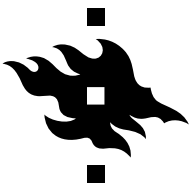


BRIEF NOTES ON THE RELATIONSHIP BETWEEN ECONOMIC DEVELOPMENT AND THE RULE OF LAW

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MAIN FINDINGS

The most recent (2024) Nobel Prize in economics has highlighted the importance of understanding institutional patterns and dynamics at a deeper level, in addition to the linkages to the rule of law. Here we illustrate some stylized facts pertaining to the rule of law, economic development, and Russia via the lens of institutional persistence. *First*, while the world on the aggregate seems to display some positive relationship between the rule of law and economic development over the last 200 years, Russia seems to be an outlier in this respect, with the lack of a relationship. *Second*, the study of Russia, rule of law, and the economy has boomed since the 2008 financial crisis, which has weakened the rule of law globally since, along with other factors that have amplified various populist tendencies. *Third*, our review of the literature concerning the post-Soviet Eastern European states, Russia, and former parts of the USSR found that typically studies have found a varying positive link between the rule of law, in its various forms, and economic development. In our future work, we will next focus on a deeper analysis of both the property rights and the credibility of the political commitment mechanisms in Russia, Eastern Europe, and other post-USSR states in the long run.

FRAMEWORK

Does enhancing the rule of law guarantee economic growth? This is one of the key questions that plagues academics and policymakers in today's world, especially in the increased global uncertainty and societal fragmentation since the 2008 financial crisis and the various crises that have emerged since. We argue that the reversals in the rule of law are rooted in historical patterns of persistence, i.e. that the informal institutional practices are most important in understanding this process, especially in cases like Russia. Similarly, the positive economic impacts typically come at a substantial delay, although the estimates vary, as do also the estimates of the magnitude of the impacts. Our claim is that the economic impacts of the rule of law, however measured, can only be understood fully by examining the historical continuities in institutions.

As Acemoglu, Johnson, and Robinson (AJR) have indicated in their many publications, stable and inclusive institutions that enable the protection of property rights, equal access to the economy, competition and innovation, as well as fair treatment of the members of the society in the eyes of the legal system should lead to economic success, often in the form of advancing along a “narrow corridor” towards higher living standards. (Acemoglu & Robinson, 2016) Respectively, extractive institutions, such as instituted in many colonies and other subjugated societies, comprise concentration of power and property in the hands of the elite, with few constraints on their extractive power, often leading to substantive political rents. (Acemoglu & Robinson, 2001) The narrow corridor, via the so-called Red Queen effect, implies a constant competition and push-pull dynamic between the state and the society, in which the institutional foundation tempers and frames this competition. (Acemoglu & Robinson, 2019)

Another cross-cutting theme in the AJR's extensive scholarly catalogue refers to the importance of transparent and credible institutional commitments, one of which is typically democracy in some form. Academics have been keen on evaluating, in particular, the potential causal relationship between democracy (however defined or measured) and economic growth (typically measured by GDP per capita). Usually, some type of positive link is found to exist, although the magnitude, the direction of causal relation, and mechanisms of the impact are not as clear, nor are the long-term historical patterns necessarily linear. (see e.g. (Colagrossi et al., 2020); (Eloranta et al., 2014); (Ghardallou & Sridi, 2020)) The AJR arguments on this process emphasize the lagged positive effects of democratizations, the various channels of influence that provide greater public good, and the need to disaggregate the economic development measures. Thus,

they argue that democracy does ultimately cause economic growth, and that institutions are pivotal in the democratization effect. (Acemoglu et al., 2019)

Rule of law is a multifaceted concept, which is often expressed in the form of various constructed indices. As in the case of democracy, there are various ways of doing this, as well as numerous ways of measuring it quantitatively. (see e.g. (Taekema, 2021); (Versteeg & Ginsburg, 2017)) Typically, it refers to a set of institutional arrangements that guarantee accountability and commitments in the society as a whole. Here we cannot get too deep into the debate about the indicators rather than utilize two of the most common ones: the World Justice Project's Rule of Law Index, and the one compiled by Our World in Data, based on the V-Dem data, which provides long-run historical data.

