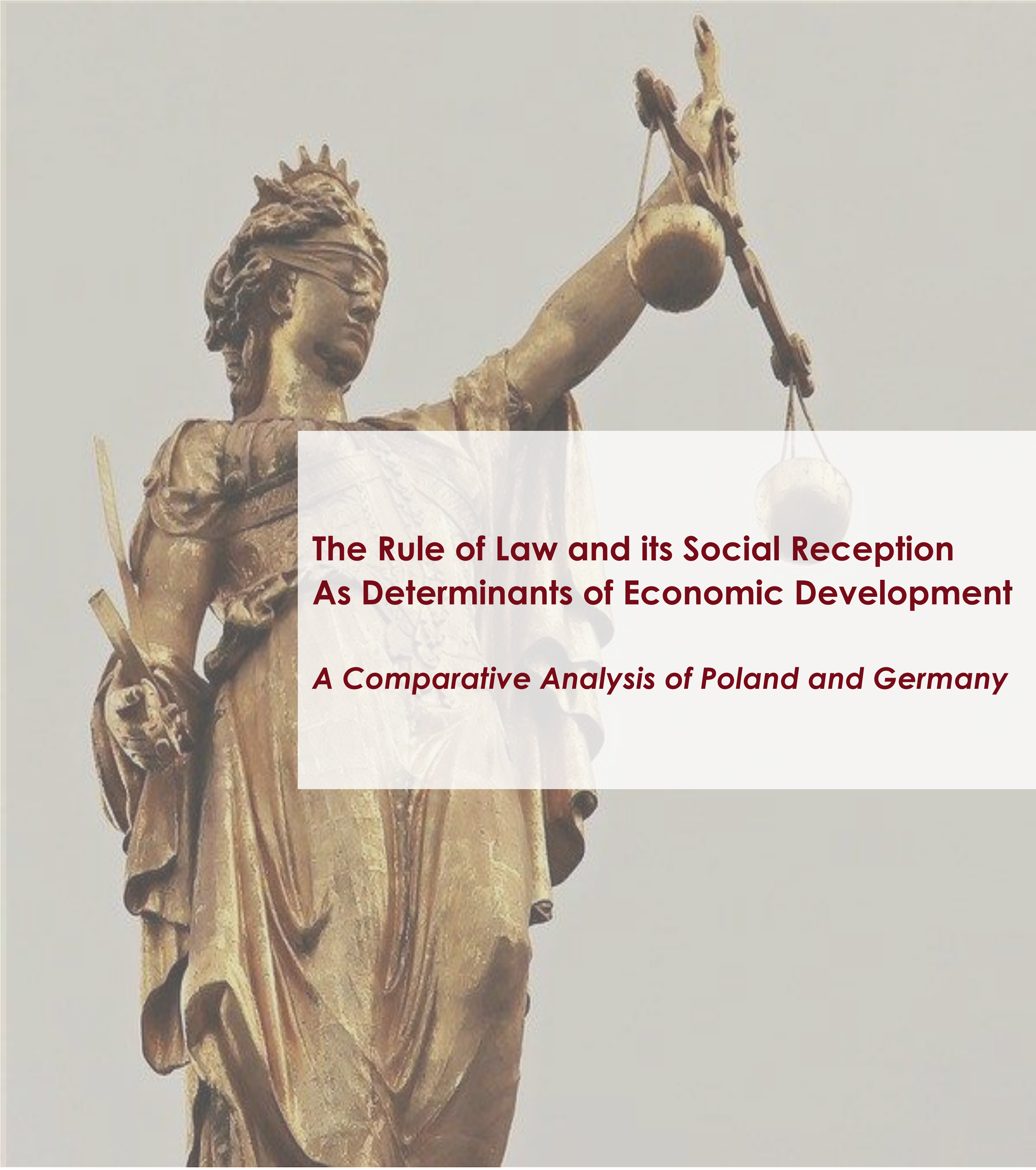

The Rule of Law and its Social Reception As Determinants of Economic Development

A Comparative Analysis of Poland and Germany

CASE

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More about the project please click.

