

“The Rule of Law and Its Social Reception as Determinants of Economic Development:
A Comparative Analysis of Germany and Poland”

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2020 Law and Development Conference

Hamburg, Germany
November 2021

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**The Rule of Law and Its Social Reception as Determinants of Economic Development:
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ABSTRACT

The rule of law is not just a necessary condition for a modern liberal society but also an important requirement for a stable, effective, and sustainable market economy. However, the relevant legal norms may be more or less successful depending on their social reception. The study explores the connection between the rule of law, especially in terms of how it is viewed socially, and the functioning of market economy on the examples of Germany and Poland. We utilise two approaches: first, societal perceptions of the various dimensions of the rule of law are studied by way of standardized surveys and in depth interviews conducted in both countries to determine the de facto state of the rule of law in the economic context. Secondly, the effect of the de jure and de facto rule of law on economic outcomes is measured using a multivariate panel analysis. Combining new institutional economics and sociology of law, our analysis finds that Polish firms perceive the rule of law and its execution by the state in a restrictive perspective, contributing to insecurity; German interviewees, however, showcase the supportive and transaction cost-reducing properties of the rule of law, hence higher trust in the state. These findings are supported by the econometric analysis, which shows the importance of rule of law in terms of a level playing field contributing to higher levels of investment.

Keywords: rule of law; development; Poland; Germany; new institutional economics; sociology of law

ACKNOWLEDGEMENT: This paper was funded by and is part of a larger research project from the Polish-German Foundation for Science, grant no.2018-26.

1. Introduction

The rule of law is not just a necessary condition for a modern liberal society but also an important requirement for a stable, effective, and sustainable market economy. Recently, the connection between the rule of law and the economy has increasingly been the focus of much scientific and analytical work (see Obinger, 2000). This finds its expression in the research programme known as *new institutional economics*. In this interdisciplinary field, economic outcomes such as gross domestic product (GDP) or the investment rate are explained not only with capital or labour inputs, as in the classical growth models, but also with institutions. Institutions, understood by new institutional economics as formal and informal rules of the (social) game (North, 1990), act as incentives which promote certain social interactions (including economic interaction) while discouraging others. Two types of institutions are singled out in the literature: extractive institutions, which favour select groups within the society, and inclusive institutions, which enhance the well-being of the entire society (Acemoglu et al., 2005a). There are different possibilities for inclusive institutions to influence the national economy:

- independent judiciary as a safety mechanism against fraudulent activities and unfair competition – through contract enforcement and the settlement of commercial disputes;
- legal certainty, e.g. regulatory stability, as a basis for private investments;
- freedom from corruption as a basis for the optimal allocation of resources (e.g. merit-based employment or competition-based project financing).

All-inclusive institutions are based on the rule of law, understood as the principle of primacy of law in social organisation and equality of all before law. Those institutions, being specialised legal norms, can be perceived as emanations of the general rule of law.

Importantly, as suggested by research in the sociology of law, the adoption of legal norms does not warrant compliance with them, and that the *de facto* state of the rule of law often diverges from its *de jure* state (e.g. Woodruff, 2006). The success or failure of legal norms depends to a large extent on the social norms that have developed historically. The different fates of similar reforms in different countries serve as an example here (Balcerowicz and Rzońca, 2014). Within the economic literature, these factors are generally called informal institutions (e.g. Tabellini, 2010) and correspond to what is referred to in the sociological literature as the social working of the legal rule (Griffiths, 2003). Sociological research indicates that the successful implementation of a rule depends on the understanding and acceptance of that rule by society (Moore, 1973).

In the context of the inclusive institutions described above, the relevant legal norms may be more or less successful depending on their social reception. For example, insufficient trust in the judiciary can lead to unofficial and inefficient mechanisms of conflict resolution; alternatively, trust in the judiciary can increase risk appetite and thereby stimulate entrepreneurship; at the same

time, the extent to which rules are understood translates to the extent to which they are complied with. In the long term, insufficient understanding of the rule of law in a society can prompt the government to abandon or undermine the rule of law, leading to negative social and economic effects. This can be accelerated by external shocks, such as the recent economic crisis, which has shaken the foundations of liberal democracies and market economies throughout Europe.

Against this background, this study examines the rule of law in Germany and Poland in the economic context from both the *de jure* and *de facto* perspectives. In particular, we seek to understand what is the *de jure* state of the rule of law in these two countries, while at the same time delineating the social reception of those institutions, i.e. what is the *de facto* state of the rule of law? To answer these questions, we perform an index and legal analysis of both countries. Finally, we also seek to link rule of law with economic development, exploring how the *de facto* of the rule of law impacted economic development in Poland and Germany. This analysis uses two methods, first exploiting new sociological findings on the perception of the rule of law in the economic context based on the results of the surveys and in-depth interviews conducted in June and July 2020 throughout both countries. Secondly, using the findings from the legal and sociological analyses as a foundation, we construct an econometric model to ascertain the drivers of rule of law and how they impact economic development.

2. Understanding the Level of Rule of Law in Poland and Germany

2.1 Germany

Until 1871, the year of the unification of the German Empire (*Deutsches Kaiserreich*), the German nation was a collection of several small states with related ethnic, cultural, and linguistic heritages. With the end of World War I, the monarchy was abolished, and Germany entered into the phase of the Weimar Republic with a strong role for federal states and even stronger political fragmentation. The latter, combined with economic crises and political terrorism, led to the rise of totalitarianism, the Third Reich, and the Second World War. More important for our purposes, Germany’s modern constitution (*Grundgesetz für die Bundesrepublik Deutschland*, or “Basic Law”) was adopted in 1949 in the Federal Republic of Germany (West Germany), and several constitutional elements of the Law, especially with regard to federalism and eventual-democratic governance, stem from this long history and evolution of German society and government. The *Grundgesetz* was originally intended to be a provisional constitutional document as long as the nation was divided, as mentioned in the original Article 23^h. While the Basic Law came into effect in 1949, the formal end of German occupation by the Western Allies of World War II (United

^h ‘For the time being, this Basic Law shall apply in the territory of the Länder of Baden, Bavaria, Bremen, Greater Berlin, Hamburg, Hesse, Lower Saxony, North Rhine-Westphalia, Rhineland-Palatinate, Schleswig-Holstein, Württemberg-Baden, and Württemberg-Hohenzollern. In other parts of Germany, it shall be put into force on their accession.’ (Original English text of Article 23 of the Basic Law, now repealed and replaced).

