

# STABILITY OF INSTITUTIONS, PROPERTY RIGHTS, RULE OF LAW AND ECONOMIC DEVELOPMENT

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**STABILITY OF INSTITUTIONS:** Stability of institutions and developing stable institutions are the basic conditions for any developed, developing or least developed countries to produce, survive, compete and develop basic human, physical and institutional infrastructure conducive for sustained economic growth over the long run. In any country where institutions are not developed and where impediments exist for the development of stable institutions, there will not be economic growth. It is stated that few private investors are interested in investing or lending under such conditions where the countries lack the requisite credit worthiness and basic human, physical, and institutional infrastructure<sup>1</sup>.

The development of stable institutions and the environment conducive for the developing of new stable institutions in an integral ingredient of the wealth of a country. A

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**\*\* The Author is solely responsible for the contents**

*1. Development Committee, Aid For development: The Key Issues., (The World Bank & IMF, Washington, D.C., 1985) P. 9.*

country may lack certain physical resources. However, if it has stable institutions, stable government, the system of rule of law, and the existence of strong property rights, this country sooner or later will attract external inflow of capital, entrepreneurs, creditors and investors to undertake profitable projects according to the rules of market-directed system.

If a country has not been able to develop a system "to avoid or later, finding itself idle and without any definite mission, will 'go into politics' and threaten the government<sup>2</sup> and destabilize the country. As a result, drawing room generals, by dint of haunting the corridors of government departments, comme to dream of manifestos"<sup>1</sup>. The process destroys the gradual development of governmental institutions. It breaks down the line of authority, responsibility, delegation of power and social discipline within the system. It creates conditions of "severe cruelty" which is displayed in relations between individuals and groups and, by officials of governments." which "is particularly true in the military dictatorships"<sup>2</sup>. In such circumstances, the whole decision-making mechanism is concentrated in the hands of a military dictator, who is declared to be the head of state or the President. The ministers, and their general directors become whipping boys of the President. Without President, no minister or no general director is able to initiate any constructive proposal or decide on any matter, no matter how trivial it could be. The process generates an over-centralization of activities under the supervision of the head of state. The affairs become unmanageable. The competition for the attention of head of state becomes severe. The "proper officials" abuse the position of power regularly by "the threat of obstruction and delay" as a "method of exploiting a position of public responsibility for private gain"<sup>3</sup>. As a result, "corruption impedes the process of decision-making and execution in all levels."<sup>4</sup> This happens because of the nature of ownership of resources. Since the President and officials of a country do not own the resources, they exercise the rights to the uses of resources without effective monitoring system. In exercising of these rights, the decision-makers decide about uses and consequences which are borne by others from the uses of resources. It is hard to pin point the responsibilities. If something goes wrong, the tax-payers will suffer the losses of bad decisions. The consequences have great impact on tax-payers whose monitoring and enforcing of their rights are very costly. This is a system of government ownership.

**1) PROPERTY RIGHTS:** The kind of property rights, rights of access to markets, rights to exchange goods and services, and rights to use and transfer of resources are influential in every aspect of a country and of institutions. It depends on different property rights in which who decides to produce what, on what manner and what proportion and for whose consumption. The decision of saving or dissaving the portion of current income for the future is a part of property rights. To answer the questions like "Ac-

2. Frantz Fanon, *The Wretched of The...* Grove Press, Inc., New York, 1963. P. 202.

1. *Ibid*, P. 202.

2. Gunnar Myrdal "need For Reforms in Underdeveloped Countries" in *The World Economic Order: Past and Prospects T* P. 518.

3. *Ibid*, P. 520.

4. *Ibid*, P. 520.

ording to whose preferences and by whose authority and who will suffer the losses of bad decisions?" is to indulge in property rights.

**Private Property Rights** have been defined as the rights of owners to choose the use of their goods and resources (including labour and time) as they see fit<sup>1</sup>. In private property rights, incentives, rewards, and penalties, are orders and signals for the wealth maximizing person to look for the best. He has to produce and bear the consequences of his actions. He has to suffer for the bad decisions. He has to reap the benefit of good decisions. When he decides to invest in certain projects, he has to invest in information in order to identify "right" kind of project and bring in right kind of capital good-not just any kind of capital good. Private property rights can be strengthened with the development of certainty of property rights. The certainty of property rights depends on existence of:

- legal institutions
- property laws
- rule of law
- reliability of the judicial process.
- security of peace
- stability of the government.

