

Outline for the Rodolfo Debenedetti Lecture by Raghuram G. Rajan and Luigi Zingales

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Inequality, Efficiency, and the Rule of Law

A growing body of research has established the importance of rule of law as a determinant of growth, productivity, and financial development. But what determines rule of law? Why in Brazil do land owners have to hire private policemen to protect their fields and are forced to travel in armored cars, while in the United States or in Sweden that is not the case? Why even within a country, with the same rules, the same judicial system, the same police force, in some areas it takes 1.4 years to judge a case, while in others 8.4?

The critical element in ensuring rule of law in most countries today is not how covetous other citizens are – a strong government can always beat down the greedy. It is not even how rapacious foreign invaders are – warfare in recent times has not typically been conducted for the express purpose of pillaging the property of enemy citizens. The critical element in ensuring rule of law has been the commitment of a country's government to respect the property rights of its own citizens. But what determines this commitment?

One essential element of rule of law is respect for property rights. A property right is a form of monopoly. It gives the owner of an asset the exclusive right to use the asset and

exclude others from its use. But what gives the owner this right? We might be tempted to answer: “The Law”. While it is true that in modern developed societies, property rights are enforced by the legal system, this answer begs the question of what gives the law force. Why in certain countries is the law respected and enforced, even against the might of the government, while in others it is not?

One possible explanation is the nature of the government. Some have argued that by constitutionally enhancing the “countervailing” power of parliament and the judiciary, a government can offer a credible commitment to not expropriate its citizens (North and Weingast, 1989.) There is, however, something incomplete in the argument that the government can show its commitment to respect property by setting up a more democratic political process, which keeps the arbitrary powers of the government in check. At the national level, most rules can be changed. The government can dispense with the democratic political process. Political power is therefore not easily conferred by legislative fiat or a change in the constitution. It is more fruitful to think of the devolution of political power and the security of property not as a political or legal phenomenon alone, but partly as an economic phenomenon. This is the approach we take.

In a nutshell our argument is as follows. A property right is much more defensible when the owner manages the property much better than anyone else. There is a substantial cost to taking the property away, for the owner’s skills would no longer be available – certainly to the extent it was earlier -- for generating value with the property. Thus property that is owned by those who can manage it best is property that not only has the law to support it, but also has economic value backing it. To the extent that the government respects economic value, either because of the power it can purchase, or the taxes it can

pay, an economically efficient distribution of ownership is much more secure than a distribution based on the accident of history or on the whims of the king.

A political institution like parliament is not irrelevant here. To the extent that owners are dispersed, parliament can help them gather and coordinate their actions. But democratic institutions are an instrument, not the source, of their power. This is not just a matter of semantics. With the “wrong” distribution of property, a country will find it very hard to achieve the right balance between the power of the government and the power of the people, no matter how many democratic institutions it has.

Hence, given the wealth distribution, the efficiency in the ownership distribution increases political demand for better rule of law. But given the level of efficiency, greater concentration leads to less secure property rights. On the one hand, the poorer segment of the population will press for redistribution more forcefully when ownership is more concentrated, because expropriating a few can benefit many. On the other hand, the rich might be more reluctant in pushing for a better rule of law, when the inequality is very extreme. In part, they fear that a demand for more secure property rights can be the straw that breaks the camel and trigger a major backlash. In part, they generally hire their own security forces and a better system of law might damage them by limiting the powers of their own security forces.

Hence, in this research we want to focus on the interrelation between wealth distribution, efficiency, and rule of law. We plan to test these interactions using both cross country and within country data (mostly from Italy). Given the difficulty in obtaining reliable measures of wealth concentration and the difficulty in measuring the degree of efficiency in the ownership distribution in a modern industrial economy, we will mainly

focus on historical data on land ownership and explore the effects of the concentration of land and the efficiency it is managed on the security of property rights and the quality of judicial enforcement. To overcome possible concerns of reversed causality we plan to use the impact of the Siccardi law (a law approved in the Kingdom of Piedmont in 1853 and then extended to the rest of the country as it got unified that expropriated many of the church properties and auctioned them off). Areas of the country where the church owned the largest properties all of the sudden found themselves with a more equal ownership distribution and potentially, a more efficient one.