Executive Summary

The rule of law, by securing civil and economic rights, directly contributes to social prosperity and is one of our societies' greatest achievements. In the European Union, the rule of law is enshrined in the Treaties of its founding and is recognised not just as a necessary condition of a liberal democratic society, but also as an important requirement for a stable, effective, and sustainable market economy. In fact, it was the stability and equality of opportunity provided by the rule of law that enabled the postwar *Wirtschaftswunder* in Germany and the post-Communist resuscitation of the economy in Poland.

But the rule of law is a living concept that is constantly evolving – both in its formal, *de jure* dimension, embodied in legislation, and in the *de facto* dimension, or its reception by society. In Poland, in particular, according to the EU, the rule of law has been heavily challenged since 2015 by government and has evolved amid continued pressure exerted on the institutions which execute laws. More recently, the outbreak of the COVID-19 pandemic transformed the perception of the rule of law and its boundaries throughout the European Union and beyond (Marzocchi, 2020).

Against this background, this study examines the rule of law as a determinant of economic development in Germany and Poland from both the *de jure* and *de facto* perspectives, in line with the following research questions:

Research question 1:	What formal institutions constitute the rule of law to the extent relevant to economic development in the countries under analysis – in other words, what is the state *de jure* of the rule of law?
Research question 2:	What is the social reception of those institutions to the extent relevant to economic development – in other words, what is the state *de facto* of the rule of law?
Research question 3:	How does the state *de facto* of the rule of law impact the economic development in the countries under analysis?

The problem that we undertake to research is multifaceted and highly complex. We address the former challenge with a multidisciplinary approach. Taking rules, or norms, as the leading theme of the project and the common denominator of its respective parts, the study bridges two research fields, new institutional economics and sociology of law, contributing to both of them. We believe that by confronting legal norms with social norms – which are often overlooked by legislators – and by grounding our econometric analysis in solid sociological considerations – which are usually disregarded or relegated to assumptions by economists – we will capture synergies that have so far been missing in academic literature.

Rule of Law de jure

The rule of law is a subtle and evolving concept, and an attempt to define it would merit a separate study. In theoretical legal literature, a differentiation is usually drawn between the formal and the substantive approaches to the rule of law (e.g. Krygier, 2015; Waldron, 2016). In the formal approach, which is usually associated with the Anglo-Saxon conception, the rule of law consists in the rightful procedures – such as separation and balance of powers, timely and orderly publication of laws, and the functioning of an independent judiciary. In the substantive approach, more akin to the German *Rechtsstaat*, substantive elements such as rights and freedoms deemed inalienable – in the economic context, *inter alia*, property rights, economic freedom, freedom from corruption – also become integral components of the rule of law.

In parallel, economists have transcended the boundaries of their science, proposing several candidates for extra-economic causes of economic growth. New institutional economics, in particular, focused on studying the rule of law as one of the core institutions determining economic growth. According to this stream of research, institutions may be either contract-enabling and stimulate economic growth, if they decrease transaction costs – i.e. the costs related to the identification of a suitable transaction, negotiation of a contract with the transaction partner, and enforcement of the contract – and increase inclusiveness – i.e. the degree to which diverse parties can participate in a transaction, thus contributing to the societal pool by way of skills and effort. In contrast, institutions are contract-disabling, if they increase transaction costs and create 'clubs' with special privileges.

Because our study has direct economic relevance, and based on existing literature in the field of institutional economics (e.g. Acemoğlu et al., 2005), we distinguish and account for those emanations of the rule of law that satisfy one or both of the above mentioned criteria, namely:

1) separation and balance of powers;
2) the independent judiciary;
3) legal certainty;
4) economic freedom;
5) property rights;
6) anti-corruption regulations;
7) free media;
8) items of general relevance (e.g. non-discrimination, state liability).

Clear, certain, and predictable regulations permit economic actors to plan their actions, allowing them to efficiently manage their resources. Property rights secure ownership of assets, driving down the costs of securing them by private means. In particular, intellectual property rights, by allowing companies to recoup investment and reap returns, play a crucial role in driving innovation. As such, they are particularly important to innovation-based economies (such as Germany) and economies facing a transition to the innovation-based model (such as Poland). Economic freedom ensures equality of opportunity, allowing everybody to contribute to the common pool. Fortified by anti-corruption mechanisms, economic freedom ensures optimal allocation of resources, as seen for instance in merits-based employment and competition-based project financing (in contrast to arbitrary allocations, such as by nepotism or cronyism). The checks and balances built into the political system keep it from being hijacked by particular interests and are strengthened by the public scrutiny routinely performed by free media. Acting as a referee, the independent judiciary provides insurance to companies and households through which contracts are enforced (e.g. default), decisions of state authorities reviewed (e.g. in tax disputes), and unfair practices of other market participants (e.g. unfair competition) screened out.

