

An Alternative View on Law, Institutions, Finance and Growth

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Introduction

- A number of large East Asian economies have grown spectacularly in the last few decades
 - China
 - Korea
 - Taiwan, China
- They are possibly the greatest economic transformations in history

The Largest 15 Economies in the World: GDP and Growth

GDP in 2011 (simple exchange rates)			GDP in 2011 (PPP)		GDP growth: 1990-2011* (constant prices)		GDP per capita in 2011 (PPP)		Per capita GDP growth 1990-2011* (Constant Prices)	
Rank	Country /Region	US\$ Billion	Country /Region	Int'l \$ billion	Country /Region	Annual growth	Country /Region	Int'l \$ unit	Country /Region	Annual growth
1	United States	15,094	United States	15,094	China	10.4%	United States	48,387	China	9.5%
2	China	7,298	China	11,300	Vietnam	7.3%	Netherlands	42,183	Vietnam	5.8%
3	Japan	5,869	India	4,458	India	6.5%	Canada	40,541	India	4.7%
4	Germany	3,577	Japan	4,440	Angola	6.0%	Australia	40,234	Korea	4.6%
5	France	2,776	Germany	3,099	Malaysia	5.8%	Germany	37,897	Taiwan	4.3%
6	Brazil	2,493	Russia	2,383	Bangladesh	5.4%	Taiwan	37,720	Sri Lanka	4.2%
7	U.K.	2,418	Brazil	2,294	Nigeria	5.4%	U.K.	36,090	Sudan	4.1%
8	Italy	2,199	U.K.	2,261	Sri Lanka	5.3%	France	35,156	Poland	3.9%
9	Russia	1,850	France	2,218	Sudan	5.3%	Japan	34,740	Chile	3.9%
10	Canada	1,737	Italy	1,847	Chile	5.3%	Korea	31,714	Bangladesh	3.6%
11	India	1,676	Mexico	1,662	Korea	5.3%	Spain	30,626	Thailand	3.5%
12	Spain	1,494	Korea	1,554	Taiwan	5.0%	Italy	30,464	Malaysia	3.5%
13	Australia	1,488	Spain	1,413	Peru	4.9%	Greece	26,294	Argentina	3.4%
14	Mexico	1,155	Canada	1,396	Indonesia	4.7%	Saudi Arabia	24,237	Peru	3.3%
15	Korea	1,116	Indonesia	1,125	Egypt	4.5%	Poland	20,334	Indonesia	3.2%

Source: IMF World Economic Outlook Database April 2012

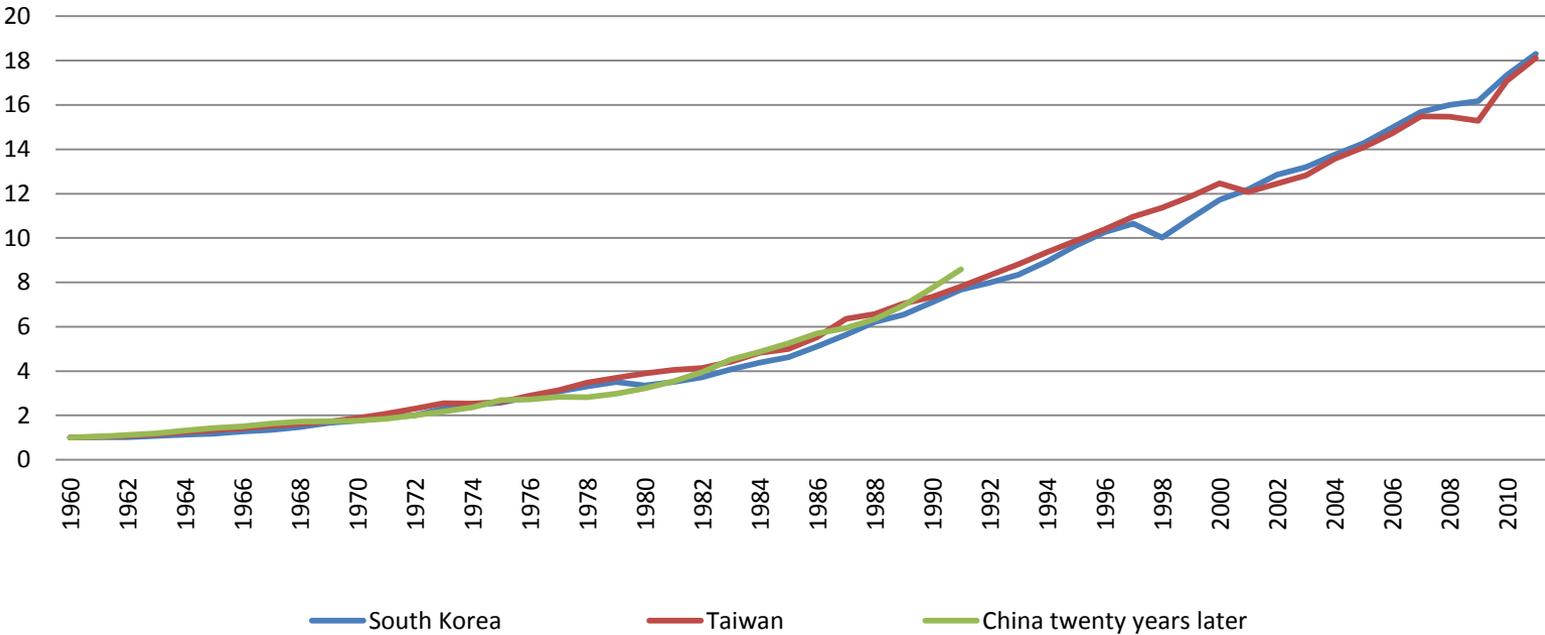
Notes: Countries with population less than 11 million, GDP less than US\$ 50 billion in 2011, or less than 15 years of GDP observations are excluded from the rankings.

