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## Efficiency of Justice and Economic Systems

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### Abstract

The growth of an economy depends not only on economic factors, but also on institutions, the citizens' trust in them, by the sharing of values and expectations. The differences between public policies and institutions are often regarded as one of the key explanations of the wide differences in levels and growth rates of per capita across countries. Among the institutions that have the greatest impact on economic performance, the legal and judicial system plays a prominent role. Understanding how laws and regulations affect economic behaviour is fundamental in modern economies and the economy facilitates the identification of those that are, in each country system, the incentives to the litigation, the process of litigation itself and the costs, in order to verify the distributive impact of the different legal and judicial systems and what features they should have to encourage economic growth. The operation of a legal system may impact on many dimensions of development: equity, the optimal allocation of resources, and the increase in total factor productivity. Moreover, the role of the judicial system in determining its dysfunctions can affect economic growth. In fact, Italian economic growth has been and is definitely hampered by the length as well as by the civil and criminal justice processes, which reduces legal certainty and confidence, increases the risk of economic activities and therefore reduces the propensity to invest. The Italian judicial system has many efficiency and organization problems, resulting in a lack of its credibility. These are very intricate, and are the product of a mixture of features that are very difficult to isolate. The aim of this work is to assess the ways in which the administration of justice in Italy influences the choices and behaviours of the two main economic actors - households and businesses - analysing if there is any (a) symmetry in their preferences. In fact, there are many factors that determine the failure of Italian justice, and among these also the users of the justice services produce a collapse in justice system when they take legal actions only for postponing a payment or avoiding an obligation. Thus, the source of the problem and its resolution could be identified in the distorted incentives generated by all of the rules connected with the process.

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Economic growth depends on economic factors, institutions and the level of trust citizens have in institutional powers. The differences between public policies and institutions can also explain the differences in per-capita growth level between Countries. Scully (1988) demonstrates that countries with a good level of institutions, in terms of stability and per capita measurement, grow faster than those with a low level of institutions.

Economic performances are influenced by the legal and judicial system, capable of forming the rules of the game.

Every society is governed by a set of rules that operate within a framework of formal legal institutions - tangible structures and codified norms - and informal ones, such as customs, habits, informal rules, moral codes, routine etc.

Understanding how laws and regulations affect economic behaviour (choices) is fundamental in modern economies. Moreover, an economy facilitates the identification of those aspects that are, in each country system, the incentives to litigation, the process of litigation itself and the costs, in order to verify the distributive impact of the different legal and judicial systems and what features they should have in order to encourage economic growth.

The importance of the rules and their relevance for the economic growth is also widely acknowledged in academic and institutional framework, and the role of judicial systems in determining economic performance has achieved ever more consideration in recent years. This is demonstrated by the research of many international organizations (World Bank, IMF).

Numerous empirical analysis generally agree that quantitative and statistically significant effects of the "quality" of the right are the main indicators of economic performance of a country.

Indeed, a legal system can affect different dimensions of the development process. These are equity, the optimal allocation of resources, and the increase in total factor productivity. In addition, some aspects of the legal system may influence the behaviour and choices of economic actors, determining the accumulation of physical and human capital (decisions relating to investment and training). Thus, the role of the judicial system in determining its dysfunctions can affect economic growth.

It is hard to identify a structure of indicators of the quality and efficiency of justice. In this direction, the Cepej report highlights mainly the problem of the length of the processes. In fact, the excessive length of civil proceedings does not guarantee adequate protection of many contracts.

Actually, Italian economic growth has been, and still is, definitely hampered - by purely economic intrinsic factors, - by the length of the civil and criminal justice processes, as well as by the processes themselves, which reduces legal certainty and confidence, increases the risk of economic activities and therefore reduces the propensity to invest. The quality of a judicial system can be estimated in numerous expressions: the length and the quality of the judgments, the efficient use of public resources, and the opportunity of access to justice for all citizens.

Among the reasons of impediments of justice, the literature indicates the level of formality of procedures (Djankov et al., 2003), organizational structures, the method of work within the judicial offices (Zan, 2006) and the incentives of the parties engaged in service provision, especially judges and lawyers (Marchesi, 2003; Buscaglia and Dakolias, 1999).

