STATE REGULATION AND COURT EFFICIENCY

CESAR ZAMUDIO

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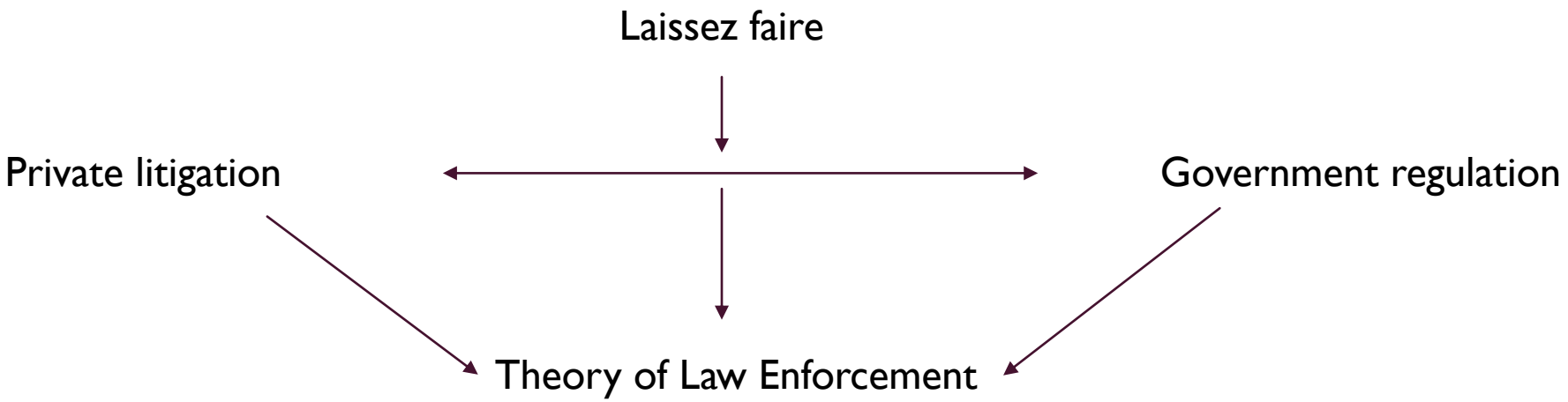
GLAESER, SHLEIFER: "THE RISE OF THE REGULATORY STATE"



INTRODUCTION

- "In our theory, whatever law enforcement strategy the society chooses, private individuals will seek to subvert its workings to benefit themselves. The efficiency of alternative institutional arrangements depends in part on their vulnerability to such subversion" (Glaeser and Shleifer 401)
- Subversion
  - A number of both legal and illegal strategies used to win
    - Legal strategies: legislation, lobbying, hiring top lawyers
    - Illegal strategies: intimidating, bribing, not paying fines
- Efficiency Questions
  - Is this the most efficient solution?
  - If people always seek to subvert the chosen strategy, is there ever a foolproof solution?
  - Are the terms fair?
  - Where do the gains go?
  - Ex post (litigation) vs. ex ante (regulation)

INTRODUCTION

- Consider three regime types based on their vulnerability to subversion
  - Most vulnerable: both litigation and regulation are susceptible to corruption and failure
  - Intermediately vulnerable: regulation may be less vulnerable to subversion than litigation
  - Least vulnerable: regulation-free litigation regime becomes optimal
- Consider the regime type in the U.S. in the nineteenth century
  - "Laissez-faire ideal" where private litigation (torts) was the prevalent law enforcement strategy
  - "Wealth and power regularly subverted the workings of private litigation
  - Subversion of private litigation resulted in unexpected/socially pessimal outcomes (injustice)
  - Independent law of torts that established negligence standard (Oliver Wendell Homes)
    - See *Lochner v. New York* (1905); *Allgeyer v. Louisiana* (1897)

PRIVATE LITIGATION

- Why was private litigation inefficient in nineteenth century America?
  - Transaction costs
    - "Large corporations possessed economic resources far in excess of those at the disposal of their opponents…and used these resources to subvert justice" (G&S 407)
  - Use of illegal and legal strategies
    - Bribery
    - Expensive lawyers
    - Political pressure
  - Not socially optimal
    - No mechanism to ensure that corporations pay the true social cost of their actions

REGULATION IN THE FACE OF SUBVERSION

- Interstate Commerce Commission (1887)
- Sherman Antitrust Act (1890)
- Pure Food and Drug Law (1906)
- Federal Meat Inspection Act (1906)
- Federal Reserve Act (1913)
  - Clayton Act (1914)
  - Securities Acts (1933/1934)

