

JUSTICE

Just(ice) in time?

(part 1)

To be, or not to be? Hamlet famously ponders his own suicide, weighing the many ills of life not against the good, but rather versus the fear of the unknown fate awaiting us after death. In the catalogue of disgraces making up for the most famous monologue in the history of theatre, *the law's delay* firmly holds its place side to side with *the whips and scorns of time*, *the oppressor's wrong* and *the pangs of despised love*. Nevertheless, some might consider justice in Elsinore much swifter, although sterner, than in contemporary Italy, at least civil justice.

"I was only a child as my father took up the case" recounts a lawyer from Cagliari, Sardinia, to a major Italian newspaper. At the first hearing, in February 1969, the defendant didn't show up, hence a delay; again, a second time, a third, a fourth, and so on for 25 years, the case never making a step forward. During the umpteenth hearing, in July 2003, the claimant's lawyer announces the passing away of his client; the process is interrupted, but the claim passes on to the heirs, who in 2009 score a temporary victory. Sadly, though, in settling the indemnity the judge commits a formal mistake, against which the claimants appeal – and the process starts over again. Life is an endless circle, some say.

The **very slow functioning of civil law** has long been a big burden for Italian families and firms claiming protection for their rights. The newspapers are littered with examples. In Bari's court, over a 16 year window, a worker has been waiting for her severance payment, 55.000 €. She still hopes for a first-degree ruling this year; "Nobody would bet on that", comments her

lawyer. In Genoa, a building material wholeseller has been claiming 20 million "lire" (about 10.000 €) from a bankruptcy procedure for 32 years. The bankrupt debtors have been back in business long since. An elderly lady of 103 writes to a judge in Rome, asking whether she can still hope to see the end of her case...

The Italian level of contractual rights enforcement compares unsatisfactorily to the **rest of the developed world**. In order to conduct international comparisons, researchers have been looking at standard procedures aimed at solving very common issues. **Recollection on a bounced check** is a widely accepted international benchmark in this respect. Aspects considered in the World Bank's "doing business" indices are the time in days, the number of "procedures" and the cost, as a percentage of the claimed amount, requested until solution. In the World Bank's indices, Italy is ranked 176th out of 188 countries in collection time, 116th if considering collection costs, peaking at 29.9% of the disputed amount. In Europe, only Albania fares worse.

Recollection on a bounced check benchmark (rank is determined according to the inverse of a weighted average of time, cost and procedural complication)