Given the complexity of measuring and studying the rule of law from the de jure perspective, we structure our analysis along the following pillars: historic review, indicator analysis, and legal analysis.

Historical review. From a historical perspective, both Germany and Poland have rich constitutional traditions. At the same time, the perceptions of the rule of law and the levels of trust in public institutions appear to be influenced by historical and economic factors and differ across the old lines of division that used to cut both countries in two (in Germany) or three (in Poland).

In Germany, trust in public institutions has been, and partly remains, lower in the East, which was a result of the economic downturn, missing identification with the newly built institutions and the legacy of the structural democratic deficit of the former authoritarian state (Roland Rechtssreport, 2015; Roland Rechtssreport, 2020; Köcher, 2019). Similarly, the available studies on Poland indicate that following the unification, with a single legal system now in place, the social working of legal rules still differs along the old partitions borders (e.g. Becker et al., 2016, Vogler, 2019). These findings correlate with the regional differences in GDP per capita levels, which also largely follow the old partitions borders, yet the establishment of a causal relationship is notoriously difficult due to the problem of endogeneity.

More urgently, the rule of law in Poland has been undergoing a clear erosion since 2015. That erosion has taken the form both of detrimental changes in the legal rules and in the ruling class's approach to law, that is legal culture. The legal analysis presented in the report describes this process with respect to the particular dimensions of the rule of law. In the second part of this report, we study how these changes translate to the wider social reception of the rule of law.

Indicator analysis. Measuring the Rule of Law is a complex task that cannot be reduced to single numbers and data. Nevertheless, we use the insights of the indices that evaluate business environment, investment attractiveness, and state of the rule of law per se to ensure a comprehensive de jure analyses of the rule of law frameworks in Germany and Poland.

From the analysis of five key rule of law indicators we conclude that Poland performs low relative to Germany and other EU countries. In the *World Justice Project Rule of Law Index* 2020 Poland scores 0.66, ranking 28th globally, but trails in both the regional and the income cohorts, at the 19th and 27th places, respectively. In addition, Poland experienced a significant downturn across all the indicators over the last years. Following a strong performance in the *World Justice Project Rule of Law Index* and a recognition as a successful reformer in the 2010 and 2011 editions of the report, Poland experienced a 25% drop in the *Constraints on Government Power* indicator between 2015 and 2019, which is the largest of the 126 countries in the study. Further, a significant decline has been recorded in the *Judicial Effectiveness* factor (by 24%) of the *Heritage Foundation's Index of Economic Freedom* since 2018.

The performance of Germany remains high and historically stable. Specifically, Germany ranks 6th globally with a 0.84 score in the *World Justice Project Rule of Law Index* with government accountability, freedom from corruption, and accessibility and efficiency of the court system being repeatedly praised as particularly strong points (World Justice Project, 2011, 2014). Similarly to Poland, Germany`s historically stable Doing Business Index score (around 79 points) has been linked with a steady decline in the relative ranking (from 14th in 2015 to 22nd in 2020). However, including social criteria to the rule of law, Germany performs better than many other countries with higher scores in the purely economic freedom indexes (e.g. the United States ranks 6th and Germany ranks 20th in the *Fraser Institute's Economic Freedom of the World Index*, but looking at the Social Progress Index of the Social progress imperative (2020) Germany is ranked 11th out of 163 countries, with the U.S. 28th).

The results have to be interpreted cautiously as different problems and challenges come with the use of these indices, including different temporal and geographical coverage, a so-called 'OECD bias' (Moller and Skaaning 2011), and reliance on expert-interviews rather than large panels. Finally, there is a big problem when it comes to the correlation between the single indices since they all use different measurements and it is not always clear what exactly is understood as Rule of Law.