States, United Kingdom, and France) occurred in 1955, as a result of the General Treaty of 1952. In addition to the end of the occupation, this treaty officially recognised the sovereignty of the Federal Republic of Germany.

On the other side of the Iron Curtain, the sovereignty of the state of East Germany (German Democratic Republic, or GDR) was established in 1949 with the adoption of its own constitution. While the constitution stated that the GDR was to be a democratic republic with extended citizens’ rights, the reality was to become a different one. The GDR rule of law had been compromised in the most vital areas of freedom of speech, freedom of movement, and political organisation. The law was not binding for all but was subject to the political will of the single political party and was interpreted or suspended arbitrarily. Nevertheless, for the ordinary citizen, the rule of law was adhered to, as long as no political opposition could be detected. The debate whether the GDR has to be defined as an unlawful state (*Unrechtsstaat*) remains difficult to answerⁱ.

After the assimilation of the GDR during unification in 1990, the legal system of the Federal Republic of Germany was copied in the newly created federal states (*Bundesländer*). The transformation and system-change of East Germany were accomplished by dissolving the old system and accessing a ‘ready-made state’ (Rose et al., 1993; Reißig, 2010), and the rapid and efficient transfer of institutions from West to East began in earnest, leading to the organisational consolidation of East Germany and the establishment of a functioning administration. Indeed, it was possible to integrate the new federal states into the institutional order of the Federal Republic in a very short time, with rapid institutional changes including the development of a common constitutional order, local self-government, and common federal structures (Reißig, 2010).

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. This has been observed by several surveys of the rule of law and its subcomponents (Institut für Demoskopie Allensbach, 2015; Köcher, 2019; Institut für Demoskopie Allensbach, 2020). For example, according to a report by the Institut für Demoskopie Allensbach of 2019, only 39% of East Germans think that courts judge independently, and every second person does not see his or her fundamental rights fully protected. Distrust in media, government, police, and administration is more common in the East than in the West (Köcher 2019). Even if the absolute numbers of trust in public institutions are rising, the gap persists and remains one of the major challenges of the Federal Republic of Germany.

2.2 Poland

ⁱ See Deutscher Bundestag (2018) for a detailed discussion of the GDR as *Unrechtsstaat*.

Poland, historically, was in the vanguard of constitutional development in Europe. The “nobles’ democracy” (*demokracja szlachecka*), which was a system of government with nobility as the political class which crystallised in the 15th and 16th centuries, with ‘Republic’ (*Rzeczpospolita*) soon appearing in the name of the state. It incorporated many elements of the rule of law, including separation of powers, economic freedom, and freedom of speech. The parliament (*sejm*) emerged as an independent branch of government between the 14th and 15th centuries and the *Nihil novi* act of 1505 forbade the monarch to enact laws without the parliament’s approval.

However, the nobles’ democracy increasingly disadvantaged peasantry and the emergent bourgeoisie, including by introducing serfdom and granting monopolies to nobility (on grain, among other goods). Combined with the notoriously weak enforcement that plagued the early Polish state and undermined legal certainty, this led to the system morphing into a clientelist oligarchy, with woeful consequences for the rule of law, and eventually to the collapse of the state in 1795. Shortly before, in 1791, the country famously adopted Europe’s first and the world’s second written constitution (known as *Constitution of May 3 – Konstytucja 3 maja*) in a bold but belated attempt to repair the crumbling institutions.

During its period of political non-existence (1795-1918), Polish society was under the influence of the three sets of formal institutions and informal norms corresponding with the three empires of which it was part: Austrian, Prussian, and Russian. There is research indicating that following the unification, with a single legal system in place, the social working of legal rules still differs along the borders of the old partitions (e.g. Becker et al., 2016; Vogler, 2016). These findings correlate with the regional differences in GDP per capita levels, which also largely follow the borders of the old partitions, yet the establishment of a causal relationship is notoriously difficult due to the problem of endogeneity.

With statehood restored under the Second Polish Republic in 1918, a democratic March Constitution (*konstytucja marcowa*) was adopted in 1921. However, it was soon replaced with an undemocratic April Constitution (*konstytucja marcowa*) in 1935, as Poland joined the European flirtation with autocracy of the time. In the wake of World War II, a Communist constitution was enforced by the Soviet Union in 1952 after Stalin himself famously revised it. It continued in force, although with crucial amendments from 1989 and 1992, for an interim period following the restoration of Poland’s independence in 1989. By 1997, the modern constitution (*Konstytucja Rzeczypospolitej Polskiej*) was ready and in force. In the period leading up to Polish accession to the European Union (EU) in 2004, the country was strongly incentivised to reform its legal system in line with the EU’s *Acquis Communautaire* (e.g. Hartwell, 2016).

Since 2015, the rule of law in Poland has been undergoing erosion in the form of both detrimental changes in the legal rules and in the approach of the ruling class to law, or legal culture. The legal analysis presented further in the report describes this process with respect to the particular

dimensions of the rule of law. However, the question of how these changes have translated to the wider social reception of the rule of law will be our objective in the next section.

3. The Sociological Foundations of Rule of Law: Evidence from Surveys

3.1 Methodology

Sociologists are rarely consulted on the rule of law, even though social trust in law and justice is presently a standard element of the relevant definition of what is conceived of as “rule of law.” We attempt to bridge this gap here by providing sociological insight to people’s reflections on some of the aspects considered crucial to the meaning of the rule of law in entrepreneurial activity as an owner, manager, or representative.