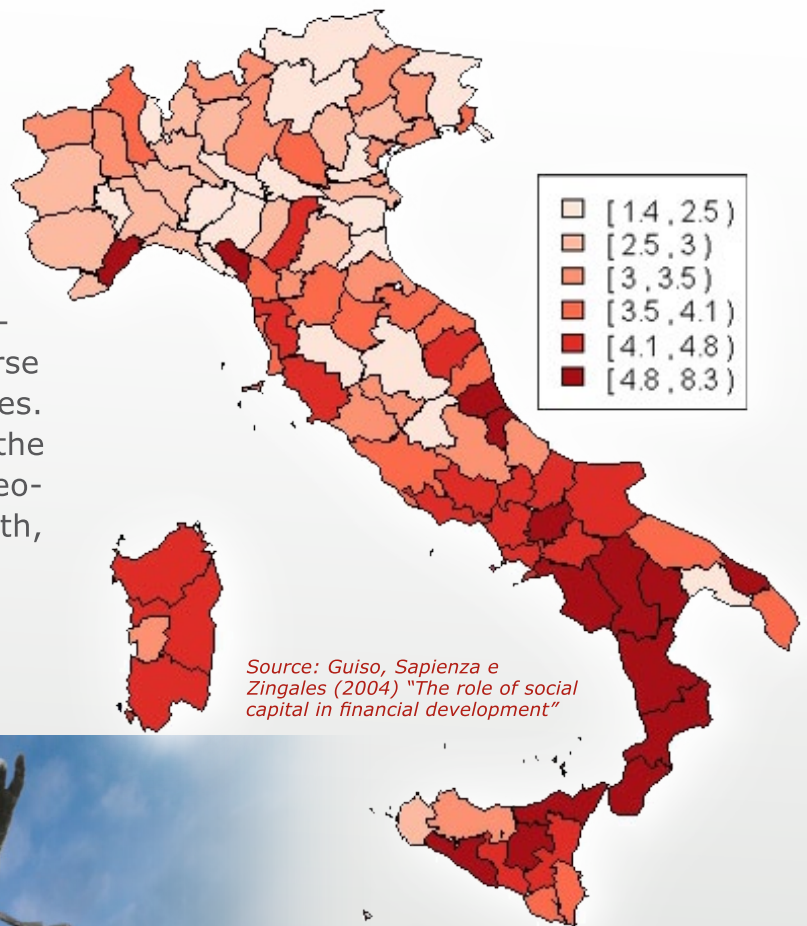
	Rank	Time (days)	Cost (% of claim)	Procedures (number)
Luxembourg	1	321	9.7	26
Germany	5	394	14.4	30
United States	6	370	14.4	32
France	8	390	17.4	29
China	19	406	11.1	37
United Kingdom	21	399	25.9	28
Japan	35	360	32.2	30
Spain	64	510	17.2	40
Italy	160	1.210	29.9	41
India	184	1.420	39.6	46
OECD high income	..	510	20.1	31
East Asia & Pacific	..	522	8.6	37
Eastern Europe & Central Asia	..	414	25.8	37
Latin America & Caribbean	..	727	30.8	40
Middle East & North Africa	..	652	23.9	44
South Asia	..	1.075	27.2	43
Sub-Saharan Africa	..	649	50.1	39

Source: World Bank, Doing Business Indicators

While number of procedures and collection costs aren't after all much different from the international average, the time to collect on a bounced check is by far where Italy does worst. In Denmark this takes 190 days, 229 in the UK, 331 in France and 394 in Germany. Spain, at 515 days, is the second-to-last among major European countries. Italians have to wait 1.210 days: 3 years and 4 months.

Within Italy, variance is high. While some parts of the country, like the provinces of Trento and Bolzano, enjoy, so to speak, "almost European" speed, those worse off suffer from really biblical times. The Italy map effectively depicts the situation, showing a general geographic gradient from North to South, but with many exceptions.

Legal system inefficiency



Source: Guiso, Sapienza e Zingales (2004) "The role of social capital in financial development"



Let us now consider the consequences on the economy at large, then those on our specific sector.

The economic consequences of property rights' enforcement quality

Douglass North, the 1993 Nobel Prize winner, introduced **transaction costs** in formal economic theory, revolutionizing the discipline. In his words, [contract enforcement] "*is the single most crucial determinant of economic performance, and the key difference that separates First from Third-World economies. Contract enforcement in time and space is the main pillar of an efficient market*".

Modern contract theory relaxes the classical hypotheses of perfect information and perfect enforcement to pursue realism in economic modelling. The ensuing costs are formalized and divided into auditing costs and **enforcing costs**. A famous contemporary example are costs relative to defaulted home mortgages: the cost of repossessing the house, the capital loss from hastily selling it at an auction.

In such a situation, institutions have the task of reducing this burden as much as possible. What if institutions "don't work"? Simple transactions, like concurrent transactions of simple goods against money, are relatively immune. The problem of enforcement becomes serious as economies specialize and open up, becoming interdependent, and transactions extend over continents and over long timespans: just think of "futures" contracts. As North estimated, in 1986 45% of US GDP (vs. 25% a century before) was spent for securing transactions instead of buying goods and services, an estimate which probably still holds today.



