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Does the rule of law add economic value?

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ISLE OF MAN LAW SOCIETY

George Johnson Prize 2014

Does the rule of law add economic value?

30th June 2014

"Corruption is like cancer, retarding economic development."

James Wolfensohn, President of the World Bank¹

Andrew Newton

Articled Clerk, Appleby (Isle of Man) LLC

¹ Statement similar to the one made by James Wolfensohn, President of the World Bank, Transition 7(9-10). p9, September/October 1996.

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No freemen shall be taken or imprisoned or disseised or exiled or in any way destroyed, nor will we go upon him nor send upon him, except by the lawful judgment of his peers or by the law of the land.

—Article 39, **Magna Carta** (1215)—

INTRODUCTION TO THE RULE OF LAW

The rule of law is today a fundamental tenet of a civilised, democratic society²; this concept has gone through thousands of years of evolutionary developments, the ancient Greeks notably recognised its importance, with the philosopher Aristotle suggesting "*The rule of law is better than that of any individual*".

A central catalyst for the dissemination of the concept of the rule of law was the Magna Carta document, entered into by King John of England in 1215. The Magna Carta commenced the divesting of arbitrary power from one individual, the monarch, in favour of empowering the law of the land to protect life, liberty and property rights of the people of England. The colonial exploits of England, and later the United Kingdom, around the world, conveyed the concept of the rule of law to many countries; bringing with it the recognition that the fate of a person should not be in a single individual's hands.

Further than merely transferring arbitrary power away from an individual, the rule of law provides for the pursuit of justice, sought to be achieved through a number of means, such as - the separation of powers within a state in order to provide an impartial judiciary, uninfluenced by political forces; the protection of fundamental rights; residual freedom; the opportunity, forum and means to uphold one's rights; openness and transparency in the proceedings of the law; the doctrine of habeas corpus; and, the avoidance of caprice in the law in order to provide predictable results.

A famous representation of the antithesis of the rule of law can be found in Franz Kafka's novel *The Trial*, where the protagonist is arrested and prosecuted by an inaccessible authority without being informed of the crime or having an avenue available for recourse.

THE RULE OF LAW AND ECONOMIC VALUE

The rule of law provides a legal framework which people in a country can reside within, encompassing the tenets outlined above. This system has often been upheld as paramount by bodies such as the United Nations³, and this paper seeks to address the question of whether societies that implement its tenets will procure economic value in return.

² <http://unchronicle.un.org/article/rule-law-and-democracy-addressing-gap-between-policies-and-practices/>

³ <http://unchronicle.un.org/article/rule-law-and-democracy-addressing-gap-between-policies-and-practices/>

The Effect of Bribery and Corruption on Economic Performance

Corruption is defined by the World Bank as "the abuse of public office for private gains"⁴, but can also refer to the paying of bribes between private sector parties⁵. Bribery is the use of funds, or payment in kind, to one party to extract an advantage for another. Bribery is a common means to corruption, with estimates suggesting that acts of bribery alone approach a figure of \$1 trillion annually⁶.

Arguments have been postulated suggesting that the payment of bribes can provide a beneficial means to avoid burdensome regulation and ineffective legal systems⁷, in essence the "grease" that can lubricate the "squeaky wheels" of rigid governments or corporates, especially in the case of foreign investment into developing countries.

However, arguments pointing to the economic benefits of bribery and corruption are widely refuted in the academic literature⁸; any suggestion of the economic benefits that the payment of bribes might procure would be short term at best, and long term the situation would be the opposite⁹. Further to that point, counter arguments proffered against the "grease" postulation rather suggest that bribery and corruption fuels the growth of excessive and discretionary regulations¹⁰, increasing the demand for bribes further meaning increased barriers to investing in capital projects. This association with corruption in host countries dampening and discouraging foreign investment has been identified in the academic literature¹¹.

⁴ P.8 World Bank "Helping countries combat corruption: the role of the world bank" (1997) (<http://www1.worldbank.org/publicsector/anticorrupt/corruptn/corruptn.pdf>)

⁵ p.4 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>)

⁶ *Global Corporate Governance Forum, Ethics and Corporate Governance in the Fight Against Corruption (October 2008)*, p.2, <http://www.cipe.org/sites/default/files/publicationdocs/Ethics%20and%20Corporate%20Governance%20in%20the%20Fight%20against%20Corruption>.