During June and July 2020, we surveyed 800 businesspeople – 400 in Germany and 400 in Poland – representing small (up to 10 employees) and big (over 10 employees) businesses. Additionally, for both Germany and Poland, we conducted semi-structured interviews with 12 business representatives from different sectors, including services and industry (six in each country), to understand different aspects of the rule of law in their country’s economic life. The target group included an equal number of women and men and an equal number of people representing small or big businesses.

- a. The quantitative questionnaire survey of businesspeople used the same basic short questionnaires (12 questions). Due to the rising costs related to the Covid-19 epidemic, different sampling methodologies were used.
- b. In Germany, our team conducted ‘river sampling’. This sampling is entirely digital and consists of a three-step process that allows scientifically valid results to be obtained within a shorter time. The innovative methodology behind this data collection, pioneered by the firm Civey (who also undertook the survey), was developed in cooperation with the Rhine-Waal University of Applied Sciences. Surveys are synchronously integrated on 25,000+ German websites of media partners. Surveys are evenly distributed via URLs to the target group to be surveyed and over the surveyed time. An algorithm decides who is included in the sample. Only the participants verified through the algorithm are taken into account in the result calculations.
- c. In Poland, a local firm (Opinia24) conducted standard computer-assisted telephone interviewing (CATI) on a random sample of businesspeople from the available register while adjusting the composition of the sample based on the respondents’ company sizes.

The basic difference between the two sampling methods concerns the way in which a respondent is identified. In the German case^j, the respondent decides her/himself to join the research. She/he is attracted to it through existing web identifiers (URL), e.g. hypertext pages, images, and sound files, and agrees to respond to a survey questionnaire. This means that only web users are contacted^k. In the Polish case, an existing Bisnode list of business addresses served as the base from which the contacted firms were randomly selected and then asked to agree to the interview^l. Hence, the Polish study belongs to the traditional family of probabilistic sampling, while the one conducted in Germany, to the newly developing family of non-probabilistic sampling.

The context of the pandemic eliminated another important differentiating factor, as classic face-to-face interviewing suddenly became impossible. While we adapted the format of the semi-structured interviews to the context of the pandemic, conducting them virtually, the online questionnaire limited to twelve closed questions became the main research tool. Also, the reason behind the dynamic increase in interest in non-probabilistic sampling – the alarming decrease in the response rate – makes the use of alternative data collection methods necessary. All these factors have brought the two methods – probabilistic sampling and non-probabilistic online sampling – closer. The difference in the applicability of the statistical analysis to the data nevertheless remains for the following reasons:

- we limit ourselves to a simple comparison of the distribution of responses to the survey questionnaire;
- we warn the reader that we are unable to estimate the representativeness of the data^m;
- the descriptions of the comparisons across Germany and Poland – where different data collection methods were used – are to be considered at best as hypotheses that need to be tested using the same data collection methods, even though it will always remain open to further cross-testing with different methods and different types of databases.

3.2 Results

This section presents our findings in a comparative manner – both between the countries and groups of respondents (i.e. representatives of small business [SB] and big business [BB]). The

^j For details on methodology see <https://civey.com/whitepaper>.

^k With over one million active and verified users per month, Civey claims to have the largest survey panel in Germany.

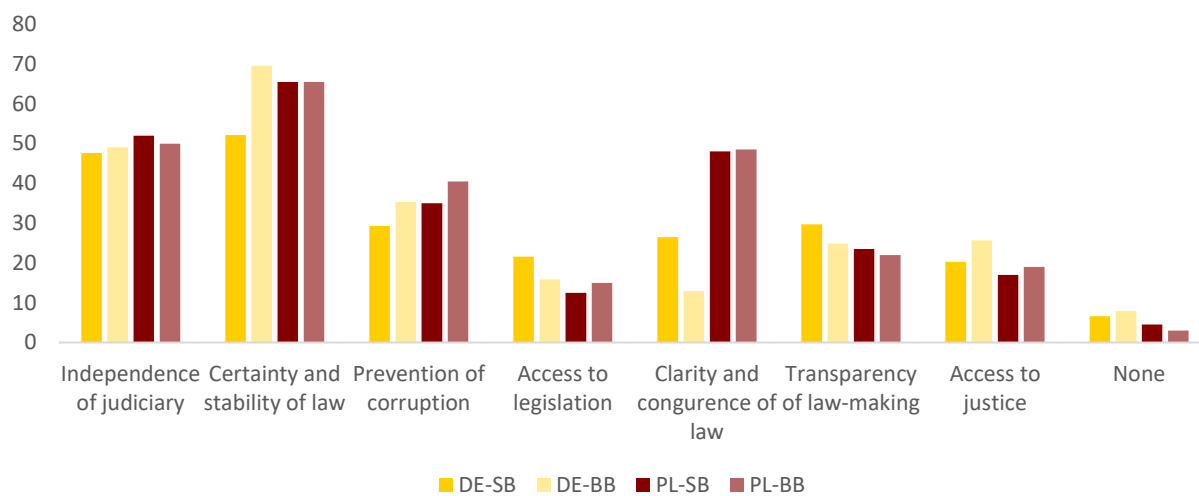
^l Bisnode, an international company active in Poland for 27 years, boasts that its databank contains data on approximately 4,600,000 companies active in Poland (<https://www.bisnode.pl/produkty/bisnode-baza-danych>).

^m In fact, the representativeness of ‘river sampling’ in general is under permanent debate in the professional world of public opinion research. In 2015, the American Association for Public Opinion Research updated its guidelines concerning reporting measures of precision from nonprobability samples: ‘Under the AAPOR Code, it is acceptable for researchers working with nonprobability samples to decline to report an estimate of variance. In such cases, it may be useful to note that the survey estimators have variance, but there has been no attempt to quantify the size.’ (https://www.aapor.org/getattachment/Education-Resources/For-Researchers/AAPOR_Guidance_Nonprob_Precision_042216.pdf.aspx).

latter comparison is methodologically pure as the same methodology was used in order to find the respondents. Further, the comparison is made between business classes from the two countries. Yet, the analysis of these relative results needs to be carried cautiously as to account for the methodological differences discussed above.