MODEL

- Goal: Elicit the optimal precaution level
- **Assumption 1**: $(P_1 - P_2)D > C$
  - The social cost, given probability of specific precautions, will be greater than the cost of precaution
  - In other words, taking higher precaution is more socially valuable
- **Assumption 2**: $p > P_1$
  - Exogenously chosen
- **"Menu" of law enforcement schemes:**
  - **Strict liability**: Firms are liable under any circumstance when damages occur (plaintiff shows cause)
  - **Negligence**: Firms are liable when damages occur under low precaution level (plaintiff shows fault/negligence)
  - **Regulation of inputs**: Firms are required to take high precaution level (otherwise fines are imposed when it fails to do so)

MODEL

- Assuming no subversion…
  - Strict liability is most efficient if the fine is greater than the cost of precaution
    - No incentives for α type firms to invest in high-level precautionary measures (eliminates inefficiency)
  - Pure regulation is never efficient because it forces α type firms to invest when they otherwise wouldn't
- Assuming subversion…
  - Strict liability requires barriers to subversion to be feasible
  - Negligence is less vulnerable to subversion but distorts incentives
  - Regulation is optimal under high levels of subversion but is never entirely efficient
  - Under high levels of subversion, doing nothing is best

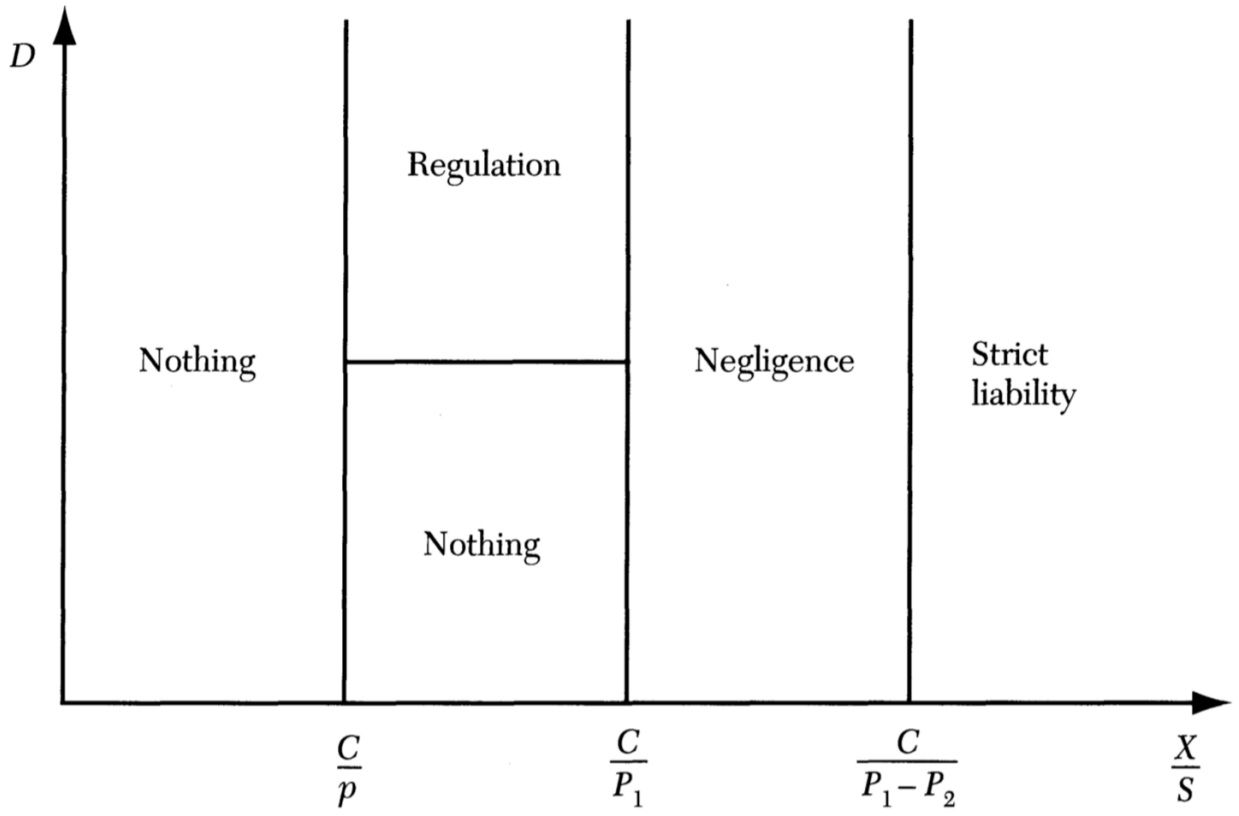


Figure 1.