Rule of law is obviously linked to democratic institutions, with contracts and political commitments enhancing their effectiveness, but democracy is neither a sufficient nor necessary condition to the rule of law. Rule of law can also be a link between democracy and economic growth. In more developed societies, formal institutions can be more effectively moderated and targeted to improve economic performance, minimizing the lesser societal risks for firms and other economic actors. In less developed ones, informal institutional arrangements can be more important. Regardless of the causal mechanism or the intricacies of the various components of these institutional markers, it seems that rule of law would, like in most studies, have some type of positive link to economic development, especially via secure property rights and credible commitments to maintaining the Red Queen competition.

Social scientists have recently been focused on understanding the persistence effects of various institutions and cultural/societal factors, sometimes of over periods of hundreds or even thousands of years. (see e.g. (Abad & Maurer, 2021); (Cioni et al., 2022)) Some scholars have also invoked the need to look at geography and climate as potential explanatory factors. (Giuliano & Nunn, 2021) AJR and other institutionalists instead make a case for institutional persistence effects, or some type of path dependence. (Bednar et al., 2015) Our review of the literature reinforces our earlier point that a) institutional persistence effect can be very deep and last for long periods of time, and b) such structures can serve as either accelerants or retardants in the process that leads in some form from the rule of law towards economic growth.

PRELIMINARY FINDINGS

What can we ascertain from examining some long-run data? As seen in Figure 1, there seems to be an apparent positive correlation between real GDP per capita and the rule of law (as measured by an index constructed from the V-Dem data) in most parts of the world; namely, as world GDP per capita increased, so did the rule of law. This does not imply causation, of course, but the two phenomena are clearly linked in some fashion. Furthermore, this correlation is not quite as clear for Eastern Europe and, for Russia, there is no such correlation. Therefore, it seems prudent to explore further the historical roots of the institutional processes that have led to the Russian development pattern and to examine how anomalous it actually is, especially from the perspective of economic growth.

The economic development of the region and how much it is associated with the progress in the rule of law also have many differences with global trends. Figure 2 presents the dynamics of the rule of law index for Russia in comparison with the World and European averages. Alexander the Second's judicial reform of 1864 dramatically improved the rule of law in the Russian empire but had only a limited impact on imperial national income that started booming only two decades later. (Zhuravskaya et al., 2024) The impact of reform was also short-lived. Similarly, the Soviet economy demonstrated substantial progress during Stalin's great leap forward (Cheremukhin et al., 2017) but the rule of law index was at a low level. Also, modern Russia's resource-based economic growth coincides with a depreciation of the rule of law indicators.

Overall, there is a rapidly growing literature focused on this potential linkage, which provides some illuminating findings to examine further. This literature is also highlighting the special case of Russia and the region, something that many scholars are now analyzing in a deeper and more quantitative way. In fact, there was a rapid increase in publications focusing on the rule of law in the Russian case, after the dissolution of the USSR, viewed through the lens of the economy. However, we can observe a clearer increase in the 2010s, both in terms of publications and citations. It is likely that this increase is related to the decline in the rule of law since the early 2000s, thus emerging at a delay in the scholarly discussions. This authoritarian turn was less observable at first, which is also reflected in the persistent political optimism that was part of international diplomacy too.