When it comes to the importance of the rule of law elements in business, ‘*certainty and stability of the law*’ and ‘*independence of judiciary*’ were selected by the majority of participants independently of the country and size of business. The national samples, however, differ with ‘*prevention of corruption*’ and ‘*transparency of law-making*’ ranking third for German large and small businesses, respectively. In the case of Poland, ‘*clarity and congruence of law*’ occupied the third position for both small and large businesses.

Figure 1 - Distribution of answers to Question 8: ‘Which aspects of the rule of law are the most important for the successful management of an enterprise?’ (in %).



Note: the choice of participants was limited to up to three elements.

In Germany, small businesses mentioned ‘*certainty and stability of law*’ as the most important aspect of the rule of law significantlyⁿ less often than big businesses. The opposite, however, was true as regards ‘*clarity and congruence of law*’, with small (but not big) businesses finding it the most important the smallest number of times. In Poland, no significant differences were found between small and big businesses as to the importance of the seven attributes of the rule of law in our list.

In a cross-country perspective, representatives of small businesses in Germany attributed significantly lower importance to the ‘*independence of judiciary*’, ‘*certainty and stability of law*’, ‘*prevention of corruption*’, and ‘*clarity and congruence of law*’ compared to Poland. Yet, they more often than the latter selected ‘*access to legislation*’, ‘*transparency of law-making*’, and

ⁿ In this report, ‘significance’ means the difference between dichotomised variables as measured by Fisher’s exact test of significance with $p = 0.05$ or less. As for the precaution, it needs to be stressed that it does not involve the fulfilment of the theoretical presumptions of such test but is used for convenience instead of any other arbitrarily chosen criterion of taking the numerical difference between the distribution of responses into account.

‘*access to justice*’ as the most important aspects of the rule of law. When big businesses from both countries are compared, the only significant difference is evident as regards ‘*clarity and congruency of law*’, which was more often of importance for Polish big businesses.

The insights from the interviews confirm that the rule of law as seen from the business perspective is not necessarily the same in terms of legal or political points of view: ‘*The rule of law is one thing that builds trust - trust that I can rely on my counterpart, that I am also secure in certain situations. Trust, I think, is the basis for doing business. If I did not have the feeling that my customer would pay for his goods, for example, or that my supplier would deliver after I had paid, then no business relationship, no business at all, would be possible. For me, that is the rule of law. I know that he [the supplier] is obliged to do so, I have paid in advance - I can rely in good conscience on [the supplier] delivering, in other words creating trust, which is essential for me*’ (DE-1). It is evident that the rule of law as perceived by the respondent is a trust-creating, hence transaction cost-reducing, device. This perspective is clearly aligned with the theoretical account of the rule of law within the new institutional theory as discussed in the first, *de jure*, part of the study.

Along similar lines, another German respondent added the following: ‘*By the rule of law I understand that one has solid and reliable boundary conditions. That starts with property and contracts. But it is also about labour law, which means that you can be very precise in your orientation on what are the rules; you can rely on them being observed; and if not, that you can ensure that they are observed. For me, that is a definition of the rule of law. But whether you like [rules] or not is another question. They are simply a reliable framework for entrepreneurial activity*’ (DE-2). This notion of the rule of law as a framework has been echoed in the definition provided by one of the big businesswomen from Poland (PL-2) quoted further on.

There are, however, more structured visions of the rule of law in occurrence, including the following: ‘*For me, the rule of law also means, first and foremost, a certain degree of certainty and stability of law. In other words, the guarantee of independent courts, compliance with the separation of powers, and the independence of courts. All in all, a reliable administration of justice that does not judge according to the political situation. And, of course, comparable to Germany, a kind of the Constitution or basic law, which, so to speak, lays down the guidelines to which the state must also adhere. For me, the rule of law does not only mean that the courts pronounce justice independently, but also that there is no arbitrariness on the part of the legislature, nor any arbitrariness on the part of the executive bodies*’ (DE-3). While here the basic referent is the certainty of law, the definition refers to the entire system of the legal state and its individual elements.

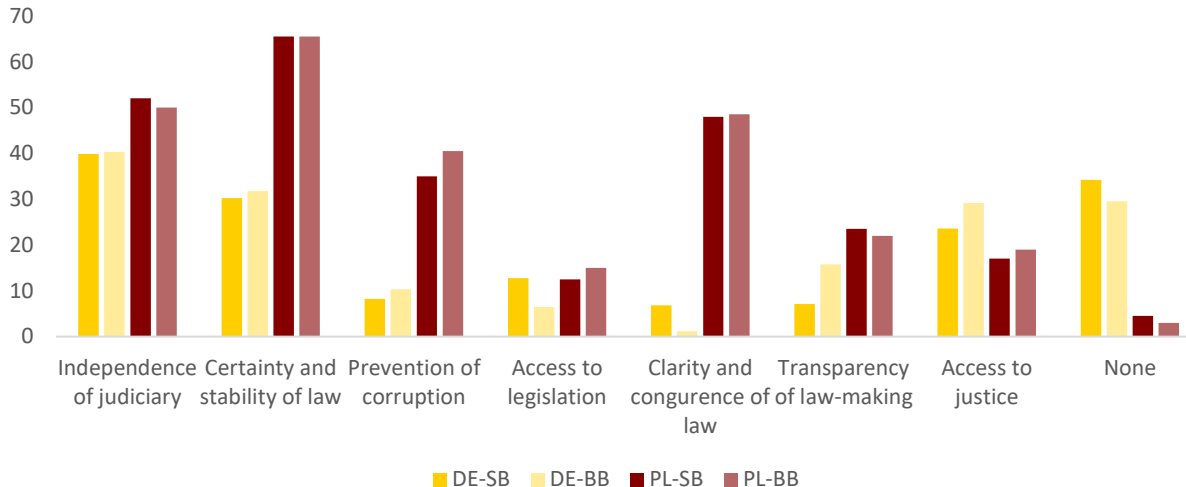
Further, ‘*the rule of law is actually the framework that is set by the state, by the community that the state is supposed to represent, with the rules it contains, and also sanctions or support measures. I think the state should not be the better entrepreneur. That is also the catchword. Instead, it should define the rules by which people try to enforce the rules so that every actor in every area adheres to them and enforce sanctions if the [rules] are violated. [...]. The framework is important, the rules are important. For me, that is the rule of law, including enforcement*’ (DE-

5). As discussed further, there is, however, a clear contrast between the levels of trust in Germany and Poland.