⁷ PasLeff, Nathaniel H., "Economic Development Through Bureaucratic Corruption" (1964) *The American Behaviour Scientist*, November 8(2): 8-14; Huntington, Samuel P. "Political Order in Changing Societies" (1968) New Haven: Yale University Press; Lui, Francis "An Equilibrium Queuing Model of Bribery" (1985) *Journal of Political Economy*, August, 93(4): 760-781 (all as cited in p.3 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

⁸ *Department for International Development, Eliminating World Poverty: Making Globalisation Work for the Poor (December 2000)*, pp.25-26, <http://webarchive.nationalarchives.gov.uk/+http://www.dfid.gov.uk/Documents/publications/whitepaper2000.pdf>; Cheryl W. Gray and Daniel Kauffman, "Corruption and Development" (1998), p.7, *Finance & Development*, <http://www.imf.org/external/pubs/ft/fandd/1998/03/pdf/gray.pdf>.; Krishnamurthy et al., "Impact of Corruption on Corporate Governance" (September 3, 2011), p.5, SSRN, <http://ssrn.com/abstract=1937733> [as referenced in - Cindy A. Schipani. "The role of corporate governance in promoting integrity and addressing Corruption" (2014) *Company Lawyer*, 35(5), 132-137]; Kaufmann, Daniel and Shang-Jin Wei "Does 'Grease Payment' Speed Up the Wheels of Commerce?" (1998) World Bank and Harvard University (as cited, p.14 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

⁹ P.27 Thomas M. Fitzpatrick *A Taxonomy Of Corruption (2007) Studia Universitatis Babeş-Bolyai, Negotia, Lii, 2*, (ftp://ftp.repec.org/opt/ReDIF/RePEc/bbn/journl/2007_2_2_Fitzpatrick.pdf)

¹⁰ p.8 Cheryl W. Gray & Daniel Kaufmann "Corruption and Development" (1998) *Finance & Development* (<http://www.imf.org/external/pubs/ft/fandd/1998/03/pdf/gray.pdf>)

¹¹ Shang-Jin Wei "Why is corruption so much more taxing than tax?" (1997) The National Bureau of Economic Research, Working Paper 6030, May. (as cited, p.9 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

Prevalent corruption and bribery has also been identified to skew the composition of public expenditure away from important health and education funds, and towards large scale defence projects. The reason behind this is thought to be because projects such as health and education projects are comparatively less easy for public officials to extract economic rents from¹². This is especially damaging in the case of developing countries, where increasing education levels and providing a healthy workforce are vital to both attracting foreign direct investment and increasing domestic investment opportunities as a means to increase gross domestic product (GDP)¹³. Ultimately this will mean a disproportionate hardship on the poor¹⁴, amplifying inequality of outcomes which it has been argued has negative economic consequences¹⁵.

Other than the argument that bribery and corruption distorts the direction of government investment, reducing investments in health and education, they also raise transactional costs for investors and create an environment of uncertainty in an economy. This impedes market confidence, undermines the state's legitimacy in its role, and results in a disincentive to follow through with both foreign and domestic long term investment projects¹⁶.

It has been noted that since the prevalence of bribery and corruption in a country can reduce domestic investment and foreign investment¹⁷, it thus has a negative result for economic growth rates¹⁸. Therefore, through analysis of empirical evidence it has been asserted that by reducing bribery and corruption in developing countries the investment to GDP ratios will be improved¹⁹, with commentators estimating that if the Philippines was to reduce its corruption level to that of Singapore it would raise its investment/GDP ratio by 6.6 percentage points²⁰, providing a boost to its GDP and economic performance.

¹² Paolo Mauro "The Effects of Corruption on Growth, Investment and Government Expenditure: A cross country analysis" (1997) Elliot; Tanzi, Vito, and Hamid Davoodi "Corruption, Public Investment and Growth" (1997) IMF Working Paper, Washington: IMF (both as cited, p. 11 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

¹³ p.20 "Eliminating World Poverty: Making Globalisation Work for the Poor" (2000) White Paper on International Development (<http://webarchive.nationalarchives.gov.uk/+http://www.dfid.gov.uk/Documents/publications/whitepaper2000.pdf>); http://www.oecdobserver.org/news/archivestory.php/aid/1241/Health_and_the_economy:_A_vital_relationship_.html; "Education in the Developing World" (CGD) Centre for Global Development (http://www.cgdev.org/files/2844_file_EDUCATON1.pdf)

