in power. But even if the government has incentives to respect judicial decisions, the judges themselves may lack appropriate incentives. The most obvious problems here are the various forms of improper influence brought to bear by interested parties, either in the form of threats (the problem of judicial coercion) or promises (the problem of judicial corruption). This sort of problem is easy to define but hard to combat.

Another concern regarding judicial incentives is that even if judges are not corrupt, their interests may not align with social interests. For instance, judicial decisions, especially in controversial cases, may reflect judge’s preexisting political or ideological commitments. Political scientists who study U.S. legal institutions have documented ideological voting on the U.S. Supreme Court and elsewhere, though the extent and significance of ideology in this context is a matter of considerable controversy (Segal and Spaeth 2002). Others have suggested that, in addition to advancing ideological or political goals, judges are concerned with their reputations (Posner 1993; Schauer 2000). This can be a good thing, if judges benefit from a reputation for probity and impartiality. But it can be a bad thing if the judge cares about his or her reputation for loyalty to a particular cause, faction, or ethnic group—a concern that may be particularly acute in deeply divided societies.

The more general take-away point here for those interested in promoting economic development through judicial reform is the importance of thinking about the judges (and other legal professionals) who must carry out the business of the judicial system not as generic idealized arbiters but as flesh-and-blood human beings who are both rational and fallible. If judicial reform is to achieve its intended goals, it must succeed in aligning judicial incentives with social incentives. One particularly nettlesome problem with efforts to address this issue is that many of the mechanisms that would facilitate the government’s ability to monitor judges and punish those who are

biased or corrupt may also make it easier for the government to undermine judicial independence. That is, there is a well-known tension between promoting judicial accountability and promoting judicial independence. Furthermore, any attempt to address an incentive problem by relying on external monitors merely shifts the incentive compatibility problem up one level.

### *The Institutional Version of the General Theory of the Second Best*

There is yet a third problem that judicial reformers often encounter. This problem is sometimes described as the problem of “partial” or “incremental” reform, or as the problem of the “interdependence” of legal rules and institutions. The basic idea is that individual reforms that look like good ideas when considered in isolation can sometimes have unintended negative consequences. This problem can be conceptualized as an institutional version of the General Theory of the Second Best described by R.G. Lipsey and Kelvin Lancaster (1956).

Though the General Theory of the Second Best may be familiar to many readers, let me offer a quick and informal summary. When a market contains multiple imperfections, correcting or redressing a subset of those imperfections does not always lead to overall improvements in social welfare. In fact, in some cases the correction of some but not all market failures can lead to an overall *reduction* in social welfare. Although the “first best” world may be the one in which all market distortions have been corrected, if the elimination of certain market failures is not possible for some reason, then the “second best” world is not necessarily the one in which other market distortions are minimized. The correction of some market distortions can worsen others.

Consider a stylized illustration involving a monopolist that produces a good with some negative externality, such as environmental pollution. Both the monopoly and the externality are market failures. If an otherwise well-functioning market is dominated by a single firm, the lack of perfect competition means that, relative to the social optimum, the market price will be too high and the quantity will be too low. In an otherwise efficient market for a good that imposes a significant negative externality, the quantity produced will be too high and the market price will be too low. Now imagine a market in which both market failures are present. If both failures could be eliminated—say, through the combination of effective antitrust policy and an optimal tax on the externality—then we would be in the world of the first best. But if one of the market failures is uncorrectable, or simply uncorrected, fixing the other one might make matters worse. Suppose, for example, that the market becomes competitive but the negative externality problem is left unaddressed. The market price will drop and the quantity produced and consumed will increase. This exacerbates the costs imposed by the negative externality, and if this externality is sufficiently costly, then the social welfare loss may exceed the social welfare gain.

Though the General Theory of the Second Best has typically been applied to classic market failures like the ones just described, the basic insight also applies to legal and judicial reform, and to institutional reform more generally. Of course, it may be more difficult to specify the “first best” conditions for complex public institutions than to

do so for markets, but let us assume for the moment that we could adequately characterize a particular constellation of institutions as first best. When actual institutional arrangements deviate from this institutional optimum in multiple respects, reforms that “improve” institutions along some but not all of these dimensions may not improve—and may in some cases worsen—overall social welfare. If certain institutional reforms are simply off the table, at least for the time being, then would-be legal and judicial reformers in the developing world are likely to find themselves confronting a version of the second best problem. A failure to appreciate the fact that movements toward first best legal and judicial institutions do not necessarily lead to better overall performance can lead the most well-intentioned reformers astray.