In literature, institutional interaction (new institutional economics) starts with Williamson (1975; 2000) who believes that transaction is only a bilateral relation. Only later does he connect transaction cost theory with relational contracts and fundamental transformation. After 1980, neoclassical theory moves from the monopolistic paradigm in favour of the liberalization of public utilities. At this stage we can assist in the development of the relations between public sector activities and private ones. Unfortunately, the binomial public-private relationship does not produce the expected results. The reintroduction (Menrad, 2004; North, 2005) of new institutional economics reveals that institutions are able to explain economic transformations and performances through a comparative analysis. The active actors in this process are entrepreneurs, employees and others, excluding the legislative figures. Personal maximization and limited rationality are at the base of the movement and institutional and contractual coordination are the mechanisms of the process.

Thus, it is rather difficult to identify the factors that help justice to operate efficiently. In fact, the main problem is the lack of market benchmarks, which are able to determine the right-price of the services offered and the factors used. It is also difficult to identify good indicators of performance for the Justice Sector. In fact, the same factors are always considered both for performance indicators or inputs sector productivity. Thus, efficiency coincides with productivity, however this is not always true and is potentially dangerous. Certainly productivity and efficiency are interrelated, because both are related to the resources available to the sector, but at the same time they present very different characteristics.

However, the main problem concerns the criteria needed to measure them. An indicator of productivity could be the distribution of the resources of justice; a possible indicator of this is given by the percentage of positions for magistrates left vacant by district. An additional indicator may be the number of cases allotted per magistrate and the distribution of the judiciary resources for the persecution of various crimes. Currently, the allocation of resources in the sector is through rationing and queues, which are patently inefficient criteria. In general, allocation processes that do not use the price system are neither transparent nor efficient. Therefore, economic efficiency is the ability of the courts to make fair, predictable and timely decisions. All these attributes act as an incentive for investment, growth and technological progress. Shleifer and Vishny (1997) argue that the quality/efficiency of a judicial system could be estimated on the frequency with which people resort to it, instead of evaluating the alternative mechanisms for conflict resolution. In practice, the frequency of litigation is an indicator to the proper functioning - or not - of the justice sector and, indirectly, to its impact on the choices of economic agents.

Many studies have shown that the inefficiency of justice in the South of Italy is produced by the supply side, and is detectable in a disproportionate number of judges rather than in the amount of processes that they are capable of defining. On the other hand, in the rest of the country, inefficiency is mainly influenced by the importance of the load of criminal cases that have not been disposed of in prior periods. We take the view that, in the south especially, the demand for justice coming from the territory exerts a considerable influence on the in/efficiency of justice; it is measured by the number of cases registered, and tied to the rate of litigation, so the inefficiency of Southern justice also takes place on the demand side and has a high social weighting. So, the operation of the civil justice system is negatively affected by high litigation, concentrated in certain subjects and geographical areas.

Moreover, the multi-dimensionality of good-justice is underlined by the fact that it takes on the role of both the output of its production function - it is our intention to try to build on this in subsequent studies - and that of the input in the economic model that seeks to measure the social capital of a nation. Many studies on social capital show how an imperfect justice system translated into an (distorted) incentive can lead to irregular/illegal behaviours, slowing the formation of networks of mutual trust. Therefore the existence of negative reciprocal externalities between slow justice and inefficient economic system is hypothesized. The hypothesis is that the slow pace of justice will damage the efficiency of the economic system because it reduces the opportunities for the protection of the injured party, who sees the increase of the opportunity cost related to the expectation of the end of the process.

At the same time, the guilty party instead sees an increase in the likelihood of a favourable transaction or even the relinquishment of protection by the same plaintiff.

The duration of the process also provides useful information on the system of penalties in force, that impacts also on the accumulation of social capital. If the demand for justice is artificially expanded, the resulted uncertainty of protection implies partially hidden charges, but which are costly to the community. Therefore, the inefficiency of the civil justice translates into uncertainty, which is a powerful factor of friction in the functioning of an economy, as well as injustice.