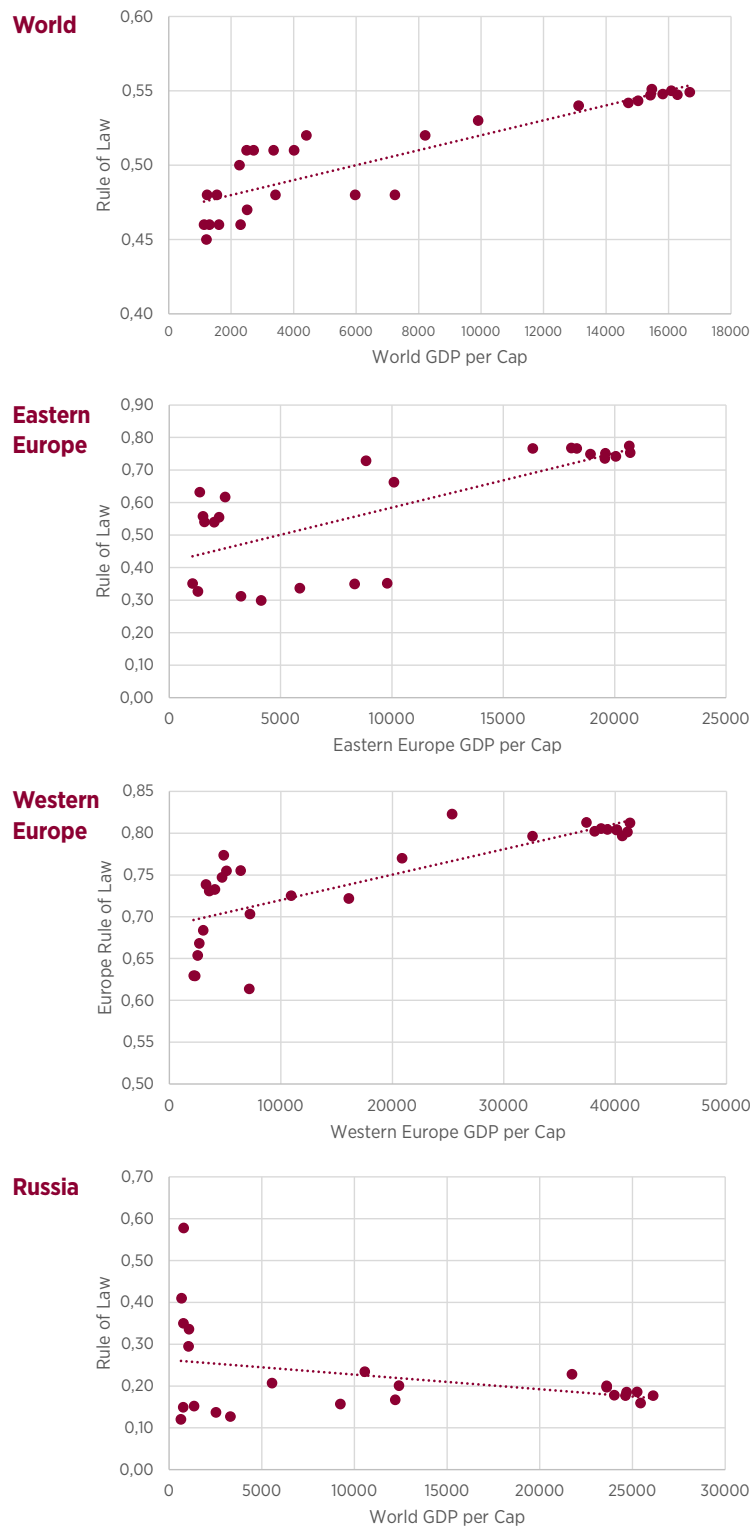


Figure 1. Rule of Law (Index) and Real GDP per Capita (2011 USD), Decadal, 1820-2022

Sources: Our World in Data (V-Dem), (Bolt & Van Zanden, 2020) and (Broadberry & Korchmina, 2024). Decadal values, except for 2015-2022. Note! Some real GDP per capita decadal values for the world in the early 19th century generated using average annual world real GDP per capita values.

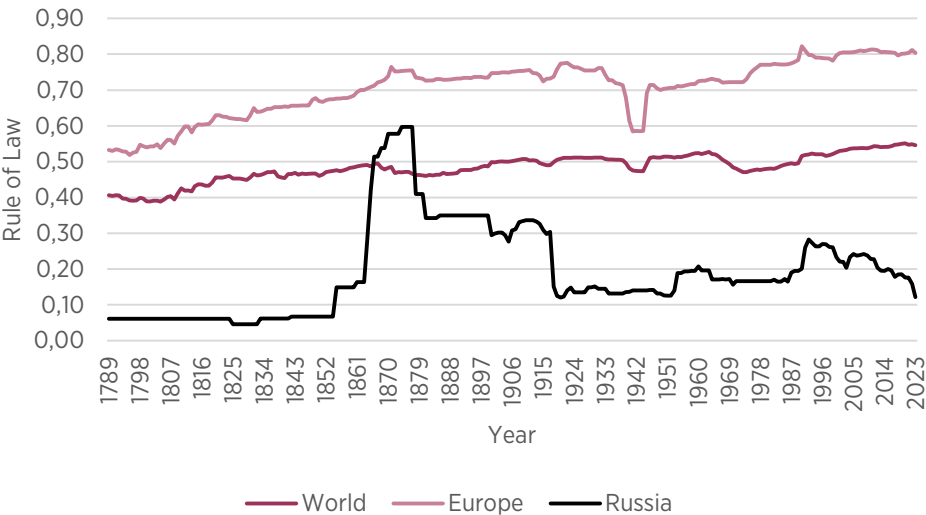


Figure 2. Rule of Law in the World, Europe, and Russia, 1789-2023
Source: Our World in Data (V-Dem).