A simple, generic example of the legal-judicial version of the second best problem concerns the optimal complexity of legal rules. Many legal rules may be thought, with justification, to be too crude. Such rules may be inferior, from a social welfare perspective, to either more complex rules or more discretionary standards. There are ongoing debates in the legal and economic literature about the optimal precision of legal rules and about the relative virtues of rules and more discretionary standards,<sup>4</sup> but we can assume for purposes of illustration that in the first-best world legal rules would entail a reasonable amount of complexity and/or room for judicial discretion. But the first best world also involves sophisticated judges subject to the right incentives. In the real world, certain legal systems may be characterized by crude legal rules and unsophisticated judges. “Improving” the legal rules to make them more complex and nuanced might be a move toward the first-best world along that dimension; however, the overall effect might be negative if unsophisticated judges make more welfare-reducing errors when attempting to implement complex legal rules than would be the case if these unsophisticated judges implemented cruder but simpler legal rules (Posner 1998; Hay, Shleifer, and Vishney 1996).

We can illustrate this general problem with a more concrete example. Although it is generally believed that private agreements between suppliers and customers or manufacturers can be welfare-enhancing, it is also possible that such vertical arrangements may facilitate monopolistic pricing (Posner 2001). It is often difficult to distinguish between good and bad vertical contracts. A sophisticated judiciary, aided by high-priced advocates, may be reasonably good at applying a general “reasonableness” standard without making too many errors. But if the bench and bar are unsophisticated, a country might do better to adopt a simple rule—either banning or permitting all vertical integration contracts—than to allow unsophisticated courts to try to evaluate particular arrangements on a case-by-case basis.

In this simple example, the policy implication appears to be that improvements in the quality and sophistication of the judiciary must precede improvements in the quality of the law. It is also possible to imagine a different example in which improvements in the sophistication of the judiciary, without improvements in the quality of the law, can make matters worse rather than better. Suppose that the law on the books is a bad, welfare-reducing law, but that sophisticated parties have figured out how to get around it, and the unsophisticated judiciary is generally unable to detect such subterfuge. In the first-best world, we might have both efficient law and sophisticated judges. But suppose that we have both bad law of the sort just

described and also unsophisticated judges, and that it is not possible to improve the law. Will improving the sophistication of the judiciary in this situation improve overall welfare? Not necessarily: The improvement in judicial sophistication may make it impossible to avoid the application of the bad, welfare-reducing legal rules. This example is a close cousin of the hypothesis that, at least in some contexts, corruption can be efficiency-enhancing because it allows parties to avoid excessively cumbersome regulatory requirements, and therefore efforts to combat corruption may be counterproductive if unaccompanied by regulatory reform (Huntington 1968).

Another example of how the second best problem can affect the pursuit of judicial reform goals involves the credible commitment problem discussed earlier. In the first-best world, we might want governments to enact welfare-enhancing legal rules that are enforced by independent courts with the power to constrain the government. This constraint is important because firms' willingness to commit assets to long-term projects may be contingent on their confidence that the government will honor its promises not to expropriate these firms' profits. But suppose we are in a world where the law is growth-retarding rather than growth-promoting, and the judiciary is under the government's thumb. Reforms that strengthen the independence of the judiciary without altering the legal rules to which the state has committed itself may make matters worse because the courts may impede efforts by the government to adopt socially desirable legal reforms. Possible, though controversial, real-world illustrations of this problem might be the decisions by a number of courts in Latin America and Eastern Europe to block, usually on constitutional grounds, neoliberal economic reforms thought by domestic governments and outside advisors to be important for economic growth. For instance, a recently created chamber of the Costa Rican constitutional court, Sala IV, was designed to safeguard individual rights, but has had the unintended consequence of obstructing economic liberalization (Handberg and Wilson 2000).<sup>5</sup>

The lesson here is not necessarily that welfare-improving changes in the law must always precede credibility-enhancing improvements in judicial power. Imagine, for example, that law is bad and the judiciary is weak. In this institutional environment, the government's only source of credibility might be reputational. That is, the government might have to demonstrate its credibility by sticking to its announced policy no matter what. If there were a truly independent court and sufficiently cumbersome impediments to policy change, then the government might be able to change its economic policies without a significant loss of credibility, since the government would be as credibly committed to the new policy as to the old. But if we are in a second-best world where no serious constraints on policy change exist, attempts to revise the legal rules might lead to a net loss of social welfare if the loss of government credibility due to the unexpected change in policy outweighs the welfare gain from the improvement in the content of the law. In contrast to the earlier example, here improvements in the credibility-enhancing mechanisms, such as judicial independence, would need to precede improvements in the substantive content of the law.

