

The Impact of Courts on Efficiency

Alf Vanags (BICEPS)
Romans Pancs (Stanford University)
Vjacheslav Dombrovsky (BICEPS)

Non-technical summary

This paper is part of a wider project on the theme of “Contract Enforcement and Enterprise Behaviour: Theory and Evidence from the Baltic States” and represents the theoretical output of the project. The starting point of this paper is well summed up by the statement from the Lex Mundi project that the ‘theoretical view of perfect enforcement contrasts sharply with the empirical observation that courts are often slow, inefficient and even corrupt. It is the enforcement of contracts by courts rather than the negotiation of contracts, that often limits Pareto improving trade.’ Also as Messick, in a survey of judicial reform and economic development, writes ‘little is known about the impact of the judicial system on economic performance’.

The novelty of the paper is that the way in which a court works is theorised within a concrete contractual framework, namely the incomplete contracts framework popularised by Oliver Hart. Hart’s work was developed in the context of an upstream producer supplying an input to a downstream enterprise and generates the now well known result that in the absence of perfect contract enforcement, the upstream supplier will in general devote insufficient effort to developing a relation specific product.

Perfect enforcement is a special case in the sense that the court perfectly observes all the provisions of a contract and settles any ‘dispute’ exactly. Thus nothing would ever come to court (if it cost something to use the court) since the parties to a contract would know in advance exactly how the court would rule. Accordingly, in order to observe courts actually being used it is necessary that the outcome of a dispute is subject to some uncertainty. In other words there should be something for the court to decide on.

Here it is assumed that the court is unable to perfectly observe (and hence enforce) the level of effort or investment stipulated in a contract but instead can undertake a judicial investigation through which it observes an estimate of the true value. In these circumstances the results of the model indicate that:

- The presence of even an imperfect courts expands the set of possible contracts and can fully restore efficiency
- When full efficiency is not restored ie when under-investment or under-supply of effort prevails, the scope for inefficiency depends upon factors in part controllable by the court. Moreover, these are potentially observable characteristics and give rise to the following possible empirical relationships:
 - less efficient courts lead to a less efficient outcome
 - the more difficult it is to collect damages the more scope for inefficiency
 - the higher the cost of litigation the more scope for inefficiency

Key words: Courts; upstream/downstream model; economic efficiency