MODEL (COMBINING LAW ENFORCEMENT SCHEMES)

- Now assume that firms can be sued and face a fine by a regulator (independent of each other)
- Relationship between obedience to law and law enforcement strategies
  - Weak/most vulnerable: doing nothing is optimal because regulation and litigation will be subverted at some social cost
  - Intermediately vulnerable: combination of regulation and litigation because penalties are modest and not likely to be subverted
  - Strong/least vulnerable: private litigation using either strict liability or negligence standard with high enough penalties so as to avoid subversion

APPLYING THE MODEL TO PROGRESSIVE ERA

- S (scale of economic activity) rose sharply during Industrial and Gilded Age
  - Higher levels of S lead to subversion of strict liability and negligence
  - Adding regulation = efficient response
  - As S rises, negligence standard becomes optimal
  - When both S and D are sufficiently large, regulation (with or without litigation) becomes optimal
- Efficient reforms would have increased X
  - Raise incentives to punish law violators
  - Recalling corrupt/inadequate judges
  - Professionalization of bureaucratic enforcement
  - Eliminating influence of political machines

INTEREST GROUP THEORY

- State regulation shaped by "interest groups"
  - Producers: subvert regulation for their own business interests
  - Bureaucrats: use regulation to benefit their own pockets
- Ex: Pure Food and Drug Act (1906)
  - Raise prices/costs for new competitive entrants
- Question to consider: Would market forces have pressured reforms without the need for regulation?

SHLEIFER ET AL.: "COURTS: LEX MUNDI PROJECT"

- Project
  - Comparative study of contract enforcement through courts across 109 countries
- "Procedural formalism"
  - Regulation of court/judicial procedures
  - Examples: requiring professional lawyers and judges, regulating collection and submission of evidence, etc.
  - Question to consider: Does procedural formalism always ensure fairness? Does it necessarily lead to justice?
  - Consider origin of judicial system (ex: French colonial civil law)
- Index
  - Seven broad categories (pg. 6)

CONCEPTUALIZING COURTS (CONFLICT RESOLUTION)

- Public interest
  - Regulating economic activity
  - Dispute resolution
  - Punishing undesirable conduct (establish precedent)
  - Reducing errors in adjudication
- Informal conflict resolution can be vulnerable to subversion (Glaeser & Shleifer)
  - Greater formalism needed to protect law enforcers from being subverted
- Legal origin as an instrument for degree of formalism in legal procedure

HYPOTHESIS

- "If countries select their legal procedures voluntarily, then one can argue that greater formalism is an efficient adaptation to a weaker law and order environment" (Shleifer et al. 13)
  - Given what Glaeser and Shleifer said in the previous paper, is this a valid assessment?

CONCEPTUALIZING PROCEDURAL FORMALISM

- Seven broad categories
  1. Professional lawyers and judges
  2. Written submission/record
  3. Legal justification (grounds)
  4. Submission/presentation of evidence
  5. Appeal and review procedures
  6. Engagement formalities/notice of proceedings
  7. Regulation of proceedings
- Goal: measuring formalism across different variety of legal systems and countries
  - Description, duration, submission, time limits, appeal, alternative administrative procedures

Table 1: Description of Variables

Statutory regulation of evidence

Judge can not introduce evidence	The variable equals one if, by law, the judge can not freely request or take evidence that has not been requested, offered, or introduced by the parties, and zero otherwise.
Judge can not reject irrelevant evidence	The variable equals one if, by law, the judge can not refuse to collect or admit evidence requested by the parties, if she deems it irrelevant to the case, and zero otherwise.
Out-of-court statements are inadmissible	The variable equals one if statements of fact that were not directly known or perceived by the witness, but only heard from a third person, may not be admitted as evidence. The variable equals zero otherwise.
Mandatory pre-qualification of questions	The variable equals one if, by law, the judge must pre-qualify the questions before they are asked to the witnesses, and zero otherwise.
Oral interrogation only by judge	The variable equals one if parties and witnesses can only be orally interrogated by the judge, and zero if they can be orally interrogated by the judge and the opposing party.
Only original documents and certified copies are admissible	The variable equals one if only original documents and "authentic" or "certified" copies are admissible documentary evidence, and zero if simple or uncertified copies are admissible evidence as well.
Authenticity and weight of evidence defined by law	The variable equals one if the authenticity and probative value of documentary evidence is specifically defined by the law. The variable equals zero if all admissible documentary evidence is freely weighted by the judge.
Mandatory recording of evidence	The variable equals one if, by law, there must be a written or magnetic record of all evidence introduced at trial, and zero otherwise.
Index: Statutory regulation of evidence	The index measures the level of statutory control or intervention of the administration, admissibility, evaluation and recording of evidence. The index is formed by the normalized sum of the following variables : (i) judge can not introduce evidence, (ii) judge can not reject irrelevant evidence, (iii) out-of-court statements are inadmissible, (iv) mandatory pre-qualification of questions, (v) oral interrogation only by judge, (VI) only original documents and certified copies are admissible, (vii) authenticity and weight of evidence defined by law, and (viii) mandatory recording of evidence. The index ranges from 0 to 1, where higher values mean a higher statutory control or intervention.