Let me give another, more concrete example of how the institutions that affect discretion and credibility can give rise to a second-best problem in the context of legal

and institutional reform. This example is drawn from Brian Levy and Pablo Spiller's (1994) analysis of telecommunications regulation in Jamaica. Prior to 1966, Jamaica's telecommunications regulation strategy involved detailed licensing agreements between the government and Jamaica's domestic telecommunications company. These contractual agreements specified relatively precise rates of return over a long period of time, typically 25 years; they could not be modified without the company's consent; and they were enforceable in Jamaica's independent courts. According to Levy and Spiller, this system provided a relatively high degree of credibility and engendered high rates of investment in the telecommunications sector.

The problem with a contractual, license-based system of regulation, however, is its lack of flexibility. Even when dramatic technological, economic, or political changes made a modification to the rate of return desirable, such a change could not be implemented under the Jamaican license-based system without the licensee's consent. Though the design of optimal regulatory institutions is a complicated and controversial topic in its own right, one might reasonably suppose that in a world of first-best institutions, telecommunications regulation would ensure credibility but would also entail more flexibility—perhaps through the use of an independent public utility commission (PUC) subject to appropriate institutional incentives and constraints—than the contractual scheme in pre-1966 Jamaica allowed.

In apparent response to the perceived rigidity of the license-based approach to regulation, in 1966 Jamaica decided to move to a different system. The Jamaican Public Utilities Act of 1966 established an independent regulatory commission, the Jamaican Public Utilities Commission, to regulate domestic telecommunications services. The statute directed the Commission to set a "fair" rate of return. The result, according to Levy and Spiller, was disastrous: The relationship between the Commission and the Jamaican Telephone Company quickly deteriorated, rate increases lagged behind inflation, and investment and network expansion ground to a virtual halt. The reason, Levy and Spiller explain, was that Jamaica in that period lacked institutions that could impose substantive restraints on the Commission's decisions. In contrast to the United States, which has had a reasonably successful (albeit imperfect) experience with rate-setting by independent utility commissions, Jamaica lacked the cluster of formal and informal institutional constraints on bureaucratic discretion necessary to maintain credibility. Also, although the Jamaican courts had proven adept at independently enforcing license contracts, their approach to what we would think of as administrative law—in particular, their review of bureaucratic discretion—was deferential to the point of being ineffectual. The problems in the Jamaican telecommunications sector lasted until the Commission was abolished and replaced with a new license-based scheme (albeit one that differed in many respects from the pre-1966 system).

This example provides a nice illustration of the second best problem. Even if we stipulate that a first best world involves the use of administrative law rather than contract law to determine public utility rates, this does not necessarily mean that changing a system from one that relies on contract law to one that relies on administrative law will necessarily improve the performance of the regulated sector. In a

country like Jamaica that lacks the political and legal institutional endowments necessary to make an administrative law system credible and workable, a regulatory system based on long-term contracts, while imperfect, may well be second best.

Let me give one more historical example of the second best problem in a context that may have particular relevance for present-day legal and judicial reformers. This example is drawn from Rachel Kranton and Anand Swamy's (1999) account of the introduction by the British colonial government of civil courts into the Bombay Deccan region of India in the nineteenth century. Prior to the British introduction of civil courts, agricultural credit markets in this region were dominated by local moneylenders who relied on their own resources and other nonlegal mechanisms to recover loans. Reliance on such costly, personalized enforcement mechanisms meant that the scope of operation for any given moneylender was geographically limited, which led to a segmented market characterized by local oligopolies and high interest rates.

The British colonial authorities believed that the introduction of well-functioning civil courts would facilitate arms-length credit transactions, thereby introducing more competition into the rural credit market and lowering interest rates to competitive levels. Therefore, they introduced civil courts capable of enforcing simple debt contracts—but, importantly, incapable of enforcing more complex exclusive dealing or state-contingent contracts. If the British civil courts had simply failed to work—if they turned out to be corrupt and unreliable, or if nobody had used them—then this case might simply be another illustration of the importance of incentive compatibility, or an example invoked by those who advance the claim that legal and institutional “transplants” generally do not work. But what makes Kranton and Swamy's account of the British introduction of civil courts in the Bombay Deccan so interesting is that the courts *did* have their intended effect of increasing the feasibility of arms' length transactions, thereby stimulating competition and lowering interest rates. At least in the short term, the introduction of effective judicial contract enforcement in the Bombay Deccan appeared to be a great success.