When this uncertainty produced by the inefficiency of justice is combined with a growing distrust in justice itself, it turns into a consistent friction factor in the functioning of the economy. In this respect, the Bank of Italy shows that the annual loss in gross national product attributable to the defects of our civil justice may come to a percentage point. In Italy, in fact, the slow pace of justice involves both social costs-i.e. a poor service to the community - and economic costs compared to the need for legal certainty of the economic system as a whole. These serious diseconomies are aggravated by direct costs to the public budget, because the State is obliged to ensure equitable relief in favour of those who have had to endure the unreasonable length of time for civil or criminal process. It has been also highlighted that its slow pace of justice represents one of the main constraints to foreign investment in Italy. In addition, the slow pace of justice accentuates regional disparities. In fact, in regions where there is a higher number of pending cases, the bank interest rates are higher, because of the connected uncertainty, thus determining difficulties in accessing credit. The credit crunch in turn leads to a contraction of private investments, a reduced economic growth and an increase in unemployment and crime. These elements do not create a favourable climate or a regulatory framework conducive to business activity.

Therefore, the performances of the judicial system affect the results of commercial litigation, the certainty of property rights, the quality of legislation, and the development of criminal activities. In addition, an inefficient justice system leads to an increase in transaction costs related to the lack of mechanisms that ensure compliance with the legal rights and obligations. Finally, there was also a dearth of reliable information about the credibility and

reputation of the justice system of the country, or at least distorted information, incomplete and focused mainly on the problems of the sector, which certainly acts as a deterrent to decisions of investment by both domestic and foreign operators, producing negative effects on economic growth processes.

Consequently, dysfunctional judicial systems may discourage saving, and increase capital flight, decreasing the amount of funds available to finance investment.

Instead, well-functioning judicial systems promote growth and encourage a more rapid accumulation of factors of production. Above all, investment in both physical and human capital will be supported by secure property rights, well-functioning legal and judicial systems and political stability (Schmidt-Hebbel et al, 1996 and Alesina and Perotti 1994).

Among all the institutions, the market most requires a reliable justice, well functioning. This is necessary because the market consists of a set of relationships, agreements, and connections among people, which are based on trust. In fact, the existence of a healthy justice system activates a process of self-respect that in turn feeds a greater efficiency; the reputation so conquered represents a further incentive to the respect of the contracts, thereby reducing a further distorting element of efficiency, given by the presence of incentives to opportunism.

Generally speaking, the reduced competitiveness of our firms is due to fragility of our production system that makes it weak in front of the new competitive environment. These deficiencies depend on internal factors of a firm - such as the small size and limitations connected with familial management models - and on external factors. Such devices include a complex and uncertain regulatory framework, the excessive length of judicial procedures, the weight of bureaucracy and the inadequacy of a protection contracts' system.

A justice clogged and slowed down leads the economic system and firms to behave in an economically inefficient way, because the choices are intended to minimize the uncertainty represented by a process. The consequence is a reduction in competitiveness. The choices of firms pursue not only the criteria of economic efficiency, but they aim to avoid the consequences of a malfunction of the justice system (distortion of incentives). In this way the inefficiency of justice results in inefficiency in the choices of economic agents.

In Italy, disincentives arising from the failure of justice in the economic system are numerous:

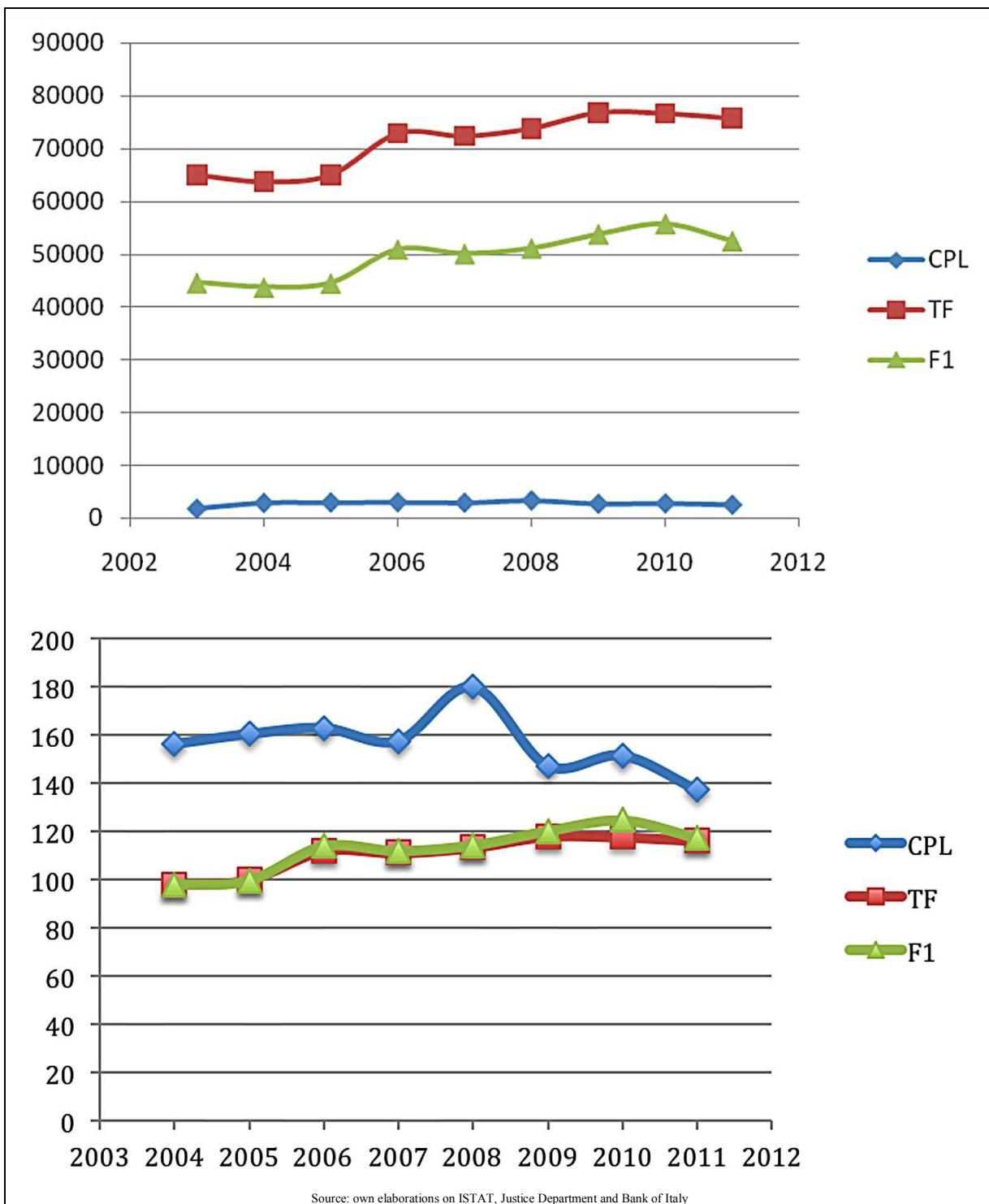
- contraction of start-ups (discouragement effect);
- the preference for the small size, which erodes the competitiveness of the national production system (dimensional effect);
- the tendency to the "loyalty of partnership" in trade relations (inefficiency in seizing the opportunities offered by a competitive system);
- frequent recourse to forms or business combinations in which the contract will be fulfilled by forms of punishment other than civil justice, such as reputation, sharing suppliers/information technologies, belonging to the same chain (management inefficiency);
- tendency of firms to integrate vertically and a system translate into an additional cost to the country's economy, which is identified in lower investment, the phenomena of freezing of capital, excessive use of the banking system.

Summarizing, because contract and property rights are not appropriately enforced, firms may decide to not pursue a number of activities, to relinquish the opportunity to specialize and exploit economies of scale, to combine inputs inefficiently, not to allocate production in the most efficient way, keep resources unemployed etc.

The selected period is 2003-2011. This choice is due both to the complete information about the involved variables, and to the idea to evaluate the crisis effects. In this stage we consider only two effects of justice's length: discouragement effect and dimensional effect.

In this section we use also the industrial dimensional class 20-49 because, analysing data, we notice some peculiarities in the dimensional dynamic of this category. For describing this phenomenon we compare the fixed base index numbers - with percentage base, of the following variables.

Actually we are still studying this phenomenon, but in this work we offer some ideas about it.



