For a smooth-running economy, rule of law matters

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Countries in which courts more easily enforce contracts see less economic volatility overall than nations that don't adhere as well to the rule of law. That's the finding from a study by a finance researcher at The University of Texas at Austin.

The research suggests that when contract enforcement is poor, employee morale suffers, ultimately sparking churn, which leads to more economic volatility and greater differences in productivity across companies. Countries that adhere less to the rule of law as measured by the World Bank have greater volatility in their growth rates and in the economy overall.

"In countries where the rule of law is worse, if I'm an employer, I have more incentive to default on my promises to you when a bad shock hits," said study co-author William Fuchs, a professor of finance in the McCombs School of Business. "Without an avenue for concerned employees to seek help, you work less, become less productive, and that amplifies the shock to the economy."

The findings appear in the *Journal of Monetary Economics*.

Fuchs, with Martin Dumav of the Universidad Carlos III de Madrid and Jangwoo Lee of Chinese University of Hong Kong, used game theory —the study of how people make strategic decisions—to create a model in which two entities, such as a boss and an employee, interact over time.

The model includes two building blocks. The first is the concept that businesses are hit by shocks that make them more or less profitable. The second is that contracts are not perfectly enforceable, depending on the legal environment. This lack of contract enforcement can tempt a person to renege on a promise, and when it's the boss, there's a cost. The business relationship is damaged.

The team compared two theoretical economic environments, one with strong rule of law, or contract enforcement, and the other marked by poor enforcement. Then they studied the effects of economy-wide and company-specific shocks.

The researchers found that a 1-point decrease (in a scale of 1-5) in the rule of law measure is associated with a reduction in aggregate volatility by 1.2 percentage points. In countries with weaker legal systems, workers in less productive businesses are quicker to stop putting in effort during rocky economic times.

India and China, for example, which rely more on relational contracts based mostly on trust between parties, could potentially decrease the ratio of productivities of the most productive to least productive companies by about 60% if they could strengthen their legal systems to the level of that in the U.S.

The findings have implications for relationships among employers and employees, businesses, and governments across the globe. Building trust is especially important for businesses in countries where the rule of law is weak and relational contracts are the norm. Organizations can work on building trust well before a major shock hits, and empowering employees to challenge broken promises can also help companies gain credibility.

"The economic cycle could be smoother if you had better rule of law," Fuchs said. "Whatever businesses can do to build trust and make a commitment to enforce promises, that's a very valuable thing."

More information: Martin Dumav et al, Self-enforcing contracts with persistence, *Journal of Monetary Economics* (2022). DOI: 10.1016/j.jmoneco.2022.03.010

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