Therefore, the relationship between the rule of law and economic growth has become an increasingly important area of research. While the rule of law encompasses a wide range of different perspectives, the research literature has placed particular emphasis on property rights and the institutional structures needed to enforce them, such as mechanisms of government control and judicial independence. (Haggard & Tiede, 2011) Through these factors, the rule of law has been identified as an important driver of economic growth.

As such, the path toward a credible rule of law is difficult, and new democracies are typically quite volatile. (see e.g. (Fukuyama, 2010); (Genyi, 2015)) The paradox is that transition countries have often achieved positive economic outcomes even when legal institutions are weak. However, these come at a price. In particular, emerging economies face the challenge of the so-called “double trap”, where the poor quality of legal and other institutions does not allow for higher economic growth and hence institutional development. (Aydin & Karabulut, 2024) Also, societies with a strong tradition of private property protection have often been better able to create the conditions for institutional development and thus a better framework for economic growth. (Socoliuc et al., 2021)

Several interrelated factors determine the effectiveness of the rule of law in practice, including the role of veto players, the credibility of the independence of the judiciary, the level of corruption, and the potential for integration into democratic institutions. The concentration of power in the hands of a small political elite has enabled (often resource-based) economic growth, but it has

also stunted institutional development, leaving the country's economy and politics vulnerable to long-term instability ((Commander & Prieskienyte, 2021); (Farhadi et al., 2015)). This resource curse, in its various forms, can have path dependent impacts on the political economy of a state. (Narh, 2023; Savoia & Sen, 2021)

Furthermore, economic efficiency suffers in countries where property protection is unpredictable and interference with private property is arbitrary. Weak rule of law discourages innovation and investment, and uncertain property rights increase capital flight as firms and individuals move assets abroad to protect them from uncertain local conditions. (Bulatov, 2022) As long as politicians or officials demand bribes, firms have little financial incentive to invest. This not only limits firms' growth opportunities, but also reduces their demand for external finance. In such an investment environment, firms may prefer to imitate other innovations rather than invest in developing new technologies. As a result, the potential growth benefits of intellectual property rights are missed. (Neves et al., 2021)

The absence of institutional veto players undermines the credibility of property rights protection. The positive effect of property rights on economic growth depends on the distribution of political power among multiple veto players. However, neither political power-sharing nor the strengthening of property rights alone is sufficient; rather, their interaction is crucial for economic growth. (Justesen, 2014) Moreover, the Red Queen competition is absent in such polities, replaced by more predatory forms of rent seeking. (De la Croix & Delavallade, 2011)

However, while formal (de jure) judicial institutions can protect private property and strengthen the rule of law, only practical (de facto) judicial independence seems to be consistently associated with economic growth. For example, it allows courts to make politically independent decisions without government interference in the judiciary. The mere promise of an independent judiciary is not enough to attract investment if it is not put into practice. De facto judicial independence enhances the credibility of the rule of law, which contributes to long-term economic stability. Transition economies often face economic transition costs as new institutional structures are put in place. This can lead to short-term instability, but in the long run the benefits of institutional reform can outweigh the costs. However, the long-term benefits require complementary institutional reforms. (Berggren & Bjørnskov, 2020)

IDEAS FOR FUTURE DIRECTIONS

Review of some of the long-run historical data on the rule of law (and other institutional indicators) and economic development indicate a positive relationship, except for certain regions and states, with Russia as our key example. Our review of the extant literature exploring the theoretical literature and the studies of the post-USSR states suggest that historical path dependencies are the key to understanding this dynamic. The concept of a narrow corridor, built on the premise of Red Queen competition between the state and the society, is useful in understanding these path dependencies, which are likely non-linear and complex. However, strengthening the rule of law seems have led to positive outcomes in most empirical cases, albeit at a time lag. The size of the impact also seems to vary substantially. Here we have suggested different types of mechanisms that can enable us to understand such transitions better. In more developed societies, changes in the formal institutional framework can have impact, while in lesser developed polities informal institutions are crucial mechanisms of transition.

In our future work, we wish to explore the case of Russia (and linked states) further, especially to gauge why there have been such pronounced differences in the rule of law outcomes in last 30 years or so. Moreover, we will attempt to estimate the persistence effects, via formal and informal institutions, in the Russian case from the 19th century to today. This can help us understand the hidden structures behind the Russian descent towards more authoritarian society in the last 20 years. In addition, we will try to estimate these linkages quantitatively, thus exploring the methodological challenges and opportunities in such endeavors.

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