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DO LAWYERS IMPAIR ECONOMIC GROWTH?

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Do Lawyers Impair Economic Growth?

Mancur Olson

Naturally, I am pleased that both Charles Epp, on the one side, and Stephen Magee and his co-authors, on the other, use books of mine in making their arguments. Although I shall later discuss the way in which I believe these books bear on the issue in dispute, the logical place to begin the present discussion is *not* with any books of mine but rather with two commonplace ideas. Elementary and familiar as the notions I will start with are, I believe that they will lead us to a place from which we can see both sides of the issue that Epp and Magee are debating from a new angle.

The first idea is that a society should be governed by “the rule of law” and therefore needs lawyers. The second is that one of the characteristics of good lawyers and good law is that they reduce uncertainty and conflict and thereby lessen the frequency with which people must go to court.

For the present purpose, there is no need to get into any definitional discussion of what the “rule of law” means—it is enough if we agree that in most of the dictatorships of the Third World and in the communist societies, people have not mainly been governed by law but rather have been subject to the more or less arbitrary discretion of dictators or government officials. In the same spirit, we need not here take into account everything that might be meant by good lawyers and good law—most of us will agree that a good lawyer will not draft contracts with needless ambiguities and thoughtless omissions and also that good laws will not be needlessly vague or self-contradictory. We will, I think, similarly agree that

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badly drafted contracts and laws generate costly uncertainties and increase the likelihood that the affected parties will end up with legal problems that require more use of courts and lawyers.

Perhaps surprisingly, both of our two commonplace ideas are important for economic development. Many years of study of economic growth have convinced me that almost nothing is as important for economic development as secure and well-defined rights to property and to impartial enforcement of contracts, and that it is only democratic societies that can protect these rights over the long run. If there is no rule of law and no lawyering in a society, that society will not have the property rights and contract enforcement needed for a thriving market economy. In part because of arguments I have been making along this line, the U.S. Agency for International Development has provided funding to create the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland, so that it can sponsor, among other things, research, education, and technical assistance for the Third World and the formerly communist countries on the importance for economic development of clear property and contract enforcement rights. I believe that the view that a democratic rule of law is essential for long-run economic development is steadily gaining adherents and may before long be generally accepted.

The second idea also has great importance for economic performance. Just as a contract that is badly drafted (perhaps because the parties to it did not hire lawyers) can generate otherwise unnecessary litigation and other great costs for the parties to that contract, so the proliferation and transformation of an advanced legal system can sometimes introduce new legal uncertainties and incentives to litigate that can damage the entire economy that is subject to that legal system. Let us temporarily set aside the question of whether this has in fact happened in the United States. We must first see why it is unquestionably possible that court-made changes in laws and new opportunities for litigation can introduce new uncertainties and problems that limit economic growth in the same way that the lack of a reliable legal system limits economic development in the Second and Third Worlds.

I

Consider the economic development of two hypothetical countries that begin with relatively well-developed legal systems with secure property and contract enforcement rights and constitutions that outlaw bills of attainder or any government action that impairs the obligation of contracts. Suppose that each of these countries becomes increasingly concerned about the victims of misfortune, including the misfortune of poverty. One of the two societies makes an explicit decision through its government that

the society as a whole should bear part of the costs of broad classes of misfortunes facing its citizens and openly raises the tax revenues needed for this social insurance. The taxes raised by this society will, of course, have some adverse effects on incentives, as will some of the subsidies to the unfortunate, but the society may conclude that it is better to bear these costs than to have its citizens face the full burden of the catastrophes of which they are victims.

Given that the innovators and firms in this society know that they cannot be punished for any act that was legal at the time that the act occurred and that the obligations of the contracts that have been made will not be impaired, the environment for investment and innovation can remain predictable. When a firm knows at the time it takes an action what laws apply and what liabilities that action could subject it to, it has a good basis for making its decisions about innovations and investments. When it is clear that the obligation of contracts will not be impaired and that the courts will attempt to enforce contracts impartially in accordance with the language in the contracts, parties in the economic system can reap the gains from a vast range of transactions. Since the legal and institutional environment in this society is relatively predictable, the people in it can reap colossal gains from the contracts, innovations, and investments they undertake.