When confronted with the Polish term ‘*praworządność*’, our Polish respondents reacted almost uniformly by stressing the rules and abidance by the rules. ‘*I consider the rule of law (‘*praworządność*’) to be the strict compliance with the rules*’, said PL-1, who represents a Polish branch of an originally German and now large international company. An Armenian immigrant who owns a restaurant in Poland (PL-3) responded similarly: ‘*One should do as it is written in law ... How possibly one can make a business without the law? You must know fiscal laws, how to employ, how to lay off [the staff] ...*’. Another interviewee (PL-2) further explained that ‘*praworządność*’ is equally significant in business as it is in the private life: ‘*It determines the frame of functioning, so in its absence, people would behave in a completely opposite way*’. She considered that this external restraining frame needed to be filled inside by a strong ethical position, meaning the business ethic as well. The respondent PL-4 (with an engineering background) listed the following characteristics of the functioning of the rule of law when he compared the situation in Poland with the one in the United States, where he worked for 10 years: ‘*Firstly, law is equal for everybody. But, secondly, it is clear, transparent, easy to understand, and stable. The law does not change so often*’.

Much more developed is the position taken by a businesswoman with a social-scientific academic background (PL-1) who manages a large private educational agency in Poland: ‘*I think that this ‘*praworządność*’ has two aspects. First one is the hard one that is the abidance by the binding law, legislation, the Constitution and [...] competence of the particular law-making and law applying bodies. But the second element is associated with the intuitively understood law, that is the widely conceived honesty, respecting – for sure – the human rights, women’s rights, and – I should say – a certain basic order that functions, principles of democracy, tri-partition of power. It is certainly for me the manner in which the laws are made. [...]. In all this [...] there is also the elementary honesty [...] and non-abuse of the law to promote the interests of one group, which is not to use the law in an instrumental way*’.

Figure 2. Distribution of answers to Question 7: ‘Which aspects of the rule of law in your country are most fulfilled?’ (in %).



As for Germany, the responses of small business representatives differed significantly from that of the representatives of big businesses as regards the assessment of the main attributes of the rule of law. Specifically, they more often appreciated the state of ‘*access to legislation*’, ‘*clarity and congruency of law*’, and ‘*transparency of law-making*’, while the opposite is true for the ‘*access to justice*’ element. In Poland, the small businesses appreciated less ‘*independence of judiciary*’, ‘*prevention of corruption*’, and ‘*access to legislators*’ relative to the big businesses.

When comparing the opinion of both classes across the countries, representatives of the small businesses in Germany appreciated ‘*independence of judiciary*’ and ‘*transparency of law-making*’ better compared to Poland. The latter, in turn, had a higher relative appreciation for the state of ‘*prevention of corruption*’, ‘*access to legislation*’, ‘*clarity and congruency of law*’, and ‘*access to justice*’ in the country. When comparing German and Polish big businesses, the only difference is apparent as regards the ‘*transparency of the law-making*’, which has been significantly less often appreciated in the case of Germany.

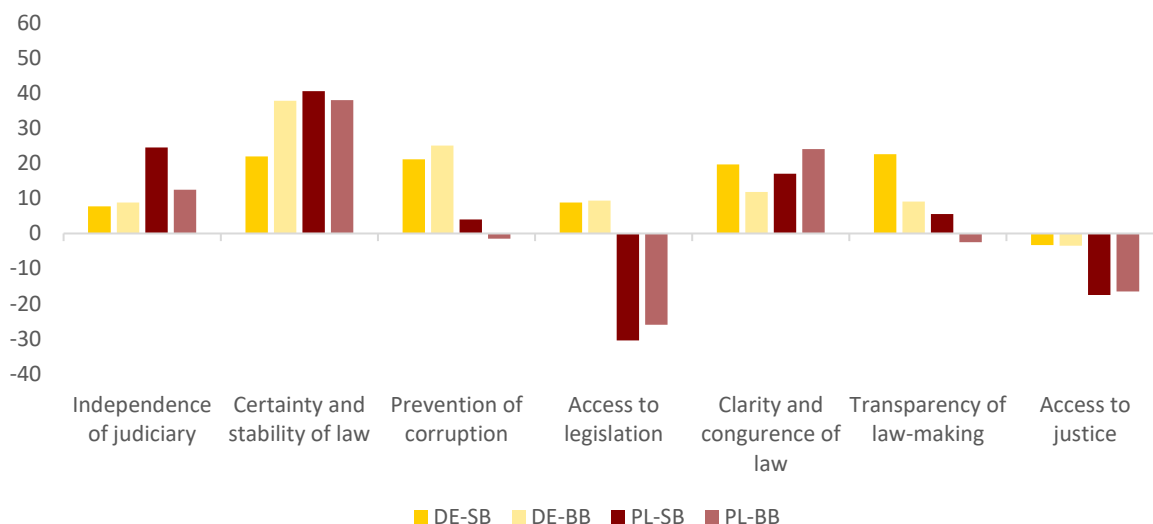
The results presented in Figure 2, however, need to be interpreted cautiously. The choice of respondents has been limited to not more than three out of seven attributes of the rule of law. Under such a limitation, selection is affected by the perceived significance of the elements. Thus, for example, corruption prevention needs might have not been recognised by the sample as important as for the respondent DE-6. This is why the results of our survey need to be discussed in conjunction with the findings of the in-depth interviews and the results from the previous question that dealt with the significance of these attributes in the economic functioning of a business.