¹⁴ Negative effects of corruption include hampered economic growth through economically inefficient decision-making, increased transaction costs due to economic uncertainty, state capture (where policy-makers collude with vested private interests to benefit themselves at the expense of the greater society), and a disproportionate hardship on the poor (e.g. bribery necessary to receive water, electricity, and other essentials). See Krishnamurthy et al., "Impact of Corruption on Corporate Governance" (September 3, 2011), p.5, SSRN, <http://ssrn.com/abstract=1937733> [as referenced in - Cindy A. Schipani. "The role of corporate governance in promoting integrity and addressing Corruption" (2014) *Company Lawyer*, 35(5), 132-137];

¹⁵ p.84 Stiglitz, J. "The Price of Inequality" (2012) Pearson.

¹⁶ p.8 Cheryl W. Gray & Daniel Kaufmann "Corruption and Development" (1998) Finance & Development (<http://www.imf.org/external/pubs/ft/fandd/1998/03/pdf/gray.pdf>)

¹⁷ p.16 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048)

¹⁸ Paolo Mauro "Corruption and Growth" (1995) Quarterly Journal of Economics, 110; 681-712 (as cited, p.9 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

¹⁹ Paolo Mauro "Corruption and Growth" (1995) Quarterly Journal of Economics, 110; 681-712 (as cited, p.9 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>))

²⁰ Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048)

The Rule of Law as a Means to Reducing Bribery and Corruption

The argument that reducing bribery and corruption can provide for a positive economic response has been made above; this is especially present in the case of developing countries, but bribery and corruption still remains present in seemingly developed countries such as Italy²¹, an example of a country whose economy has suffered in recent years²², and also in global organisations such as FIFA²³.

The role of the rule of law as a means to effectively combating bribery and corruption has been noted by commentators²⁴. Such approaches should embody all the tenants of the rule of law in an attempt to achieve success in pursuit of economic value returns. For example, Nigeria has made concerted efforts to introduce new laws as the principal mechanism for curbing corruption, such as updating its criminal code; however, the country still remains mired in corruption, crime, poverty, and violence²⁵. It has been noted that while statutes have been introduced the legal system is dysfunctional which means problems occur justly enforcing rights, there is a general lack of transparency, and there is a history of difficulty in interpreting the statutes to define rights²⁶. It has been asserted that the more difficult it is to understand the laws of a country, the more likely there is of corruption occurring²⁷.

As in the example case of Nigeria, the failure of a country to provide an empowered, qualified and impartial judiciary will stand against a country attempting to combat bribery and corruption. It is also essential for the state to detect as well as effectively prosecute acts of corruption, therefore providing means for whistle blowers to come forward, such as anonymous phone lines, and to protect individuals once they have done so is very important²⁸.

²¹ <http://www.bbc.co.uk/news/world-latin-america-27692334>

²² <http://www.bloomberg.com/news/2014-06-10/italy-economy-shrank-0-1-in-first-quarter.html>

²³ <http://www.independent.co.uk/sport/football/news-and-comment/qatar-world-cup-2022-corruption-allegations-hyundai-becomes-latest-major-sponsor-to-turn-up-the-heat-on-fifa-over-newspaper-claims-9514439.html>

²⁴ p.21 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>)

²⁵ p.6 Abiodun Elijah Obayelu *Effects of Corruption and Economic Reforms on Economic Growth and Development:*

Lessons from Nigeria Department of Agricultural Economics, University of Ibadan, Nigeria

Being a paper prepared and submitted For 2007 African Economic Conference (<http://www.afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/25068317-EN-OBAYELUS-PAPER-ON-CORRUPTION-MODIFIED-VERSION.PDF>)

²⁶ p.6, 10 & 11. Abiodun Elijah Obayelu *Effects of Corruption and Economic Reforms on Economic Growth and Development: Lessons from Nigeria Department of Agricultural Economics, University of Ibadan, Nigeria Being a paper prepared and submitted for 2007 African Economic Conference* (<http://afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/25068317-EN-OBAYELUS-PAPER-ON-CORRUPTION-MODIFIED-VERSION.PDF>)

