Economics and the Rule of Law

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My remarks are in the nature of a bridge – a consideration of the rule of law that bridges Joe Smouha QC's expert outline of the world of international investment treaties and Chief Justice Menon's masterful synthesis of all important aspects of this topic.

My bridge has advantages over the one we visited last night. Most importantly, I'm not going to ask you jump off it, even with a bungy cord attached - my mother always told me not to jump off a bridge if my friends told me to.

Rather, my bridge occupies a relatively abstract position straddling the worlds of law and of economics. The disciplines of law and economics are based on fundamentally different methodological underpinnings.

Law, particularly in the common law world, is inductive and contextual. It reasons from one case to another, formulating rules based on analogies and distinctions between different factual contexts. Law is concerned with the specifics of precedents and concerned with justice overall.

Economics is deductive and abstract. It is shaped by its subject matter of economic exchange and deploys quantitative empiricism. It involves the systematic application of well-defined assumptions to characterise and predict human behaviour. Economics is unconcerned with context and idealises it away, deducing models of general behaviour based on what can be heroically simplistic assumptions.

Each discipline has its strengths and weaknesses, its analytical leverage and its blind spots. So putting them together is helpful in enabling each to complement the other. The now well-established field of Law and Economics has done this for many years and can yield important insights complementary to both disciplines. The Law and Economics Association of New Zealand, of which I am the current President, promotes that complementarity.

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The confluence of economic activity and the rule of law represents a particularly productive field for the application of law and economics, sometimes shading into political economy and the economics of organisation. I think particularly of the work of Nobel Prize Winner Douglass North and, earlier and more ideologically, Friedrich von Hayek who has already been mentioned here.

In my brief comments today I want to offer a "minimalist" definition of the rule of law and link it to the value in economics of stability in behavioural expectations – particularly including those governed by international investment treaties.

The Rule of Law

As we have heard during this conference the rule of law is a fundamental building block of modern democratic constitutions.

Yet its content remains uncertain. There are so many different conceptions and definitions of the rule of law that there is a distinct lack of certainty about its precise meaning. We know it when we see it; or, rather, when we don't. But we disagree on how to capture that in words.

One eminent New Zealand jurisprude, Professor Jeremy Waldron who hails from here in Otago but currently divides his time between NYU & Oxford, has suggested that the rule of law is "an essentially contested concept" which can be used to mean little more than "hooray for our side".[1] It can be, and is, invoked on very different sides of the same issue – as it was in the controversy over the US Supreme Court's *Bush v Gore* decision in 2000. In his small but perfectly formed book, Lord Bingham cited the views of various respected commentators who doubt whether the rule of law is meaningful at all.[2]

Here I offer a conception of the rule of law that is designed for the purpose of attempting to hone in on its conceptual essence. I seek the core elements of the doctrine that are common to most others' accounts, that are likely to be widely accepted, and that can be simply and coherently stated so that the rule of law can, relatively easily, be grasped and applied.

As I have noted elsewhere this definition centres on certainty and the freedom from arbitrariness in the law.[3] It involves taking seriously the words of the phrase "the rule of law". The phrase itself suggests there is some distinctly separate or objective

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1 Jeremy Waldron "Is the rule of law an essentially contested concept (in Florida)" (2002) 21 Law & Philosophy 137.

2 Tom Bingham *The Rule of Law* (Penguin Books, London, 2010) at 5.

3 Matthew S R Palmer "New Zealand Constitutional Culture" (2007) 22 NZULR 565 at 586-589; Matthew S R Palmer, *The Treaty of Waitangi in New Zealand's Law and Constitution* (VUP, Wellington, 2008) at 285-289.

meaning to law that is independent of human agency. It is law itself, in its independent meaning, that rules and that should rule.

I suggest a useful working definition of the rule of law is that it requires that the meaning of law is:

Independent of those who make the law.

Independent of those who apply the law.

Independent of those to whom it is applied.

Independent of the time at which it is applied.

You can see in it links to Dicey's and Bingham's conceptions – even Aristotle's. And also the nice encapsulation yesterday by LexisNexis that "no one is above the law".

This formulation emphasises that the rule of law is an ideal. The ideal that the rule of law strives for is to remove, as far as practical, the biases of the particular human actors. The rule of law seeks to advance justice by invoking a Rawlsian veil of ignorance of one's particular interests in relation to its content.[4] Removing human interests from decisions made through human agents must be an ideal – like a limit approached but never reached through differential calculus. But a worthy ideal is worth attempting to approach. This conception may also suggest that there must be a continuum of degrees to which a proposal is "consistent" with the rule of law, rather than a black and white binary choice.

It can be seen clearly how this conception of the rule of law is intimately bound up with the separation of powers and judicial independence. The separation of powers is a necessary (but not sufficient) condition for the rule of law. If a lawmaker not only makes but also interprets and applies the law then the meaning of the law that is interpreted and applied will more likely reside in the lawmaker's intention at the time it is applied - retrospectively justifying "what I meant" even if that was not present or evident in the legal text at the time. It is this aspect of the combination of making and applying law that is contrary to the rule of law – the meaning of the law becomes that which the maker/applier later deems correct rather than that of the law itself.

This is also why making retrospective legislation is pernicious. Legislation that is made retrospective, and contrary to the reasonable understandings of those subject to it at the time, substitutes the preferences of today's legislators for those of

[4] John Rawls *A Theory of Justice* (Belknap Press, Harvard, 1971).

yesterday's legislators, without affording those affected by the law yesterday an opportunity to adjust their behaviour so as to comply with the law. This offends against the requirement that the meaning of law be independent of the time at which it is applied.

I accept that the conception I offer is more in the tradition of the "formalist" rather than "substantive" theories of the rule of law, according to the dichotomy analysed by Paul Craig.[5] And it is a "formalist" ideal rather than a "historicist", "legal process" or "substantive" ideal in terms of a four-part classification proposed by Richard Fallon.[6] That is the consequence of looking for uncontested (or, perhaps, less contested) essence of the doctrine.

I suggest that this conception of the rule of law zeroes in on essential underpinnings that are common to the most influential commentators on the rule of law. It seems to me that the rhetorical attraction and power of the phrase the rule of law is a temptation to freight it with other worthy but essentially separate and different, aspirations. For example, Lord Bingham's magisterial enumeration of principles of the rule of law suggests that principle 5, "the law must afford adequate protection of fundamental human rights", is part of the conceptual essence of the rule of law. Justice Beazley, this morning, mentioned that the European Court of Human Rights has also emphasized this. But, to be provocative, I question this.

I agree wholeheartedly with the imperative; **but** I see it as deriving from the fundamental importance of human rights, not from the rule of law. As Joseph Raz states:[7]

> .. the rule of law is just one of the virtues by which a legal system may be judged and by which it is to be judged. It is not to be confused with democracy, justice, equality (before the law or otherwise), human rights of any kind or respect for persons or for the dignity of man.

The New Zealanders in the audience will know me as a public lawyer. And will, hopefully, know my commitment to upholding human rights, justice, equality and democracy and the dignity of both men and women. And where any of those values are breached, the rule of law will usually be breached as well. Just this year I asked the High Court for declaration that, if an Act of Parliament retrospectively overrode my client's application for judicial review, that would be not only inconsistent with the NZ Bill of Rights Act 1990 but also inconsistent with the rule of law.

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5 Paul Craig "Formal and Substantive Conceptions of the Rule of Law: An Analytical Framework" [1997] PL 467 (though I suggest that my conception is not "formalist" in the sense of relating only to procedure, because it is concerned with the substance of a law).

6 Richard H Fallon "'The Rule of Law' as a Concept in Constitutional Discourse" 97 Columb L Rev 1 (1997).

7 Joseph Raz "The Rule of Law and its Virtue" (1977) 93 LQR 195 at 196.

But these other values are, in my submission, not part of the notion of the rule of law and it doesn't help us to confuse them.

I offer a definition of the rule of law that hones in on a minimalist, essential, definition of the rule of law. My suggested essence of the rule of law is, in my humble submission, closely related to the stability of behavioural expectations that are also important to economic activity.

Stable Behavioural Expectations

Economic activity requires a framework of stable behavioural expectations in order to function most effectively and efficiently. In the language of law and economics, unpredictability of behaviour, caused by the absence or lack of clarity in the default rules of property and liability cause transactions costs and informative asymmetries that can inhibit efficient economic exchange.

Such does not have to be provided by law. It may be provided by social norms, in either traditional tribal societies or even modern economies, as Bob Ellickson demonstrated in analysing the norms of property rights in rural California.[8] Common law is a step towards formalising social norms in rules enforceable by the coercive machinery of the state, though it also retains the spontaneously evolutionary nature so beloved by Hayek.

But, in most modern nation states, stability in behavioural expectations is mostly provided for by legislation. And this is where and why the rule of law bites as a constitutional doctrine. There are few pure Westminster systems left in the world – New Zealand may be the only one. And, here, the doctrine of Parliamentary sovereignty or supremacy holds pride of place in our constitutional firmament. But Parliamentary sovereignty exercised by majorities elected every three years, even under a system of proportional representation, can result in dramatic shifts in the content of law. More importantly the existence of the power to make or unmake any law whatever can also tempt legislators to use that power retrospectively, or to target or favour a particular individual, group or company, or even to favour legislators themselves.

There are examples of each of these occurring in recent New Zealand history; which is why the doctrine of the rule of law is important not only in a constitutional but in an economic sense. The rule of law, manifested in the concept I have advanced today, militates against the law meaning something that depends on who made it, or

[8] Robert C Ellickson *Order without Law: How Neighbors Settle Disputes* (Harvard University Press, Cambridge MA, 1991).

who applied it, or to whom it is applied, or that depends on the time at which it is applied.

In a very real way the rule of law is a countervailing force against arbitrary use of executive and legislative power. We are familiar with the constitutional reasons for that. But my point is that arbitrary use of either executive or legislative power can also be directly detrimental to the stability of the behavioural expectations necessary for efficient economic exchange. That is as true of the rule of international law as it is of the rule of domestic law.

International Investment Treaties

And here, finally, I move to international investment treaties. The international sphere has traditionally been less regulated than the domestic. Lex mercatoria evolved, for a while, to provide a form of social norm based stability for economic exchange and, according to Singapore's vision, may again. Custom and norm is still important in international economic exchange. But international treaties have created a complex interlocking network of rules backed by international organisations. International investment treaties are particularly crucial to the efficient functioning of the world economy because of the mobility of capital across borders. So the creation of the International Centre for Settlement of Investment Disputes, the 1965 Washington Convention and the subsequent interlocking network of bi-lateral investment treaties have transformed the costs of international investment, largely for the better.

And the rule of law, in the sense I have defined it, is crucial to that regulatory framework because of the importance of stability in behavioural expectations:

- Uncertainty over whether sovereign debt lending can be enforced against a reluctant sovereign, wielding the power of domestic Parliamentary sovereignty, will only be reflected in higher sovereign risk premia. And it will be contrary to the rule of law.

- If a clause of an international investment treaty favours or targets a particular nation or multi-national corporation international investment and development will be inhibited. And it will be contrary to the rule of law.

- If an international tribunal applies a rule in a new way, retrospectively, the international horses of finance will be frightened. And it will be contrary to the rule of law.

- If a rule of a bilateral investment treaty is applied differently because it is applied to the United States, or because it is not the United States, capital as well as horses will be frightened, flee and become more expensive. And it will be inconsistent with the rule of law.

This is why I suggest that it is in the interests of sovereign nations to ensure that, when they choose to legislate by committing themselves to a bilateral investment treaty or an international regulatory framework, they must ensure that the dispute resolution mechanisms comply with the rule of law. More particularly:

- The outcome of a dispute must not depend on who has made the law – it must favour all nations equally. There must not be a system bias, for instance against developing states.

- The outcome of a dispute must not depend on who has applied the law – we must be able to have confidence in the independence of those resolving disputes, such as the composition of tribunals.

- The outcome of a dispute must not depend on to whom the law is applied – all borrowers and lenders must be equal before the law.

- And the outcome of a dispute must not depend on when the law is applied – law, including the law governing expropriation, must apply prospectively not retrospectively.

Investment treaties are international law that should conform with the same expectations we have of any form of economic law. Breach of any of the aspects of the rule of law in relation to international investments will increase the cost of capital for us all. And, perhaps just as importantly, it would not be consistent with a fundamental building block of our constitutions – the rule of law.