PL-1 criticised the recent rule of law situation as a ‘*dishonest application of the law that may transpire in all spheres of living, including economic life. If one does not abide by general law such as the Constitution, why should not we do it in [economic] sphere? This foments great anxiety [...] which may be more felt in some areas. [...] If the independence of judiciary is so tightly*

limited, it might appear dangerous in a situation of a dispute, especially if the State Treasury is the opponent [...]’. The respondent also shared a story about the public inspections that suddenly arrived to control the agency she was in charge of. When asked if such situations applied to the courts as well, she answered: ‘I think yes, yes. As our reality shows, there are the attitudes of the invincible judges and those judges who follow the career path exploiting this moment. These are [...] purely human factors. Someone may be motivated by the fear and not necessarily by the career. Yes, certainly I think that if this administration of justice is not or may not be independent, it would create a great barrier to the economic activity’. She further shared an example of a large foreign company that had withdrawn from Poland because of the above-mentioned insecurity.

If the demand for the rule of law had been determined by the distribution of answers to Question 8 on the importance of the various elements of the rule of law, a simple step forward would be an assessment of the discrepancy between how often a parameter is considered as important and its availability, that is, the frequency of answers to Questions 7 and 8 as presented below.

Figure 3. Deficit/Surplus of the attributes of the rule of law (in %).



In both countries, the deficit in ‘certainty and stability of law’ is the largest or almost the largest independent of the size of business.

Similar to the Polish experience invoked before, these concerns also appear in Germany (DE-4): ‘There is now a new law from the tax office, which is actually valid since the end of December 2019. There is also a transitional period that will soon expire. That is something I would have to take care of. So the tax office now also wants to access all the cash register data. In principle, [...] each individual cancellation is documented and recorded. The tax office can then actually ask at any time, why was it cancelled at that time? I have the feeling that new laws are coming all the time. So, I am very much involved in this everyday business. There are always new regulations on packaging and food labelling. At the moment I have the feeling that if you are such a small

company and you do not have your own [legal] department to take care of all these things, it is a bit difficult to keep up with all the regulations.’

Table 1. Ranking of the rule of law attributes in terms of deficits/surpluses of performance.

	DE-SB	DE-BB	PL-SB	PL-BB
Independence of judiciary	5	5	2	3
Certainty and stability of law	2	1	1	1
Corruption prevention	3	2	5	4
Access to legislators	6	4	7	7
Clarity and congruency of law	4	3	3	2
Transparency of law-making	1	6	4	5
Access to justice	7	7	6	6

Note: The Table presents the ranking of each attribute of the rule law for each target group on a scale from 1 to 7 (i.e. total number of attributes analysed) with ‘1’ corresponding to the highest gap between how often a parameter is considered as important and its availability (that is the frequency of answers to Questions 7 and 8) and ‘7’ – to the lowest gap, respectively.

As Table 1 shows, countries differ strongly as to the ranking, with the ‘*independence of judiciary*’ ranking first in Poland and near the bottom (uniformly fifth) in Germany. Yet, there is a certain uniformity with the ‘*accessibility of justice*’ ranking the lowest or almost the lowest in both countries. This means that ‘*accessibility of justice*’ was more often assessed as one of the three best functioning attributes of the rule of law while being less often mentioned among the three most important elements. This aspect is discussed in detail in the further sections focused on the analysis of business attitudes towards courts in dispute settlement.

Further, the difference between frequency rankings in our four samples can be measured with Spearman’s rho coefficient of correlation as presented in Table 2 below.

Table 2. Spearman’s rank order (rho) correlation between samples.

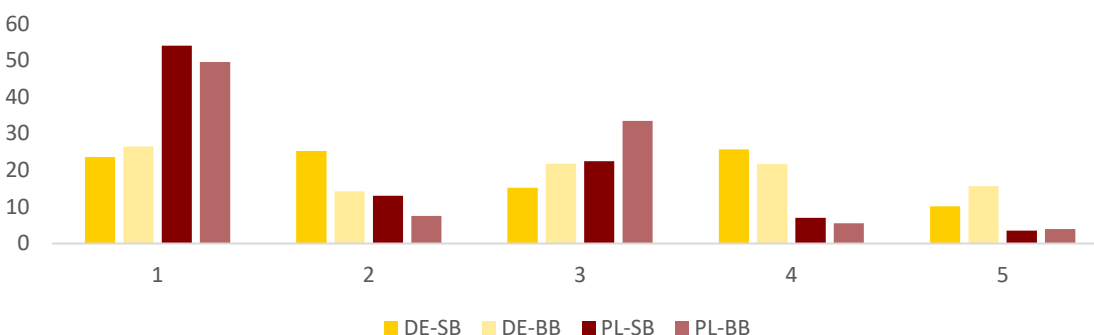
	DE-SB	DE-BB	PL-SB	PL-BB
DE-SB	x	0.429	0.536	0.500
DE-BB		x	0.214	0.643
PL-SB			x	0.929***

The orders of frequency differ between the samples as correlations between the rankings are statistically insignificant. The only exception is the correlation between the rankings of Polish small and big businesses (Spearman’s rho = 0.929, $p < .002$), which showed a high concordance of the order of frequency between two Polish samples. Polish businesses can, therefore, be seen as relatively more homogeneous.

3.2.1 Rule of law in relations with the state

One obvious understanding of the rule of law dates back to times of monarchy when the principle of ‘*non rex regnat sed lex*’ was raised against the absolutist rulers. The simple test of the state of the rule of law, therefore, is whether the administration abides by the law when dealing with businesses, and this was exactly the question we asked respondents.

Figure 4. Distribution of answers to Question 9: ‘How often did you experience that the administration did not follow the rules that govern the relation between administration and enterprises?’ (in %).