Legal analysis. Our legal analysis of the rule of law in the economic context underlines that both countries are subject to the rule of law in all of its aspects, namely: equality, non-discrimination, and other items of general relevance; separation and balance of powers; the independent judiciary; legal certainty; economic freedom; property rights; anti-corruption regulations; free media. The current state of the rule of law in Germany and Poland has specifically benefited from the common legal tradition and the European Union's acquis communautaire.

Further, in both Germany and Poland, the concept of the rule of law plays a central role for economic subjects to adhere to certain proceedings that guarantee a just, independent and free treatment of economic disputes. Nevertheless, it became clear that the social aspect of the law has a more fundamental role in the German Constitution and industrial relations.

Since 2015, in particular, the official rule of law elements, including checks and balances, free media and judicial independence have suffered in Poland. This includes the 2016 re-merge of the offices of Minister of Justice and General Prosecutor, which reduced the independence of the prosecutors to the advantage of the government, as well as serious and public pressure on judges and unlawful structural incursions on the independence of the judiciary. The long-term effects of this transition on Polish economy have yet to realise in the upcoming decades.

Rule of Law de facto

By combining the insights of our *de jure* analyses with the findings from surveys and in-depth interviews with representatives of small and big business in Germany and Poland, we find significant divergences in terms of understanding and execution of the rule of law in both countries.

Our sociological results, in particular, show that many Polish firms consider rule of law as formal obedience of rules, which is primarily their responsibility vis-à-vis, the state. At the same time, the state is largely mistrusted by Polish business representatives with '*position of the opposing party*' and '*social capital that parties dispose of*' being recognised as one of the most important factors for a successful trial in 35.5% and 24% of cases by small and big business, respectively. Such distrust towards the Polish state helps explains why large portions of Polish society are relatively indifferent to the breaches of the rule of law by the government with regard to judiciary independence, political opposition, and free media, among others. When analysed from a historical perspective, these findings can probably be related to the long periods under foreign rule (168 years in the 19th and 20th centuries), including the old imperial powers and, more recently, the communist regime.

In Germany, on the other hand, firms view the rule of law more as an instrument at their disposal, to be used vis-à-vis business partners and the state. This perception is not devoid of critique, with about a third of small and big business representatives in Germany stating that '*none*' of the rule of law elements is being adequately fulfilled in the country.

Impact of the rule of law on the economic development

Thus, there is a clear contrast between the evaluation of the of rule of law performance and the role of state in both countries. While many companies in Poland confuse the 'rule of law' for the 'rule by law', the German perception is significantly closer to the understanding of the rule of law as a device primarily at service of society (including in its economic capacity). In comparison with the Polish firms, the attitude of German firms is also closer to the spirit of the social contract and also shows an implicit awareness in German firms of the advantages of the rule of law as theoreticized by new institutional economics. For instance, at least three interviewees from Germany clearly highlighted that the rule of law reduces transaction costs, which realises in a form of insurance against uncertainty and facilitated dispute resolution, among others.

Further, considering transaction reducing properties recognised by the German respondents and lower degree of uncertainty as to state's action and intentions, one can expect higher levels of investments, hence economic development in the long-term. Our empirical findings further confirm this assumption. Using a novel estimation technique on a new database of Polish and

German variables, we found that level of rule of law can be predicted strongly by both political and macroeconomic conditions. Plugging these results into an equation relating investment to rule of law, we found that rule of law does indeed also positively impact investment, quite substantially over the life cycle over a worker and almost immediately.

Specifically, at the maximum level of rule of law predicted by our analysis, a country would see an increase in its income-based capital per worker of an additional USD 16,941 *per worker* in 1990 constant US dollars. Conversely, if Poland or Germany were to suffer the lowest level of rule of law, their workers would see USD 38,466 *less* capital. This effect begins to peter out the further away we examine the level of rule of law (starting in year 3 and persisting for years after that), meaning that the domino effects of poor rule of law are substantial indeed as well as immediate. Put simply, given the opportunity cost – not just today but in future years – of foregone investment, recent year rule of law is crucial for building up an adequate level of investment for workers.

These results show how decisions affecting the rule of law have longer-term ramifications for a country, and that lower levels of rule of law can ultimately result in far lower levels of investment and hence, development.