There was a problem, though. The problem had to do with the impact of effective enforcement of simple debt contracts on the ability of borrowers to insure against financial risk. Prior to the introduction of effective civil contract enforcement, if a borrower found himself unable to repay his debt due to natural disaster or some other misfortune, the local moneylender had an incentive to forgive or roll over the debt rather than to seize and sell the farmer's land. If the defaulting farmer retained his land and remained financially viable, then the moneylender could be confident that this farmer would provide a stream of super-competitive interest payments on future loans. Once the civil courts made arms' length transactions feasible, however, no moneylender could be confident of extracting a future stream of monopolistic profits from any individual borrower, and so the incentive to forgive or roll over debt instead of seizing assets dropped considerably. The result, as Kranton and Swamy persuasively argue, was economic disaster and widespread rioting when exogenous economic shocks, including a sudden drop in the international price of cotton, led to widespread defaults and asset seizures by creditors.

The situation in central India prior to the British reform of the civil court system was not first best. Instead, it was characterized by at least two relevant legal/institutional

failures. First, the absence of effective civil contract enforcement led to monopolistic interest rates and an undersupply of credit. Second, the region lacked both an adequate public social safety net and the institutional infrastructure for a well-functioning private insurance market. The introduction of judicial institutions that could effectively enforce simple debt contracts alleviated the first market failure but, in so doing, it exacerbated the second one. This example may be especially salient for modern legal and judicial reformers, given the fact that many rural and poor urban communities may still rely primarily on informal insurance mechanisms. Legal and judicial reforms—even, and perhaps especially, successful ones—may sometimes disrupt these risk-spreading mechanisms.

I have dwelled on these examples of the institutional version of the second best problem because it is, in my view, underappreciated in the literature on institutional reform. It should not, however, be interpreted as a counsel of despair. Incremental institutional reform can, and often does, lead to improvements in overall welfare: The theory of the second best shows that correcting some but not all market imperfections *may* lead to social welfare reductions, not that it necessarily will do so. And, even when partial reform does have counterproductive effects, these problems may be short-lived if the initial incremental reform efforts are followed by more extensive reform of other institutions. The important lesson is that individual reforms cannot be considered in isolation, and that we can and should draw on the tools of economic analysis, applied in a particular context, to try to identify situations in which certain institutional reforms that appear to be movements toward an unachievable first-best world will actually move us away from an achievable second best.

## Conclusion

In this short essay, I have attempted to provide a summary of some of the difficult problems that confront reformers who hope to address the problem of global poverty through the reform of institutions, particularly legal and judicial institutions. The goal is to encourage both scholars and practitioners to pay greater attention to the inherent trade-offs induced by resource scarcity; the importance of making sure that individual incentives are properly aligned with institutional objectives; and the dangers that particular institutional reforms that appear to be welfare-improving when considered in isolation may have counterproductive effects, if other institutional reforms are unachievable.

The more general lesson, it seems to me, is the importance of greater cooperation between those in the policy and scholarly communities who specialize in more abstract and general economic theory and those who possess detailed, country-specific knowledge of particular institutional environments. The need for such cooperation seems self-evident, yet for some reason the communication between technically minded general theorists and context-sensitive country experts has sometimes been characterized by misunderstanding and mutual skepticism. My hope in elaborating on some of the more difficult and recurring generic problems in the field of legal and judicial reform is that the exercise will make an incremental contribution to thinking

more seriously and collaboratively about ways to identify and avoid these pitfalls in the context of specific legal and judicial reform efforts.

## Notes

1. For two recent examples, see Acemoglu and Robinson (2006) and Grief (2006).
2. See, for example, Kranton and Swamy (1999); Lee (1993).
3. For a summary of various theories, see Stephenson (2003).
4. See, for example, Kaplow (1992).
5. To be clear, I am agnostic as to the desirability of the particular economic reforms at issue. I proceed under the assumption that these reforms would have been welfare-enhancing in order to illustrate the nature of the problem.

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