Source: own elaborations on ISTAT, Justice Department and Bank of Italy

Fig. 1: Trend among CPL, TF and F1 (observed and indexed data)

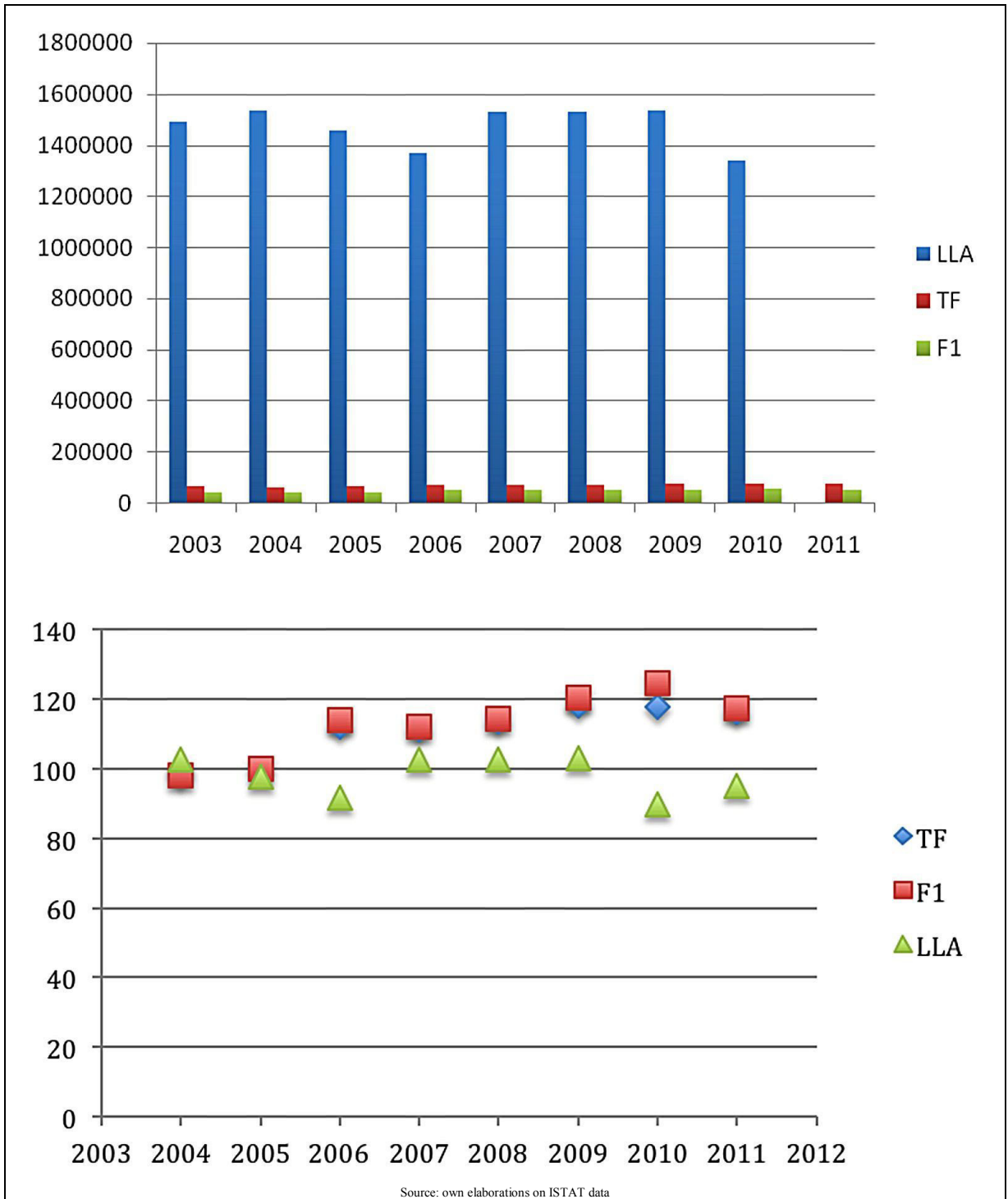


Fig. 2: New procedures, Total number of firms and Firms 20-49 (observed and indexed data)

In figure 1 we observe the relation between civil processes' length (CPL- average days, Bianco et al., 2007) and the total number of industrial firms (TF – number and indexed number) and the industrial dimensional class 20-49 (F1- number and indexed number).

The variable CPL is growing with some exceptions connected with some reforms in civil justice. Both the other variables, TF and F1, are in line, and they register a very limited increasing for the period, the only exception is a small decrease in 2011, probably connected to the crisis.

In figure 2 we evaluate, for the selected period, the trend among the new legal actions (LLA - indexed number), as an indicator of the length of justice, and TF and F1. Obviously, both TF and F1 present the same trend of figure 1. The variable LLA presents a trend quite in line with CPL. We explain this peculiarity because the less LLA, the higher speed in closing the existing proceedings.

This work is a primary study of a wider project that analyses a wider range of variables in order to demonstrate the effects of an inefficient judicial system on an economic productive system.

We are still collecting data from different sources. We know that there is a lack of good statistical information but we hope to statistically supporting our idea using more and interesting variables.

The selected variables were ready-references. We calculated Pearson and Spearman coefficients, but the results were not totally significant. Therefore, we prefer only to describe the meaning of the work using few variables.

With respect to the size of a firm, there are many ways in which the inefficiency of justice can affect the dimension of the business. Generally the performance of the judicial system may influence several features of firms' performance like employment, investment, organizational paradigm, and contractual relationships with counterparts, all of which have an effect on firm size. According to the literature, an inefficient justice implies a smaller average size of firms. Kumar, Rajan and Zingales (1999), point out that in Western European countries, superior judicial systems are connected with significant average firm size. Moreover, Beck, Demirg-Kunt and Maksimovic (2006) analysing the largest industrial firms in 44 countries, demonstrate that firm size is positively related with institutional progress. The size of Italian firms is on average 40 % smaller than other European countries.

The undersized firms are considered a disadvantage of the Italian productive system and the main source of the Italian low productivity and GDP growth. Furthermore, justice efficiency in Italy is very weak, according to the World Bank's Doing Business report. This inefficiency is largely associated to the excessive length of judicial proceedings. Indeed, the excessive length of judicial proceedings decreases contract enforcement.

Above all, an inefficient judicial system has an effect on investment choices by firms and in this way it influences firm size. In fact, imperfect contract enforcement amplifies the risks associated to the contracts and this can result in less investment and less growth occasions.

Moreover, the performance of justice can determine the employment decisions of firms through its effects on the enforcement of employment legislation. In addition, to avoid the high transaction costs related to reduced enforceability of contracts, firms tend to vertically integrate. Finally, in response to the poor enforceability of contracts, firms are less disposed to interact with new partners and tend to intensify reliance on relational contracts. These relational contracts usually produce barriers to entry for new firms that are commonly smaller than incumbent ones, thus decreasing average firm size (Johnson et al., 2002).

So, domestic enterprises need to avoid the uncertainties, the costs and times associated with any litigation, and therefore perform economically inefficient choices. Business decisions involve a reduced demand for justice, while non-entrepreneurs perform opposite choices. There is a sort of gap in the demand for justice by families (characterized by high litigation, resulting in the crowding of the courts) and companies (which have avoiding lawsuits among their primary objectives). Therefore, the uncertainty acts as an incentive on the two types of users (individuals and firms) in the opposite way: in fact, while it represents an unknown cost that it is best to avoid as much as possible for businesses, it is an input to opportunistic behaviour on the part of private enterprises, who rely on a long and not foreseeable time that characterizes its administration in order to postpone their contractual obligations. At the base of the choices, there is a common factor represented by the distrust of the proper administration of justice.

In Italy, a considerable portion of the demand of justice is pathological because there is no request to the courts to resolve legal and uncertain difficulties, but to obtain economic advantages by exploiting the inefficiency of the system. Among the reasons that support this type of demand and determine incentives to engage in a process rather than executing own obligations, we have a positive differential between the market interest rate and the legal rate of

interest. Moreover, the legal rules for distributing the costs of the proceedings are not adequately penalizing for the loser person. The numerous recourses to the courts seem originated from a phenomenon known in literature as moral hazard: people are pushed to engage in hazardous activities when there is a high chance that the costs associated with a negative outcome from falling on society.

Our attention has focused also on two interrelated aspects:

- i. the ways in which an inefficient justice system affects the functioning of the credit system and the relative cost (interest rate), as well as the effects that the increase in these costs exerts on the amount of domestic investment, thereby undermining the potential growth of the country;
- ii. the ways in which an ineffective justice system is a deterrent to foreign investment, thus compromising the territorial competitiveness of the country.