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Why the insurance contract is particularly sensitive to the issue

Financial transactions are often contracts extending through time and space. In this respect, literature (e.g. Guiso, Sapienza and Zingales on the American Economic Review) has investigated the effect of transaction costs on the credit system in terms of **trust**: trusting one's counterpart reduces the



estimated probability of litigation, hence the positive nexus the Authors find between trust and the use of checks and other forms of fiat money. On the cost side, Leaven and Majnoni (World Bank WP) show how judicial system efficiency helps reducing the **cost of credit**, measured as the spread of lending rates with respect to policy rates. Fabbri and Padula, on their part, identify a credit rationing effect, which becomes more evident for poorer households: in provinces where judicial efficiency (which they measure as the inverse of the backlog of unfinished trials) is lower, the likelihood of being refused credit is, other things being equal, higher.

A particularly complicated instance of financial transaction, the insurance contract creates contingent obligations which extend on very long timespans, often of years or even decades, exchanged for either lump sums of money or a plan of recurring payments. At the same time, it entails sizeable transaction costs because of the need to accurately state the scope of the obligation, and requires expensive auditing in order to eliminate, or mitigate, the informational asymmetry between the insurer and the insured. Based on contract theory, insurers have come up with a range of devices to reduce such costs and reduce the exchange towards optimality: from **accurately written policy terms** and conditions to sharing mechanisms, like deductibles and bonus-malus clauses, penalizing misreporting and encouraging proper behaviour on the insured's part.

No matter how good a contract design, nobody's perfect: in case one of the sides does not comply, a slow or inefficient enforcing of the contract can bring up sizeable costs for the claimants, be they insurers or insureds. Bad enforcement inserts a wedge between the demand and supply sides just as a tax would do: an implicit "**system malfunction tax**" whose effect is a reduction in both the welfare of producers and consumers.

International evidence on finance, insurance and property rights

There is a considerable amount of research on the effects of the quality of the legal system on various aspects of economic and financial development, such as firm ownership and firm size, resource allocation or the firms' ability to raise capital: see the pioneering work of La Porta and co-authors on legal

protection and equity and debt markets, and Modigliani and Perotti on its influence on the choice of equity versus bank credit. Levine shows the positive dependence of bank development from creditor rights enforcement. In all these cases, there is a **direct correlation** between **the quality of law enforcement** and the **positive evolution of the financial system**.

International evidence on insurance and property rights has analyzed the influence of rights motivating it on two grounds. Firstly, since insurance policies may be viewed as analogous to risky corporate debt, enforcement may be needed in case the insurance company proves insolvent. Secondly, because the enforcement of property rights creates an economic incentive to acquire and insure property by protecting it from damage or expropriation and allowing the owner to buy and sell it securely.

Yet in advanced economies the insolvency of an insurance company is a rare event, albeit not impossible as witnessed by a number of well-known cases.

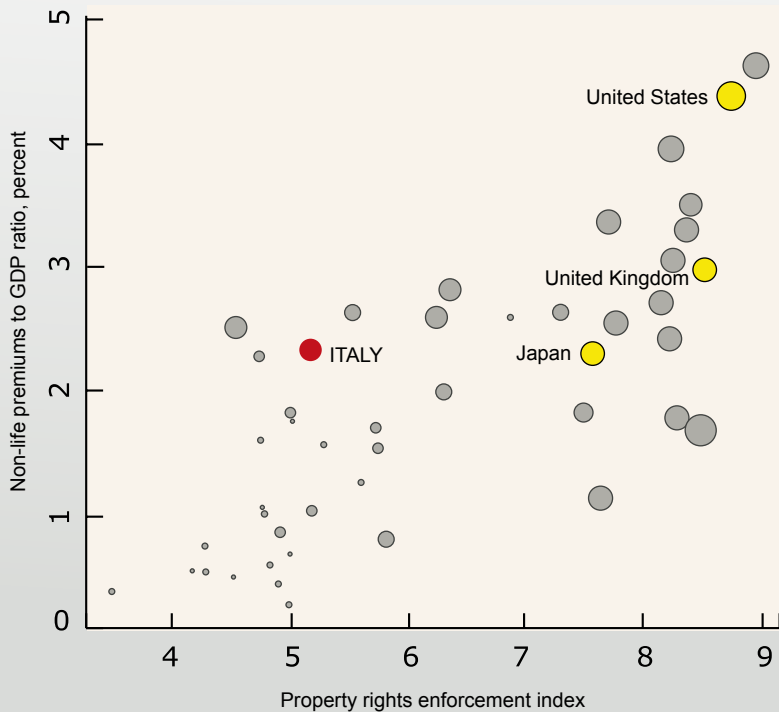


Chart 1: Property rights enforcement and Non-life insurance density in the World; (Source: Sigma, Djankov et al.); bubble size is proportional to per-capita GDP.