²⁷ Tanzi Vito "Corruption Around the World: Causes, Consequences, Scope and Cures" (1998) IMF Working Paper (As cited, p.27 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle?" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2048>))

²⁸ p.21 Shang-Jin Wei "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle" (1999) Harvard University and National Bureau of Economic Research (<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2048>); P.4, *Issues Paper On Corruption And Economic Growth*, G20, OECD doc. (<http://www.oecd.org/g20/topics/anti-corruption/Issue-Paper-Corruption-and-Economic-Growth.pdf>)

The Rule of Law as a Means to Creating Stability and Confidence for Investors

It has been delineated above that bribery and corruption can hinder an economy through redirecting government expenditure away from economically beneficial projects and hindering the pursuit of an environment conducive to encouraging both foreign and domestic investment. The latter point can be expanded on further than merely the enforcing of the rule of law to overcome the inefficiencies presented through prevalent bribery and corruption.

The absence of an effective rule of law is a barrier to the proper functioning of a market economy for a variety of reasons²⁹. Accessible, legitimate and empowered courts are important means to encouraging economic behaviour, providing an enforceable means to uphold contracts, and to protect ownership rights, especially from state ownership, as has occurred in Africa to the detriment of the native populations³⁰. This offers the stable environment that not only attracts foreign investment into a country but also provides the stability and confidence to inspire and encourage the indigenous population to set up business schemes and invest within the home economy³¹. In Mozambique for example, a country which has undertaken reforms by making its laws more transparent, introducing laws and regulations focused at creating fair and equal competition, and empowering a reliable legal system to enforce such laws, there was a six-fold increase in foreign direct investment into the country between 1994 and the year 2000³².

CONCLUSION

The tenets of the rule of law, transparency, liberty, justice, equality and fairness, provide for an environment where stability and predictability are present, and where rights and obligations can be upheld and enforced. This presence of the rule of law to create this environment not only acts to reduce and extinguish bribery and corruption in an economy, shown above to be deterrents to economic growth, but it also actively encourages confidence in investors, both foreign and domestic, to dedicate funds to long term projects.

Further so, the rule of law incentivises economic activity within the domestic economy, providing confidence and knowledge for individuals and small operations to speculate and innovate; these small commercial enterprises play a fundamental part of a positive, progressive economy, benefiting economic growth and value³³.

²⁹ p.24 *Eliminating World Poverty: Making Globalisation Work for the Poor* (2000) White Paper on International Development (<http://webarchive.nationalarchives.gov.uk/+http://www.dfid.gov.uk/Documents/publications/whitepaper2000.pdf>)

³⁰ <http://www.theguardian.com/global-development/poverty-matters/2012/mar/02/african-governments-land-deals>

³¹ p.50 *Eliminating World Poverty: Making Globalisation Work for the Poor* (2000) White Paper on International Development (<http://webarchive.nationalarchives.gov.uk/+http://www.dfid.gov.uk/Documents/publications/whitepaper2000.pdf>)

³² p.50 *Eliminating World Poverty: Making Globalisation Work for the Poor* (2000) White Paper on International Development (<http://webarchive.nationalarchives.gov.uk/+http://www.dfid.gov.uk/Documents/publications/whitepaper2000.pdf>)

³³ P.4 Robert McIntyre *The Role of Small and Medium Enterprises in Transition: Growth and Entrepreneurship* The United Nations University, World Institute for Development Economics Research

Therefore, the pursuit of policies to entrench the rule of law within a society can provide a means to achieving economic value and benefits twofold. As outlined above, economic value can be achieved by restraining detrimental behaviours to the economy, such as bribery and corruption, and increasing government accountability, resulting in the redirection of funds to economically positive goods such as education and health. Furthermore, while encouraging positive economic behaviours of investment and transactional commerce, the rule of law is providing a catalyst for beneficial economic outcomes.

Policies that entrench and empower the rule of law should therefore be considered as fundamental policies for development economics where a country is suffering within a culture of bribery and corruption, investor confidence is low and barriers of knowledge and means are restricting the development of small commercial enterprise. Such policies, as alluded to above, include ensuring the separation of powers between the legislature, the executive and the judiciary. This is in order to provide an impartial judiciary that both garners respect domestically and internationally, but also provides just and consistent outcomes for users. Further policies include laws that are both understood and transparent in their introduction and interpretation, and the assurance for users that the forum for upholding rights is both open and accessible.