Suppose that in the second hypothetical society the growing concern for the unfortunate interacts with the organized power of those with an interest in litigation in a way that continually generates legal innovations. Suppose further that legal innovations occur when disputes are settled in the legal system and that justice often comes with long delay. Suppose that the society, sensing that low-income people on average need money more than high-income people do, conflates the case for aiding the unlucky and the poor with the adjudication required for the rule of law. That is, there is a systematic tendency for liability to be shifted more as time goes on to the parties with more money. Finally, suppose that there is the further conflation of deep pockets and high income—a failure to understand that shifting costs to insurance companies, for example, may (especially given the greater capacity of the rich to self-insure) *not* have any income-equalizing impact.

In an environment where new incentives to litigate combine with other factors to create a less predictable legal environment, decisions about innovation, investment, and long-term contracts must be made without knowing what principles will ultimately govern decisions about the types of liability and other costs an undertaking will be subject to. Innovators, investors, and those who make long-run contracts (such as those for insurance) must contend not only with the inherent risks of nature, technology, and economic life but also with uncertainty about the legal environment as

well. To the extent that the principles and precedents that govern legal decisions grow out of disputes that are settled slowly, the principles and precedents that apply when a decision to innovate, invest, or make a long-run contract is made will not be the law that will govern over the time that innovation, investment, or contract is in effect.

If new incentives to litigate and other changes create an uncertain legal environment, the already great risks of the innovations, investments, and long-term transactions that are the main sources of economic growth are made even greater. This increase in uncertainty, no matter how much it shifts costs to deep pockets, does not insure individuals in the society against misfortune or poverty: any attempt to remedy inequality or to provide social insurance that is a side effect of the adjudication of legally actionable disputes is bound to leave out many even of the poorest and unluckiest people in the society. Thus legal innovations that increase the exposure of deep pockets, even if they should happen to be egalitarian on average, are no more rational for purposes of social insurance than a distribution of lottery tickets to the poor would be. They nonetheless greatly damage economic performance.

This damage can occur in at least two ways. First, the metastasis of a legal system can paradoxically introduce, even in a country with a long history of rule of law, some of the problems that arise in large parts of the world from the absence of the rule of law. The tumorous growth of a legal system implies that some of the social vitality—the innovation, enterprise, and mutually advantageous exchange—facilitated by the predictable rule of law is lost. Thus the hypertrophy of a legal system introduces some of the same problems for economic performance that exist in the Second and Third Worlds.

Second, when there are incentives to litigate previously unambiguous rights, more people are attracted to the law. If, as I believe, lawyers are on average relatively talented and industrious people who would be extremely productive for the society in other endeavors, this is an economic issue of great quantitative importance.

II

The foregoing account of two hypothetical situations cannot, of course, lead by itself to any conclusions about any specific society. But it should make it obvious to everyone that Stephen Magee is clearly right in saying that a society can have either too few or too many lawyers. More precisely, there are optimal systems of law and for each society with an optimal system there will also be an optimal number of lawyers.

An ideal legal system with a socially optimal number of lawyers will greatly reduce the uncertainty and conflict in a society, and it will make an

overwhelming contribution to economic progress. In an ideal legal system an optimal number of lawyers will be profoundly useful to society—they will be “conflict-reducing” and “uncertainty-reducing” engineers. The phrase Charles Epp passes on about lawyers being “transactions cost engineers” isn’t quite right, even for an optimal number of lawyers in an optimal legal system: the cost of the *transaction* is less without lawyers, but the saving in transactions costs increases the uncertainty and the probability of conflict and thus reduces the economic gains from innovation, investment, and long-term contracts.¹ The analogy to engineers, on the other hand, is good, for it conveys the correct idea that lawyers in the right kind of legal system are no less valuable to society—and no less important for economic growth—than engineers.

The truth of this point does not argue against Magee’s conclusions. On the contrary, it underlines his point that just as there is an optimal number of engineers, there is also an optimal number of lawyers—or, more precisely, an optimal legal system that will, with freedom of entry and exit in a competitive economy, attract a socially optimal number of lawyers.