As a matter of fact the firm existence of private property rights is an important part of wealth of a country. If the people, are less fearful of theft of the wealth they accumulate, they will have incentives and positive encouragement to invest more. The more secure they feel about their wealth the more investment they will undertake to increase their riches in different field of activities in which they perceive opportunities for profit.

The weakness of private property rights and weakness of enforcing and protecting private property rights is one of the main obstacles to rapid economic growth and development in so many poor countries<sup>1</sup>. They will stay poor and vulnerable as long as their unwillingness or inability in strengthening the private property rights persists. When private property rights exist, the demand of the consumers and productive capacities of the entrepreneurs will regulate the market. Consumers will compete with the consumers and the producers will compete with the producers to produce at the cheapest cost as possible. In this manner through market competition, the scarce resources of the society is efficiently utilized. Here we witness the market discrimination. An entrepreneur will not discriminate to its employees because of race, creed, religion or personality. The discrimination based on prejudism in private sector will cost dearly to the entrepreneurs. As wealth maximizing persons struggling to stay in competition; they can not afford the luxury of prejudism, misconceptions, discrimination and nepotism.

As stated earlier, the existence of strong private property rights is one of the sources of greater wealth of society in which the individuals will:

<sup>1</sup>. Armen A. Alchian and William R. Allen, *Exchange and Production Theory in Use*, (Wadsworth Publishing Company, - Inc., Belmont, California), P. 153, PP. 239-251.

<sup>1</sup>. *Ibid*, P. 560.

- increase saving through lower current consumption;
- generate production through investment in land, machine and inputs;
- increase productivity by efficient use of human and non-human resources in exploiting profitable investment options.
- provide opportunities for the development of mental talents of the society for constructive business activities.
- develop conditions to utilize the knowledge of laws of nature by processing natural resources to beneficial ends.

Ownership of property with certainty of private property rights is an integral part of freedom in which freedom of speech, freedom of resource and job mobility, freedom to search for the truth, freedom of initiative, individual dignity and freedom of alternatives would exist and flourish. In private property, the prices and profits are the basis for economic activity. The resources are mobilized because of expectations of higher prices and profits. Prices and profits have been employed as incentives and rewards to solve the economic questions. The government would protect and enforce private property rights. The governments can supplement private investments through incentives and tax-relief. Governments can increase investment in education, health, and physical infrastructure, etc. In other words, government can provide conditions conducive for private investment. **In public sector**, on the other hand, the uses of resources are divided among various people in government agencies with orders and penalties. The economic questions are solved through political power and exchange of non-privately held rights. Then, political exchange, political decision-making and political competition shape the society and regulate the behaviour of people accordingly. The resources are used and privileges are given according to the preferences of people in authority. No one suffers in authority to the losses of bad decisions at least in the short run. No one in the country will take risk of losing his government job to question the way the resources have been utilized. Indeed, it is the "lack of ownership, not personal greed," which "is responsible for wasteful use of resources"<sup>1</sup> in government agencies and agencies owned by governments. The problems with less and least developed countries become more crucial when the concentration of decision-making process is within the hands of a few. They use the power of authority for personal gains. As we can see in the case of many governments where the rulers use the state power for years with their cronies who "have extraordinary wealth and influence through official favours, privileges and connections ..... costing the country dearly in the process....."<sup>2</sup>. They waste scarce resources for big monuments, entertainments and uneconomic projects, since they do not pay from their pockets. As a result of these activities, exchange rate and monetary policies they follow, necessary stability for private initiative and capital accumulation is not established. Uncertainty and fear cause the flight of capital. The country becomes poorer. It becomes very difficult to ar-

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1. *Ibid.*, P. 563.

2. Chris Sherwell, "Marcos Business Cronies Under Attack," *Financial Times*, Feb 20, 1986. P. 5.

rest and reverse capital flight as one economist indicated that capital flight, in which exports are underpriced or imports overpriced for reasons of fear, hedging or personal preference, has weakened not only local savings and capital formation, but also exchange reserves, vital to keep essential imports flowing<sup>3</sup>. The protection of private property rights, even in foreign exchange, and "sound policies at home are the key" for stability in which, "some of the money can come back."<sup>1</sup> IFC has been trying to channel private capital from industrialized countries to some of developing countries because of "A show of confidence from foreigners will be a great incentive for domestic investors to invest in the stock market in their own countries"<sup>2</sup>. IFC will teach the domestic investors about the stability of their own countries.