The Top Large Economies in terms of GDP per capita in 2011

**GDP per capita in 2011
(PPP)**

Rank	Country /Region	Int'l \$
1	U.S.	48,387
2	Netherlands	42,183
3	Canada	40,541
4	Australia	40,234
5	Germany	37,897
6	Belgium	37,737
7	Taiwan, China	37,720
8	U.K.	36,090
9	France	35,156
10	Japan	34,740
11	Korea	31,714
12	Spain	30,626
13	Italy	30,464
14	Czech Republic	27,062
15	Greece	26,294

A Comparison of Growth in GDP per capita in Taiwan, Korea, and China



Base year is 1960 for Taiwan and Korea , and 1980 for China

Source: Maddison GDP stat

- What economic lessons can be learned from the remarkable growth performance of these countries?
- Are they simply applying the conventional wisdom, which is to copy European and US development?
- Or are they doing something fundamentally different that Western economists and lawyers have yet to fully understand?

Conventional Wisdom

- Key driver for long-run economic growth is efficient institutions that facilitate business transactions (e.g., Coase, 1960; North and Thomas, 1973; Williamson, 1979).
- Emphasis has been on two types of *formal* institutions:
 - First, the law and finance literature posits that a strong legal system that enforces contracts and resolves disputes is important for finance and growth(LLSV).
 - Second, a developed financial system, and in particular, financial markets and a banking sector, are vital sources of external financing to fund firm growth (e.g., McKinnon 1973; King and Levine 1993; Levine and Zervos 1998).

Alternative View

- China provides a counterexample to the conventional wisdom (Allen, Qian, and Qian (2005)). China's legal and financial systems were not well developed yet its economy grew at the fastest pace in the world.
- Similarly the legal system plays a very limited role in finance and commerce in Taiwan, Korea, Vietnam and Japan.
- Despite India's English common-law origin and a British-style judicial system, formal legal and financial institutions are of limited use (Allen, Chakrabarti, De, Qian, and Qian (2011)).

Lessons

- What lessons can we draw from this alternative view?
- China is an extreme example
- In the West we take it as given that finance and commerce should be undertaken using the law as the basis for contracts

Alternatives to the legal system in 19th Century China

- Historically, China did not use the legal system in commerce but it had a highly commercialized society - How did this operate?
- The alternative to law in assuring performance is other mechanisms such as
 - Reputation
 - Connections and networks
 - Positive financial incentives

Other Countries

- China is just one example
- Taiwan
- Korea
- Vietnam
- Japan
- India
- UK, Germany early in their development

Advantages of Law

- Criminal law
 - Can use criminal penalties such as imprisonment to affect people's behavior and provide high-powered incentives
- Civil law
 - Can use financial penalties to affect behavior
- The legal process can be anonymous and transparent

Disadvantages of Law

- Political economy factors suggested by Rajan and Zingales and others
 - Difficult to change the system if circumstances change and a new set of rules becomes optimal
 - Any change must be passed by the government
 - Interest groups may try to prevent such changes if it affects the rents they obtain

Disadvantages (cont.)

- In democracies the electorate has to be persuaded that the change is desirable despite the fact that they may have little information about the issues
- There is a limited amount of time each year that can be devoted to financial and commercial laws
- The legislature has a monopoly and is the only body that can make changes

When is the use of the legal system optimal?

- In a **static** environment where growth rates are low the advantages of using the law can outweigh the disadvantages
 - The incentives that can be provided by the legal system mean that efficient systems can be designed that do not rely solely on positive monetary incentives
 - The fact that change is difficult does not matter in such circumstances

When is the use of the legal system not optimal?