III

Once it is understood that the lack of the rule of law (and the lawyering that goes with it) is, in much of the world, the missing link in the chain that is needed to pull the poor nations into the set of advanced economies, and once it is also understood that incentives for the overuse of lawyers and the legal system can also easily limit economic performance, we can begin intelligently to investigate the question of whether there are incentives to overuse or to underuse the legal system and lawyers.

In large parts of the world, there is one obvious factor that makes the role of law and of lawyers less than it should be. This is the interest that dictators (and elected officials seeking arbitrary power) have in avoiding the constraints of law. The leader of a government can achieve his personal objectives more readily if he personally is not constrained by law, and in an autocracy there is by definition no other force that can require an autocrat to abide by the law. Since lawyers use laws and have a vested interest in the rule of law, they are a problem for the governmental leader who is or aspires to be a dictator. This gives power-hungry leaders in some countries an incentive to minimize the number of lawyers. In Chad, for

1. The transactions costs metaphor is sometimes applied so loosely and in contexts so far removed from market transactions that gave rise to the metaphor that any costs beyond the costs that would be incurred even in a Robinson Crusoe society are called transactions costs. On this broad and analytically blunt definition of transactions costs, everything lawyers do would either increase or decrease transactions costs.

example, the IRIS Center has found that the number of full-fledged lawyers can be counted on the fingers of the hands and an active lawyer in that country leads a dangerous life.

In long-stable democracies like the United States, it is evident from the work of both Magee and Epp that lobbying power is one of the determinants of the demand for lawyers. I am pleased that both have used my book on *The Logic of Collective Action* in this connection. In the article under consideration here, Epp uses that book to argue that lawyers do not have much of any organized power.

The Logic of Collective Action shows that collective action to lobby or to collude arises only when one or both of the following conditions apply:

1. *Small numbers.* When, as in a concentrated industry, there are a small number of large firms, each firm will get a significant share of the benefits of collective action and this makes voluntary collective action possible.

2. *"Selective incentives."* The benefits—the "collective good"—provided by a lobby go to everyone in some industry, occupation, or other category, whether or not he or she has paid dues or otherwise borne any of the costs of collective action. This means that large groups cannot act collectively unless there is some incentive that is, unlike the collective good itself, selective and thus punishes or rewards individuals according as they do or do not bear the costs of collective action.

In arguing that *The Logic of Collective Action* shows that lawyers cannot organize for collective action, Epp must be focusing exclusively on the fact that lawyers are not a small group. It is indeed the case historically that the U.S. steel industry, for example, has been better able to organize and collude in its interests than lawyers have. Because the steel industry consisted of a relatively small number of large firms, it may well have had effective cartelization (e.g., "Pittsburgh Plus" pricing) and lobbying power before lawyers did.

But collective action can also arise because of selective incentives, and powerful organizations of lawyers have in fact emerged for this reason. These selective incentives have taken many different forms, but the simplest is the compulsory, closed, or "integrated" bar—in some states, membership in the bar association is a legally necessary condition for practicing law. The incentive to join the bar association is, then, the earnings that may be obtained from the practice of the law, and the selectivity of this incentive is ensured by the requirement that only members of the bar association can enjoy such earnings. Epp provides evidence of this and contradicts his own argument when he points out that 33 states make membership in the law association compulsory. This and other selective incentives explain why a large proportion of lawyers are organized for collective action. The proportion of lawyers who belong to bar associations

greatly exceeds the proportion of blue-collar workers who belong to unions, for example, not to mention the proportion of consumers or taxpayers who belong to organizations serving their interests. It is also obvious from certain political outcomes, such as when trial lawyers defeat "no-fault" auto insurance, that lawyers have some organized power, and certainly more than consumer and taxpayers who bear much of the cost of any higher prices that result from any overuse of the legal system.