Table 4: Eviction of a tenant and check collection by legal origin and income level

This table classifies countries by GNP per capita and shows the formalism index for the case of eviction of a tenant and the case of collection of a check. All variables are described in Table 1.

	All countries		*English legal origin countries*		*French legal origin countries*	
By GNP per capita level	Eviction	Check	Eviction	Check	Eviction	Check
			Low income - bottom 25 percentile			
Mean	3.69	3.76	3.20	3.18	4.44	4.58
Median	3.60	3.68	3.11	3.19	4.66	4.71
Number of countries	28	28	13	13	10	10
			Medium income - middle 50 percentile			
Mean	3.95	3.73	3.18	2.71	4.59	4.46
Median	3.91	3.93	3.35	2.45	4.54	4.57
Number of countries	54	54	18	18	23	23
			High income - top 75 percentile			
Mean	3.14	2.88	2.53	2.33	3.60	3.32
Median	3.20	2.95	2.51	2.50	3.60	3.23
Number of countries	27	27	11	11	7	7
			All countries			
Mean	3.68	3.53	3.02	2.76	4.38	4.29
Median	3.63	3.52	3.10	2.64	4.33	4.10
Number of countries	109	109	42	42	40	40

Table 8: Outcomes and the formalism index (OLS regressions)

Panel A: Eviction of a tenant

Ordinary least squares regressions of the cross-section of countries for the case of eviction of a tenant. Robust standard errors are shown in parentheses. All variables are described in Table 1.

	Independent variables:			
Dependent variables:	Log GNP per capita	Formalism index	Constant	N [R^2]
Log of duration	0.0215 (0.0501)	0.3225[a] (0.0747)	3.8787[a] (0.5508)	109 [0.14]
Efficiency of the judicial system	0.8281[a] (0.1242)	-0.7366[a] (0.1359)	3.1661[b] (1.4065)	56 [0.59]
Access to justice	1.6093[a] (0.1717)	-0.8574[a] (0.2511)	-5.7556[a] (1.7325)	77 [0.57]
Enforceability of contracts	0.7962[a] (0.0735)	-0.6193[a] (0.0920)	1.6002[c] (0.8514)	52 [0.80]
Corruption	1.0104[a] (0.1037)	-0.5260[b] (0.2082)	-0.1247 (1.1458)	86 [0.60]
Human rights	0.4676[a] (0.0629)	-0.3521[a] (0.1016)	1.0766 (0.7609)	57 [0.51]
Legal system is fair and impartial	0.0993[c] (0.0540)	-0.4451[a] (0.0786)	4.3855[a] (0.4777)	65 [0.26]
Legal system is honest or uncorrupt	0.2181[a] (0.0599)	-0.4188[a] (0.0742)	3.2849[a] (0.5359)	65 [0.28]
Legal system is quick	0.0056 (0.0859)	-0.2816[a] (0.0794)	3.3915[a] (0.7280)	65 [0.11]
Legal system is affordable	-0.1251[b] (0.0487)	-0.1106 (0.0706)	4.4672[a] (0.4030)	65 [0.13]
Legal system is consistent	0.0946 (0.0608)	-0.2602[a] (0.0741)	3.4090[a] (0.5225)	65 [0.14]
Court decisions are enforced	0.1067[c] (0.0559)	-0.2082[a] (0.0676)	3.4581[a] (0.4226)	65 [0.12]
Confidence in legal system	0.1390[b] (0.0539)	-0.0945 (0.0768)	3.0863[a] (0.4874)	65 [0.11]

a=significant at 1% level; b=significant at 5% level; c=significant at 10% level

FINDINGS

- Formalism is greater in civil law countries
- Lower formalism in the richest countries
- Expected duration of dispute is significantly long (about 230 days) and independent of level of development
- Formalism is associated with a less efficient justice system
- Some of the burdens of formalism should be reformed, especially for small claims
- Ceteris paribus, legal origin is likely to determine judicial quality
- Contract enforcement is not costless

QUESTIONS TO CONSIDER FROM BOTH READINGS

- How can institutions better enforce the terms of private contracts?
- Recall the first reading. Can regulation be an appropriate response to large-scale law firms who deal with private contract litigation such as eviction or check collection?
- For countries with weak law enforcement schemes, is it better to do nothing when dealing with the contract enforcement problem presented by Shleifer et al.?