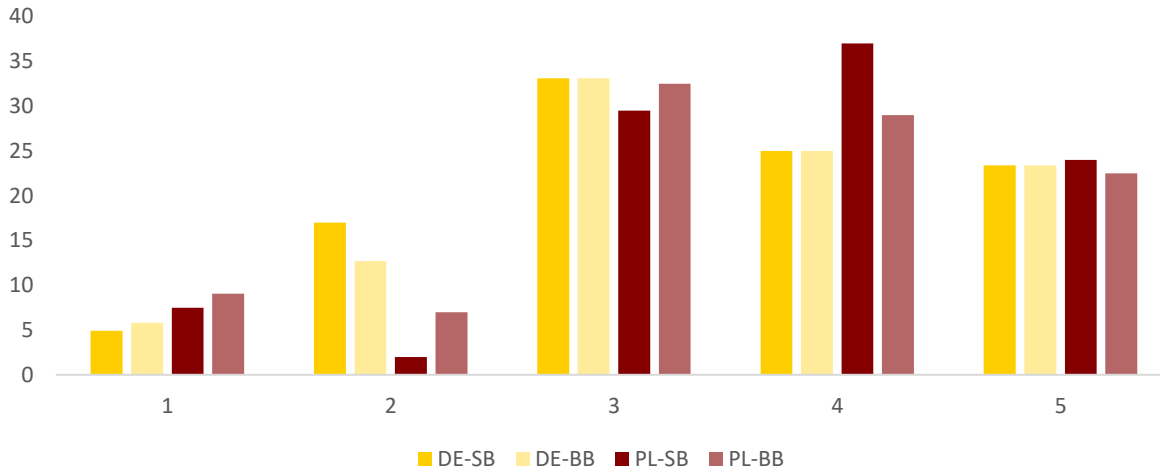
Note: range from 1 (unlikely) to 5 (certain).

The minority of the respondents are on the pessimistic side of the diagram while the majority are optimistic or in the middle position with significant national difference. Polish businesses independent of size are more optimistic as to the legality of the administration than German businesses.

When one of the interviewed respondents (PL-1) was asked about the relationship between the rule of law in citizen-state contacts and business-state contacts, she stressed the continuity between the two: ‘*I think that, despite different matters, the relations between business and the state have a lot to do with the rule of law. [...] For instance, there is a legislative proposal [...] allowing that in some circumstances the state may take a firm under its control if the [the entrepreneur] is for instance abusing the law according to a state’s organ [...] This is disciplining the business through the law [...so] If we do not like a certain entrepreneur [...] and we found something on him, we can take over his business [...] I invented this example to show how law may be used in a disciplinary way against the business in a very discretionary way.*’ It is obvious that the public appearance of such legislative ideas in the times of the ‘good change’ (as the ruling parties are calling the abrupt reformation of the Polish state) foments suspicion and distrust on the market.

Another possible threat is the preferential treatment of public companies. The respondent also mentioned legislation that risks undermining fair competition, for instance in the banking sector, where the state is developing policies to nationalise banking.

Figure 5. Distribution of answers to Question 5: ‘According to your knowledge and experience, how likely is it that in adjudicating a dispute between a company like yours and the public administration, the court would act biased and pass the verdict in favour of the administration?’ (in %).

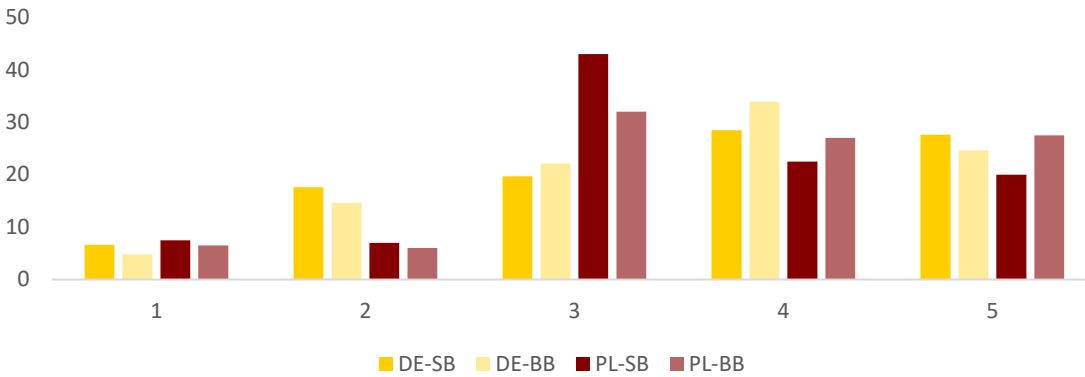


Note: range from 1 (unlikely) to 5 (certain).

In both countries, businesses suspect that in cases of disputes with administration, the courts would favour public administration. We found, however, that German small businesses were less pessimistic than the Polish ones in this regard.

If, nevertheless, the company wins such a trial, the majority of respondents in both countries believe that the verdict would be implemented, with German businesses being significantly more optimistic. However, small businesses in both countries were found to be less optimistic compared to big businesses.

Figure 6. Distribution of answers to Question 6: ‘Let’s assume your company has won a case of this kind (against the administration) in court. How likely, according to your knowledge and experience, is the court verdict to be implemented in practice?’ (in %).



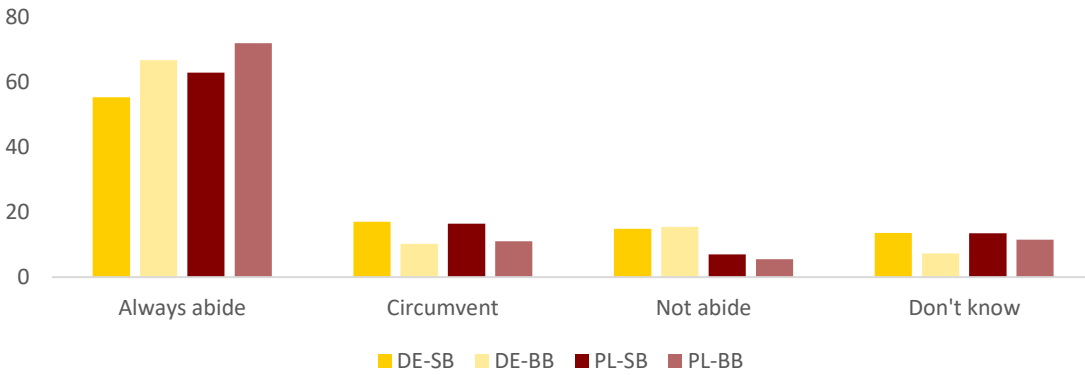
Note: range from 1 (unlikely) to 5 (certain).