IV

Just as Charles Epp has been a little one-sided in using one aspect of *The Logic of Collective Action* while ignoring another, so he has also been selective in citing empirical studies that test the arguments in that book and in my *Rise and Decline of Nations*. This is not the place to list all the empirical studies, but happily several able and disinterested scholars have written books or articles, or edited anthologies or symposia in scholarly journals, that extend and survey the empirical tests and other literature growing out of one or the other of those books. My knowledge of these surveys is probably incomplete, but they include important books written or edited by Todd Sandler,² Kwang Choi,³ Dennis Mueller,⁴ and Russell Hardin,⁵ and symposia in journals like the *International Studies Quarterly*⁶ and *Scandinavian Political Studies*.⁷ A reader who had only Epp's article as a guide would suppose that there were at least as many studies that refuted as supported the two books of mine that he uses. Anyone who reads the symposia and other book-length literature, or who fairly samples the shorter published studies, will become aware that, in this respect (as, I think, in some others) Epp's article is unbalanced.

V

The Rise and Decline of Nations and the literature that grows out of it show that because more and more groups overcome the difficulties of collective action as time goes on in a stable society, the long-stable societies tend to have more special interest lobbying, cartelization, and collusion

2. Todd Sandler, *Collective Action* (Ann Arbor: University of Michigan Press, 1992).

3. Kwang Choi, *Theories of Economic Growth* (Ames: Iowa State University Press, 1983).

4. Dennis Mueller, ed., *The Political Economy of Growth* (New Haven, Conn.: Yale University Press, 1983).

5. Russell Hardin, *Collective Action* (Baltimore: Published for Resources for the Future by Johns Hopkins University Press, 1982).

6. E.g., 27 *Int'l Stud. Q.* (1983).

7. E.g., 9 *Scandinavian Pol. Stud.* (March 1986).

than otherwise comparable societies. Special interest legislation, regulation, cartelization, and collusion are in general most harmful to economic efficiency and growth. They normally make the private return to economic activity in each sector that obtains favored treatment different from the social return and thereby generate an allocation of resources that generates less output than would have resulted from impartial treatment of the different industries and sectors. They also normally increase the degree to which the productive and innovative decisions of firms are constrained by regulation or by tacit or explicit agreements with competitors, and thereby slow innovation.

Because of the totalitarianism, defeat, and occupation they had gone through, in West Germany and Japan after World War II the slates had been swept relatively clean of special interest organizations. Both because the catastrophic consequences of dictatorial experiments had convinced their populations of the virtues of a democratic rule of law and also because the victors gave them little choice, these countries also enjoyed spare and simple but secure protection of individual rights, including rights to property and contract enforcement. As the argument offered here predicts, both countries for a time enjoyed economic growth so rapid and unexpected that it was dubbed "miraculous." As the argument also predicts, this rapid growth is not proving to be permanent, and has diminished as these societies have come to have a higher density of special interest organizations.

Great Britain and the United States, although they certainly had an elaborate democratic rule of law, had by the end of World War II accumulated a great deal of special interest organization. This was especially true in Britain, the longest-stable society, and in the longest-settled and stable parts of the United States, the Northeast and the older Middle West. As the theory predicts, the older economies performed less impressively—the British suffered the British disease of slow growth and much of the industrial activity of the United States shifted from the older Northeast to the previously unindustrialized South and West. There is massive evidence from a great many studies that the process that is described in these prototypical cases after World War II is a general process with effects that can be seen in country after country throughout many different periods of history.

If the law and lawyers are somehow exempt from the general process that affects other organizable industries and occupations, then we can be as complacent as Epp is. But the law and lawyers are surely not exempt from the general process. They have the same incentive to organize and seek arrangements that serve their group interests that other organizable groups do. As Epp has shown, in 33 states membership in the bar has even become compulsory.

Even if organizations of lawyers have not influenced the process in the slightest in their own behalf, the proliferation of special interest legislation and regulation brought about by *other* organized interests has increased the demand for lawyers and the number of lawyers. The more special legislation and regulation there is for each industry or group of firms, the more lawyers need to be retained and the less efficient and dynamic the economy will be. The lawyers are not, of course, to blame for the consequences of the special interest legislation, regulation, and collusion obtained by others, but they nonetheless increase in number because of it—they are a symptom of a profound problem even if they have had no role in causing it.

Thus just as most societies in the world have far too little law, so some societies have too much. In the law, as in so many other things, there is a golden mean. We will probably never find it, but we will be in real trouble if we don't even understand that a society can be on either side of it.