**2) LAW AND ORDER:** The establishment of law and order is a pre-requisite for the development of private property rights. By law and order, it does not mean the suppression of any voice by brutal force. By law and order it means the use of the rule of law for every one in the society as a basis for ultimate judgement. With the lack of law and order, it means the rule of arbitrary dictators as a basis for ultimate judgement. Without the rule of law, no legal institutions and laws protecting private property rights can develop. With the rule of arbitrary dictators the potentialities, the resources, and the mental talents of the society will not be utilized for the benefit of all, including the benefits of the dictators in the long run. Without the certainty of property rights and the reliability of the judicial process, no investor will dare to undertake the financing of a viable and profitable project. In so many less developed countries, the rulers and their ministers themselves do not have trust in their very governments for the lack of use of the rule of law and the lack of the reliability of the judicial process. The minute they are dismissed, their property and their lives could be in danger. If there has been established the certainty of property rights and the use of the rule of law as a basis for ultimate judgement in less and least developed countries, if a person loses authority, there is nothing for him to be afraid of law if he has not committed crimes and accumulated public funds for private uses. He can face the court and keep his property because of certainty of property rights and the reliability of judicial process. The persons of wealth and power, including the dictators of less and least developed countries, invest a portion of their wealth in Switzerland, London, Paris and New York because of the certainty of property rights over there. The dictator knows for sure if he loses his power base, his property in his own country will be confiscated immediately with a decree whether he runs away or dead during the power struggle<sup>1</sup>. If the laws weaken the property rights, less investment and less flow of resources will be channeled to the sectors. If the expectation of weak property rights persists, then less current saving and more current consumption out of current income and wealth will take place in the private sector. The political leadership is unwilling to develop legal institutions as a permanent wealth of a country. The development of these institutions

3. Leonard Silk, *Economic Scene*: "Latin Nations' Capital Flight," *The New York Times*, April 17, 1985.

1. *Ibid.*

2. William Hall, "World Bank Investment Concept: Looking for Third World Winners," *Financial Times*, Feb. 18, 1986, P.24

1. "Haïti: Le gouvernement annonce la nationalisation des biens de l'ancien Président Duvalier" *Le Monde*, 20 Fevrier, 1986, P. 8.

and stability take long time to mature and bear fruit. The political leadership does not have incentives to strengthen property rights and the use of the rule of law as a basis for ultimate judgement which are pre-requisite for economic development and sustained economic growth. The fear of competition to the political leadership pushes the people in the authority to maximize their own wealth and privileges by leasing strategic areas to "friendly" donors in order to get political, military and economic aid to purchase their security and "prop up their sometimes shaky regimes than promoting long-term social and economic development."<sup>1</sup> The persons in authority keep their position and invest a portion of aid given by donor countries in stable countries as long as they continue to be useful to donor countries. When to cost of keeping "friendly" persons in power in "friendly" countries becomes costly to donor countries, the extended military, political and economic aid is cut short and the service of persons in the authority approaches to an end. If the persons in authority leave their country alive, this will create a problem for donor countries to seek a place of peace and security for their former clients<sup>2</sup>.

In summary economic activities will flourish in environment in which positive incentives have been provided, and the certainty of property rights and the reliability of the judicial process for the use of the rule of law as a basis for ultimate judgement are established. If these are provided, the stability of the institutions, the stability of developing new institutions and the stability of government will take place. The savers and investors will search for profitable opportunities and projects to maximize their wealth not only for their current consumption but also for the future consumption of their offsprings. With stable environment there is no need for the World Bank to establish a fund to guarantee investment in less and least developed countries against confiscation and nationalisation.

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1. Michael P. Todaro, *Economic Development in the Third World*, (Longman Inc. New York, 1981), P. 412.

2. The assets of President Marcos of Phillipines, worth more than \$ 300 million in the United States. The United States offered a plane to evacuate Marcos and his family from the Phillipines for the United States offered a plane to evacuate Marcos and his family from the Phillipines for the United States. See *New York Times*, Feb 24, 1986.