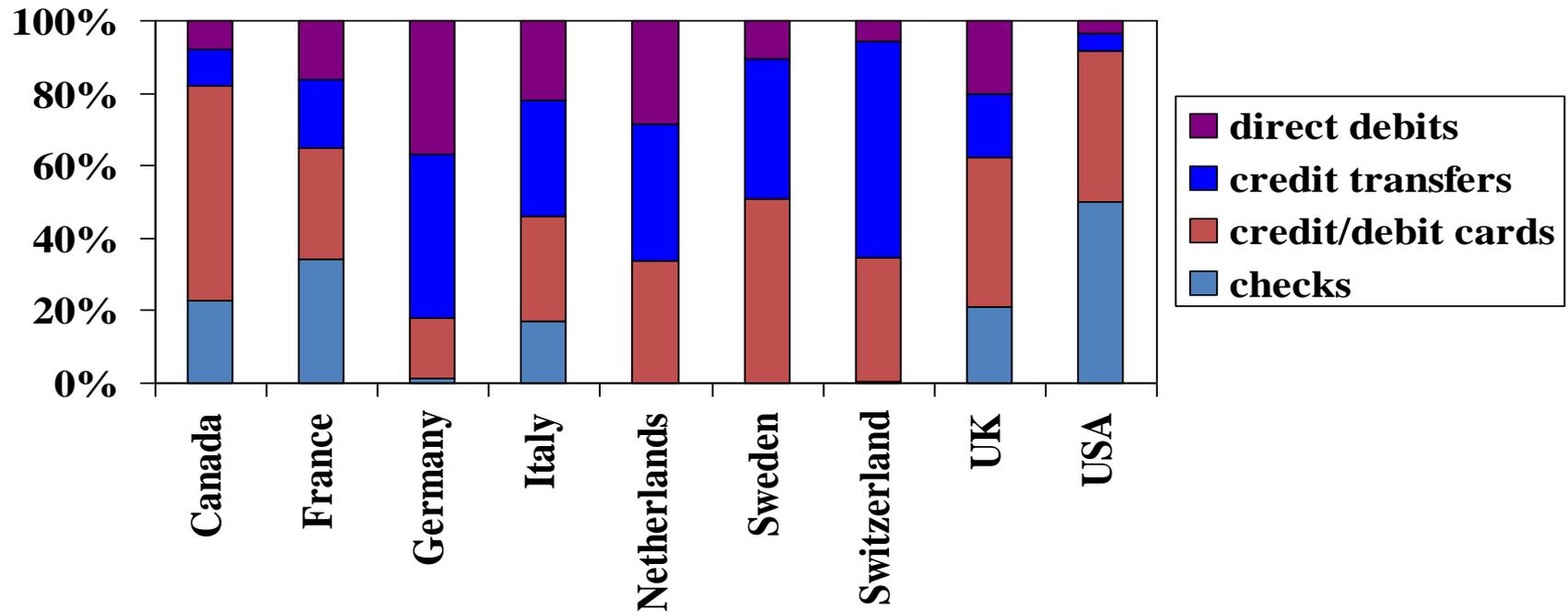
- In a **dynamic** environment barriers to change can outweigh the static incentive aspects
 - Rather than rely on incentives provided by legal mechanisms it's necessary to rely on reputation, connections, and financial incentives
 - However, private systems can change much more quickly
 - Competition between different systems is possible and often the most efficient will prevail

Why are some Asian countries so successful?

- The conventional view is that Asian countries are successful **despite** their lack of Western institutions
- The suggestion here is that they are successful **because of** their lack of Western institutions and their use of alternative institutions

Example of inefficiencies of legal systems

- Limited capacity of legislature: US Payments System



Example (cont'd): US Payment Systems

- At the start of the 21st Century the U.S. had a 19th Century payments system relying on checks and the mail
- Checks had to be physically transported from where they were deposited to a central operations center, then to the clearer and then back to the banks they were drawn on
 - Physically canceled check is the only legal proof of receipt (payment)
- Savings of 1-2% GDP per year moving from checks to debit cards etc.: Humphrey et al. (1996) and Bolt et al. (2005)
 - Savings in the US (10-yr growing annuity): \$1 to 2 trillion
- 9-11-2001 terrorist attacks acted as a catalyst for change:
 - *Check Clearing for the 21st Century Act*
 - Act signed in October 2003 that allows electronic image to be a substitute

Further examples

- Intellectual Property Rights – Do patents improve or impede innovation?
- Alternatives to Patents – Example of Penicillin
- JSTOR and SSRN
- Google scanning of libraries vs. Baidu's Bai Du Wen Ku
- Linux vs. Windows

Conclusions

- China, Korea, Taiwan and other Asian countries' success contains important lessons
- Using the law in finance and commerce is a Western idea and can be optimal in static environments
- In dynamic environments such as these Asian countries experience it may be better to use other mechanisms that do not rely on the law because this reduces the inefficiencies associated with political economy factors