A series of panel surveys on the functioning of justice in the Italian provinces (Felli et al, 2007), shows that credit is more rationed in Italian provinces with more ongoing or pending processes. This result is witnessed by some international studies that insert between the proxies of justice inefficiency, the amplitude of mortgage markets. The effect associated with this restriction is given by the increase in interest rates, and its result is widespread in geographic areas characterized by a slower justice, since the level of interest rates are also the result of competition among lenders. The interest rates are charged by the credit system incorporating "slow" justice and when the costs associated with legal proceedings necessary to enforce receivables grow, the conditions applied to mortgages are heavier. In fact, in decisions relating to the different loan conditions, banks seem to consider the probable costs to be faced in the event that the subsidized subject is in default. This widespread tendency produces a crowding out of private investments and the multiplier associated effects.

This result is even more critical in a globalized context, where companies are multinational and tend to break away from the territory of reference and lose the direct connection with a specific ordering of the State. It implies the occurrence in time of opportunity to "choice" law. In this way, states are obliged to confront and compete also in economic terms, with respect to which, reference is made to the judgment delivered by the rating agencies on a range of economic/financial parameters, even in legal terms. The perception of market participants on the functionality of public administration, the effectiveness of legal instruments, and the timeliness of administrative and judicial decisions are of strategic importance. At present the benchmarks related to this competitive process between jurisdictions does not appear in our favour. The costs and timing of our justice system are high and uncertain, and the consequences are spread throughout the country.

A further disincentive to foreign investment would seem to lie in the lack of political credibility of a country, as perceived by both the private sector and externals, as already documented in some reports of the World Bank (it is revealed that the countries with a high perception of credibility have high levels of investment and vice versa). Therefore, legal uncertainty – linked to the problems of efficiency of the justice system– and institutional uncertainty – linked to the credibility of national policies – end up making unstable rules of the game. Greater efficiency in the administration of justice can be obtained primarily by solving the problem in the stock of arrears to be disposed of. To this end, the actions to be taken should include measures of deflation procedures, adjustment of the workforce, and redefinition of the areas of territorial jurisdiction. Institutional reform also seems necessary, especially in civil trials, which eliminates the strong incentives that force stakeholders today into behaviours that induce the lengthening of the process.

A way to discourage individuals from appeals to justice should be identified, even for less relevant cases, which aggravate the cost and promote further alternative forms of administration of justice. Perhaps the relative deterrence should be practiced also against lawyers who sponsor these types of disputes. In the light of the current economic crisis, the even higher costs - monetary, social and economic - referring to the justice sector and associated with a significant inefficiency of the same, make the need for reform ever more stringent in order to aim at making the justice system efficient, rapid, reliable and accessible to all. Moreover, as in public services sectors, management also focuses on the standardization of certain production processes (ratings/processes/ discussions/hearings), ensuring the same quality of related services. In general, the three conditions necessary for a more efficient management of all public services - including justice - are represented by the measurement of performance, transparency and meritocracy. This involves adopting a particular perspective of the concept of "justice services" and accepts the hypothesis to estimate its comparative costs at the local level (benchmark). The delays and inefficiencies that characterize the justice system have been transformed from a right recognized, protected and



guaranteed to all citizens to an object of consumption of the same, for which the rates of litigation seem to grow in proportion to the time of justice. This circumstance has transformed the citizen from justice user to consumer of justice, aggravating the possibilities of governance of the system.

Generally, legal reforms are not produced exogenously, expressing the interest of some groups in society. Therefore, it is necessary to identify which are the conditions that lead a country to carry out legal reform. These vary according to the composition of a society, the distribution of income and the need to protect the property rights.

The justice reform must first restore to the sector its dignity as a public provision constitutionally protected and, above all, at the service of all citizens, defined as users and not as consumers of a good that cannot be traded on markets. Finally, any reform must be the result of a legal, healthy culture and of responsible ethics. The future sector will be self-critical, suitable to adapt and experiment (i.e. not resistant to change), prepared to proceed from a system designed to satisfy the producers of justice to one intended to benefit its users and thus act as a driving force for the economic progress, ethical and social development of the country.

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