The reality of the rule of law, however, is the world of social interactions that might be – and sometimes are – legally interpreted. In relations between business and the state, it holds true as the sincere explanation of a German small businessperson (DE-4) illustrates: ‘*What I have noticed is that it is extremely important to have a good connection to the controlling organs. For example, the food inspectors who have been coming to us annually for years to check that everything is in order. I get along quite well with them. I consciously tried to find a good level with her because, if in doubt, I can call or email and say: ‘Hey, I am not quite sure if this is the right way to design our labels. Is that the law? Can you look over it and tell me if it fits or not?’ Then that is what she does. Then she says that everything is okay or that we have to look over it again.*’ This is a clear example of a casual and informal way of addressing regulations that is the core of the sociology of law and in clear contrast with the restrictive and worrisome perception of regulations in Poland.

3.2.2 Rule of law as abiding by the law

On the other side of the spectrum is the abidance of the law by the business itself. This is the most commonly used indicator of legality among sociologists of law, who usually analyse the law in reference to individuals either as citizens or private individuals (Fuszara and Kurczewski, 2016; Kurczewski and Fuszara, 2017). Thus, by asking business representatives how they act in the face of laws considered unfair, we are able to raise the issue of legalism within an important yet little explored area.

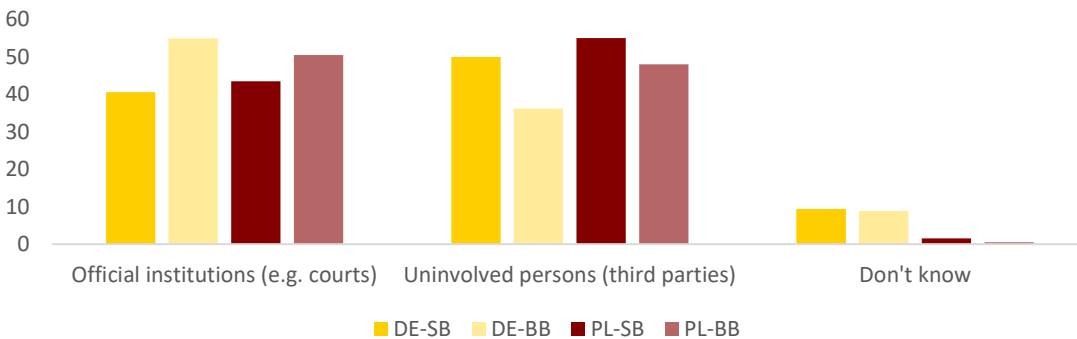
Figure 7. Distribution of answers to Question 11: Do you agree with the statement: ‘*Enterprises should always abide by the law, even if they think it is unfair?*’ (in %).



German small businesses were found to be the least inclined to strictly abide by the law. When comparing these figures with our knowledge and findings on Polish society, one is stricken by a much higher rate of declared legalism among the business representatives compared to the average population as surveyed in the representative samples.

The following story shows how for the general public, as the majority of business representatives are, law abidance may become almost an obsession unless interaction with the official legal field is supported by legal professionals. *‘I have the feeling that in my everyday life I have to concentrate all my energy on constantly paying attention to the rules I have to implement, the laws I have to obey, and the things I have to adapt in my everyday work to comply with the whole thing. Sometimes I wish I had a little more time to be creative in my profession, to be able to say that I have new ideas for the shop. Things may not be like this right now because of Corona but what can I do for the customers in my [grocery store]? A large part of my energy at the moment goes into thinking that I still have to work [things] off and we have to be à jour [in the store] with the new legislation and so on.’* (DE-4).

Figure 8. Distribution of answers to Question 12: ‘What do you think is better if your company has a dispute with another?’ (in %).



In general, German representatives of small businesses were the least inclined to use the court or another official dispute settlement agency. If hesitant responses are excluded, the figures for the court acceptance ratio^o stand at 0.1 and 0.2 for German small and big businesses and 0.12 and 0.02 for Polish small and big businesses, respectively. These results underline the intrinsic inclination of small businesses in both countries for informal dispute settlement. Similarly, the results of the 2014 survey of the representative national sample in Poland showed comparable figures (52%). People in better social positions, however, were found more often inclined to use the courts than people in lower social positions (Kurczewski and Fuszara, 2017).

As one of the German representatives of a small business explained: *‘I always prefer informal [settlement]. I think that [German] courts are so busy with people who want to push through banalities. So, I am always informal first. That is the way we tried with all [disputes] and that I would try in the [dispute] with state. My gut just tells me that the state is not very informal. So, I cannot imagine that the state will sit down at the table with me and find a compromise. Well, as I have come to know the state, it is extremely pedantic. So, if I have a reason to go to the court, the state will be very sure that it is in the right. That is why I do not think there will be a settlement [...]. I would have hope, especially in [disputes] among entrepreneurs. We have also had 1 or 2 [disputes] where we found compromises and have not had to go to court [...]. And we always found an out-of-court settlement. Entrepreneurs are not as subjective as customers who want to push a [dispute] through out of principle. [Customers] are buying and want the maximum return at the lowest cost. A lawsuit that ends up at 50:50 does not help anyone. [Entrepreneurs] are more objective, so [disputes] are definitely out of court.’* (DE-1).

Another small business entrepreneur stated *‘[...] most of the dealers we work with we have been working with for years. So here too, it is important to me that we have long-term and trusting business relationships. And most of them are, so you accept [informal settlement] without hesitation. [...] So sometimes we say: ