



2006

International Rule of Law and the Market Economy - An Outline

Samuel Bufford

Penn State Law

Follow this and additional works at: http://elibrary.law.psu.edu/fac_works

 Part of the [Banking and Finance Law Commons](#), and the [International Law Commons](#)

Recommended Citation

Samuel Bufford, *International Rule of Law and the Market Economy - An Outline*, 12 *Sw. J.L. & Trade Am.* 303 (2006).

This Article is brought to you for free and open access by the Faculty Works at Penn State Law eLibrary. It has been accepted for inclusion in Journal Articles by an authorized administrator of Penn State Law eLibrary. For more information, please contact ram6023@psu.edu.

INTERNATIONAL RULE OF LAW AND THE MARKET ECONOMY – AN OUTLINE

*Commentary by the Hon. Samuel L. Bufford**

I. INTRODUCTION.....	305
II. FEATURES OF THE RULE OF LAW SUPPORTING A MARKET ECONOMY.....	306
A. <i>Legislation</i>	306
1. Private Law.....	307
2. Public Law.....	307
B. <i>Administrative Systems</i>	308
C. <i>Judicial System</i>	310
III. CONCLUSION.....	311

Law matters in economic development. The Rule of Law¹ is an indispensable foundation for a market economy, which provides an essential environment for the creation and preservation of wealth, economic security, and well-being, and the improvement of the quality of life.² The Rule of Law is part of the “software” of governmental regulation that is needed to operate the “hardware” of free markets.³

* U.S. Bankruptcy Judge, Central District of California

1. For an attempt to capture the essence of the meaning of the “Rule of Law,” see Gary Goodpaster, *Law Reform in Developing Countries*, 13 *TRANSNAT’L L. & CONTEMP. PROBS.* 659, 673-74 (2003).

2. See, e.g., Allan A. Schmid, *Law and Economics: An Institutional Perspective*, in *LAW & ECONOMICS* 57, 67 (Nicolas Mercuro ed. 1989) (economic activity is not a natural occurrence: it is determined by the structure of the rights that exists in society, and the levels of and changes in these variables are in some part a function of the legal structure and legal changes over time).

3. The interrelationship between the legal and economic process creates a circular chain of functionality. The economy influences the law and legal reasoning and in turn, the law and legal change influence economic outcomes. The interpenetration and interrelations between governments and the economy create a system in which law and conduct in the mixed market economy and economic performance are dependent on each other in a process of circular cumulative causation. See Steven G. Medema et al., *Institutional Law and Economics*, in 1 *ENCYCLOPEDIA L. & ECON.* 418, 423 (Boudewijn Bouckaert & Gerrit De Geest eds. 2000).

Its promotion can make a major contribution to economic growth,⁴ and an infrastructure that creates and promotes legal rights is an essential platform for economic development.⁵ The cumulative costs of doing without the Rule of Law in a modern economy are enormous.⁶

Establishing a firmly rooted system of the Rule of Law is unfinished business in the countries participating in the Central American Free Trade Agreement (“CAFTA”).⁷ Building an effective Rule of Law is essential to the promotion of a free market economic system that fosters transparency in business transactions and operations. The Rule of Law in the commercial sector promotes economic stability and growth, encourages investors to make investments, creates jobs, increases the standard of living, and promotes prosperity.⁸

The Rule of Law requirements for a market economy differ rather substantially from the Rule of Law requirements for other types of social needs. The purpose of this comment is to outline those Rule of Law features that are essential to the proper functioning of a free market economy and to call attention to the unique

4. A free market economy is often seen as an economy free of government regulation – the less regulation, the freer the market. However, the market is not a self-defining or self-regulating institution. The institutionalization of a market requires rules on what can be voluntarily traded, who can trade, what constitutes a completed transaction, and what constitutes voluntariness. The rules of the market are more than mere ground rules for fair exchanges: they can have an enormous influence on the distribution of wealth and power in society. See Donald C. Clarke, *Regulation and Its Discontents: Understanding Economic Law in China*, 28 *STAN. J. INT’L L.* 283, 284 (1992).

5. Economic behavior is strongly conditioned by the institutional environment within which such activity occurs, and, simultaneously, economic activity affects the structure of the institutional environment. The mutual interaction among institutions and the conduct of economic actors is an evolutionary process. Furthermore, the unconscious free play of economic actors with the market will at times cause economic conflicts to arise. Such conflicts cannot always be resolved by the market mechanism within a free market economy. Thus, legal regulation of economic activity is necessary in order to channel and resolve the conflicts inherent in economic relationships. See ROBERT A. GORDON, *INSTITUTIONAL ECONOMICS* 124-25 (1964).

6. A certain degree of economic development is certainly possible without the Rule of Law. Family relationships, rather than the Rule of Law, usually provide the backbone of economic structures in less developed economies. However, such economic structures are limited by the size and resources of the underlying families and must rely on family cooperation for economic discipline. Furthermore, family membership is a quite formidable barrier to entry.

7. The Dominican Republic - Central America - United States Free Trade Agreement, Aug. 5, 2004, available at http://www.ustr.gov/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/Section_Index.html (implemented by Dominican Republic-Central America-United States Free Trade Agreement Implementation Act, Pub. L. No. 109-53, 119 Stat. 462 (2005), at article 10.17).

8. See UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW ¶¶ 1, 7 (2005) [hereinafter UNCITRAL Legislative Guide].

characteristics of these legal features. Part I introduces the role of the Rule of Law in a free market economy. Part II describes the major legal systems that the Rule of Law requires to support such an economy. Part III of this Comment concludes that the Rule of Law is an indispensable basis for a free market economy.

I. INTRODUCTION

A free market economy requires a legal structure to function effectively. A market economy consists of many private actors who establish consensual economic relations to promote their separate and mutual advantage. This multiplicity of actors creates a variety of markets for property and services where supply and demand balance out in equilibrium. It is grossly inefficient for every actor to undertake to negotiate the entire structural framework in which that actor's economic transactions take place.⁹ Therefore, a legal system is needed to provide the foundations for a superstructure made up of reasonable expectations that a particular transaction can produce. A market economy also needs regulation to internalize the costs of doing business and to prevent the substantial externalization of such costs.

The business law system needs to be widely known and accepted as a foundation for economic activity in order to provide an atmosphere of predictability and minimize disputes.¹⁰ When disputes do arise, the legal system needs to provide a systematic approach for the resolution of differences, to minimize transaction costs involved in resolving disputes.¹¹

9. The guarantee of property rights and any necessary enforcement of contract compliance can be more efficiently organized collectively than individually. Thus, transaction costs are decreased by property and contract law. The exchange of goods and production factors in market economies presume definition, allocation, assertion, and protection of individual property and contract rights. Without the legal definition and protection of contractual rights and property interests, individually organized guarantees to such rights and interests would be unenforceable. This lack of protection through governmental police power substantially decreases efficiency in two respects: it increases market transaction costs, and it creates uncertainty as to the outcome of market transactions. See Johan den Hertog, *General Theories of Regulation*, in 3 ENCYCLOPEDIA L. & ECON. 223, 225-26 (Boudewijn Bouckaert & Gerrit De Geest eds. 2000).

10. In order for a market economy to function properly, people must learn how a market economy is supposed to function, and they must come to accept the legal structures that make a market economy possible. Until this learning takes place, neither a market economy nor a system of legal structures on which it is based is likely to take root. See Hon. Samuel L. Bufford, *Bankruptcy Law in European Countries Emerging From Communism: The Special Legal and Economic Challenges*, 70 AM. BANKR. L.J. 459, 474 (1996).

11. See Bradley Klein, *Democracy Optional: China and the Developing World's Challenge to the Washington Consensus*, 22 UCLA PAC. BASIN L.J. 89, 91 (2004) (legal systems that promote predictability, limit government authority, and protect the economic rights of citizens may be a necessary adjunct to economic development in today's global market economy).

A business regulatory system is also necessary to maintain a level playing field for all economic actors and to curb excesses. Rules that limit this free flow to raise the cost of doing business, reduce a country's share in economic growth, limit the creation of wealth and reduce the standard of living. In particular, it is important that the rules apply equally to foreign as well as domestic actors, to encourage foreign investment and the export of domestic goods and services.¹² This permits a national economic system to participate in the broader economic world and the free flow of capital and resources.

II. FEATURES OF THE RULE OF LAW SUPPORTING A MARKET ECONOMY

The distinctive rule of law features required for a market economy impact the enactment of laws by the legislature, the resolution of disputes by the judiciary, and the regulation of the economy by the executive branch of government. Together, the various branches of government must enact and administer a legal system that provides a structure for efficient economic activity and provides a dispute resolution system to resolve controversies in the economic system.

A. Legislation

The network of legal relations necessary to support a market economy has both public law and private law dimensions.¹³

12. See Patricia Isela Hansen, *Judicialization and Globalization in the North American Free Trade Agreement*, 28 TEX. INT'L L.J. 489, 499 (1993). The Rule of Law is often seen as a requirement for a full transition to a market economy. Foreign investors must believe that they can get justice in local courts, contracts must be taken seriously, and property rights and laws must be enforceable. See, e.g., Joel M. Ngugi, *Policing Neo-Liberal Reforms: The Rule of Law as an Enabling and Restrictive Discourse*, 26 U. PA. J. INT'L ECON. L. 513, 550 (2005).

13. Society is a cooperative endeavor for the mutual benefit of all, where there are both identities and conflicts of interests in ongoing human interaction. The existence of conflicting interests necessitates both a process for deciding between competing interests and a method for determining how conflicts will be resolved. See Warren J. Samuels, *Interrelations Between Legal and Economic Processes*, 14 J.L. & ECON. 435, 449 (1971). Given the importance of human interdependence, the role of the legal system, in both public and private law, is to provide a framework or system of conflict resolution and to develop legal rights. See Warren J. Samuels & Nicholas Mercurio, *The Role and Resolution of Compensation Principle in Society: Part One - The Role*, 1 RES. L. & ECON. 157, 166 (1979). Within this system of mutual interdependence, social institutions, such as the legal system, both enhance the scope of cooperative ventures and channel political-legal-economic conflicts toward resolution. See, e.g., Nicolas Mercurio, *Toward a Comparative Institutional Approach to the Study of Law and Economics*, L. & ECON. 1, 2 (Nicolas Mercurio ed. 1989).

1. Private Law

The private law legal structures include contract law, property law, company law (including partnership law), agency and employment law, secured transaction law, and tort (extracontractual liability) law. Contract law provides the underlying rules to fill in the details of the obligations of the parties to transactions, absent agreement to the contrary.

Property law protects the repository of wealth in the society and provides the economic support for transactions. It typically provides separate legal regimes for real property (immovable property) and for personal property (movable property). Company law provides for the organization of business firms (including partnerships) and regulates their structure and operations. Employment and agency law regulates the rights, powers, and conditions of persons acting on behalf of others, permits numbers of people to conduct economic activity on behalf of a firm, and allows them to aggregate their efforts for collective benefit. Secured transaction law facilitates the provision of secured financing for business expansion. Tort law provides for the internalization of adverse impacts that a business might otherwise attempt to impose on third parties and the public, and to absorb them as costs of doing business.

2. Public Law

The public regulation of private transactions is designed to protect the public good.¹⁴ The public law required to support a market economy includes insolvency and bankruptcy law, tax law, environmental law, securities law, banking law and public international law. The various business regulatory systems are typically very numerous and often very detailed. Such regulation needs fine tailoring to assure that it does not unduly hinder business development.

Insolvency and bankruptcy law provides for the orderly reorganization or termination of unprofitable enterprises that are no longer able to compete efficiently in the marketplace, and the redeployment of their assets to more efficient and productive commercial activi-

14. The goal of protecting the public good, or rather public interest, through use of public regulations is to create the best possible allocation of scarce resources for the benefit of the individual and for society as a whole. Regulations can improve this allocation by facilitating, maintaining, or imitating market operation, thus correcting market surpluses and shortages, encouraging beneficial market behavior, and discouraging market behavior, which would be detrimental to society. See Hertog, *supra* note 8, at 225.

ties.¹⁵ At the same time, its collective action function substitutes a more efficient and equitable procedure in comparison with individual debt collection efforts.¹⁶

Financial intermediation laws regulate the activities of banks, insurance companies and other institutions that collect capital and funnel it into investments. Banking law provides for payment systems for the exchange of goods and services and for the accumulation of capital through savings programs. Insurance law provides for the sharing of unexpected exogenous economic risks by institutionalizing the sharing systems.

Securities law regulates the public markets in the public ownership of businesses through bonds and shares of stock in order to promote public investment in the economy. Environmental law protects the environment for public use and enjoyment, and requires businesses to internalize the environmental impacts of conducting business, rather than imposing them on the public. Public international law regulates relations between states and international commerce (which relies on a mixture of public and private law), and provides the legal framework for international commerce.

Tax law serves a dual purpose. First, it provides revenue for the financing of governmental regulatory operations and the provision of public goods whose benefits are too diffuse to impose the costs directly on particular businesses. Second, it gives the government an opportunity to balance the costs and benefits of civilization by transferring a measure of wealth from those who are economically well endowed to those who are needy, so that all can share (at least to a certain degree) in the fruits of economic wealth and development.

B. Administrative Systems

Government provides several different kinds of functions in a market economy. First, government administration is often needed to assure the effective application of the laws regulating economic activity enacted by the legislature. In addition, government promotes efficiency in the market by intervening to deter monopolies, to secure investor confidence, and to prevent externalities (spillover effects imposed on others outside the marketplace), such as air and water pollu-

15. See generally UNCITRAL Legislative Guide, *supra* note 7; WORLD BANK PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS (April 2001), http://www.worldbank.org/ifa/ipg_eng.pdf.

16. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19 (1986) (describing the collective debt collection function of bankruptcy law).

tion, strip mining, hazardous wastes, unsafe drugs and foods, and radioactive materials. Government regulation also imposes macroeconomic policies to stabilize business cycles and to minimize adverse impacts on employment, income and markets.¹⁷ This regulation includes monetary policy, fiscal policy, and government spending.¹⁸

Second, government also contributes to the effective functioning of the economy by providing public goods, such as roads, sewer systems, schools, police departments, and national defense – goods that would be uneconomical for the private sector to provide on its own.

Third, government licensing can be beneficial to promote orderly business conditions and to regulate the provision of expertise to the market. Government licensing establishes minimum standards for the provision of expertise by professionals with special training and experience such as lawyers, accountants, stockbrokers, contractors and engineers. Governmental regulation is needed to assure that such professionals obtain a minimum level of education and experience before they are permitted to offer their services to the business community.

At the same time, the Rule of Law limits the discretionary intervention of the state in economic activities. One function of the Rule of Law (embodied in the concept of “due process of law”) is to constrain and limit arbitrary governmental action in the economic sphere. It is important that regulation be exercised with a light hand so that trade is not restricted and costs increased unreasonably. Excessive government regulation can kill a marketplace, deter investment, and prevent economic growth. The role of government in the economy is

17. In the ideal market, the allocation of resources by means of the market mechanism would be perfect. However, the perfect conditions of this ideal market are not realized in practice. Thus, the allocation of resources is not optimal and a need arises for methods to improve this allocation. Under the public interest theory of economics, one means of achieving an efficient allocation of resources is government regulation. Government regulation, by virtue of its control over the way in which business is conducted, can be used as an instrument for overcoming the disadvantages of imperfect competition, unbalanced market operations, missing markets, and undesirable market results. See Hertog, *supra* note 8, at 225.

18. See Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 75-76 (2002) (Within the confines of a free market economy, the government is unavoidably responsible for facilitating and maintaining the market by securing investor confidence. Thus, a comprehensive legal scheme for securing investor confidence and minimizing the threats that fear poses to the economy is necessary if the market economy is to function properly in order to maximize efficiency. Such a comprehensive legal scheme must include mechanisms for regulating the integrity of financial markets, mechanisms for the regulation of monetary policy to stabilize macroeconomic performance, and mechanisms for regulating government expenditures to stabilize and enhance macroeconomic performance).

to control excesses, not to manage the economy. If government behavior in the marketplace is not constrained, economic freedom cannot be guaranteed, private economic actors will not take risks, and the economy will wither.

C. *Judicial System*

The judiciary is the guardian of the Rule of Law. An effective and independent judicial system is necessary for the resolution of business disputes (including disputes over governmental regulation) that arise in an economy. Such a system must provide independent judicial decisions, reasonable access to justice, and must not impose unreasonable costs on the participants. No person or institution should be “above the law” and exempted from its requirements. It is important that judicial and administrative officials treat relatively similar parties similarly.¹⁹

Judicial independence is an essential cornerstone for the Rule of Law and for the proper functioning of a market economy.²⁰ A market system can operate effectively and efficiently only if marketplace disputes are resolved by courts on the merits, based on legal rules duly adopted and evidence properly presented to the court.²¹ In economic matters, both governmental institutions and private parties must be prevented from tipping the scales of justice in one direction or another absent grave problems of economic or public order.

The judicial system must provide for the prompt resolution of disputes on their merits by an impartial judiciary. Unreasonable delay

19. See Goodpaster, *supra* note 1, at 673.

20. For example, in the case of Mexico, the lack of legal institutions that are perceived as efficient, transparent, and impartial for the purposes of dispute resolution has hindered its capacity for sustainable development and international competitiveness. Seemingly indeterminable legal proceedings, overburdened dockets, outdated and unclear laws, and general lax sense of mandatory compliance created by a combination of a weak enforcement record and a historical tendency to evaluate subjectively the moral worth and justness of legal norms can increase transaction costs, deplete scarce resources, and obstruct the effectiveness of government operations. Such outcomes in turn restrain development by impeding production factor accumulation, economic productivity, and financial development. See Robert Kossick, *The Rule of Law and Development in Mexico*, 21 ARIZ. J. INT. & COMP. L. 715, 720 (2004).

21. See Goodpaster, *supra* note 1, at 673 (It is a basic principle of the Rule of Law that, in any case where facts or the application of the legal rules to the facts are in dispute, decisions should be based on a fair hearing conducted pursuant to neutral procedures as between the parties, where disputing parties may present their case and challenge the cases presented by other parties. The procedures for such hearing should also guarantee against infringement by the government or other parties).

seriously undermines the Rule of Law²² – “justice delayed is justice denied.” The Rule of Law also requires at least some level of appellate review of judicial decisions. Not every case can be decided correctly in the first instance by a busy court with many cases to resolve.

The most important Rule of Law requirement for a judicial system, and one of the most difficult to provide in developing countries, is that judges must be honest and not open to bribery. Where a judicial decision is for sale, justice cannot be provided. Furthermore, a country that tolerates judicial bribery will always be poor: bribery bleeds assets from the economy, and both domestic and foreign investors will refuse to make investments in the country.

Reasonable access to courts includes the conduct of judicial business in public. The Rule of Law also requires the regional dispersion of business courts (except in small countries) so that parties and witnesses are not required to travel inconvenient distances and incur excessive expenses to obtain judicial assistance.

Unreasonable costs are a common impediment to judicial access. The provision of a court system is a governmental function, for which the government should provide the required financial support. A modest level of filing fees and court expenses is merited to deter the filing and litigation of meritless cases and to promote the settlement of disputes. However, imposing filing fees based on the amount of recovery that is requested or obtained is rarely justified.

III. CONCLUSION

The Rule of Law is an indispensable foundation for a market economy, and provides an essential instrument for the creation and preservation of wealth, economic security, and well-being, and the improvement of the quality of life. Separate legal structures are required to support a market economy and to provide for its effective operation. These structures must operate at the legislative, the administrative, and the judicial levels. Without adequate legal structures to support economic activity, a country will always be poor.

22. Judicial delay is a major concern in several CAFTA countries. For example, the court systems in Costa Rica, El Salvador, and Honduras are overburdened, slow, and vastly inefficient. These untenable delays seem to be contributing to a lack of public confidence in the court's ability to resolve effectively and efficiently commercial disputes. See BOOZ ALLEN HAMILTON, USAID TRADE AND COMMERCIAL LAW ASSESSMENT – COSTA RICA (2005), http://www.bizlawreform.com/country_assess/CostaRicaTCLA.pdf; BOOZ ALLEN HAMILTON, TRADE AND COMMERCIAL LAW ASSESSMENT - HONDURAS (2005), http://www.bizlawreform.com/country_assess/HondurasTCLA.pdf; BOOZ ALLEN HAMILTON, USAID TRADE AND COMMERCIAL LAW ASSESSMENT - EL SALVADOR (2005), http://www.bizlawreform.com/country_assess/EI%20SalvadorTCLA.pdf

Virtually all economic opportunities beyond subsistence agriculture require the guarantee of the Rule of Law.²³ It is the Rule of Law that makes a developing nation, such as the CAFTA nations, a safe and reliable investment partner, and that promotes its economic growth and increased prosperity for its people.

23. See Daniel Schneider, *The Rule of Law and Global Poverty*, *THE UPDATE* (A.B.A. Rule of Law Initiatives, Wash., D.C.), Winter 2006, at 4 (quoting William Easterly, N.Y.U. Professor of Econ., Speech at the International Rule of Law Symposium (Nov. 9-10, 2005)).