Moreover, while the argument sounds plausible as regards some developing countries, it is unlikely that a citizen of the developed world chooses not to acquire insurable properties because of fear of (unlawful) expropriation: rather, he might be induced to acquire and insure it.

Indeed, considering a sample of 90 countries throughout the World, the data (see Chart 1) indicate a **strongly positive association** between **law enforcement quality** (according to the synthetic index of Knack and Keefer, see also Djankov and co-authors) and **insurance density**.





The association with the cost of the procedure in percentage of the claim is not as clear: while developed countries (see bubble size, which represents per-capita GDP at purchasing power parity) cluster around the lowest end of the cost line, bubbles seem to scatter randomly on the vertical axis (not shown).

Drawing instead our attention to the particular aspect of **slow justice**, this is most likely to kick in during policy-level litigation,

which is relatively common and likely to enter the decision making process of the prospective insured. Concentrating on the specific effect of the time-inefficiency of the judicial system on the demand for non-life insurance, it may be hypothesized that the possibility of facing an uncertain, but plausibly long trial duration in order to receive one's dues can be a **deterrent to the purchase of an insurance contract**; Italy, a developed country where property may be considered comparatively secure and the outcomes of trials relatively fair and unbiased, but where the duration of the trials themselves has reached unsustainably high levels, provides an interesting case study.

At world level, one can at best see a weak negative correlation: there seems again to be no clear relationship between procedure length and insurance penetration (Chart 2) apart from the obvious observation that Italy, as observed above, stands out as one of few outliers.

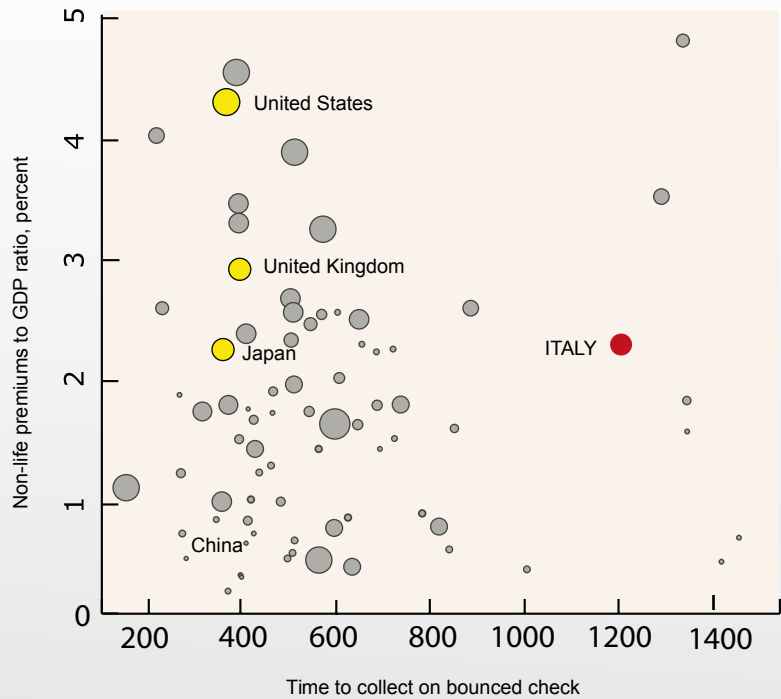


Chart 2: Time to completion of procedure of collecting on a bounced check (days) and Non-life insurance density in the World: bubble size is proportional to per-capita GDP (Source: Sigma, World Bank)

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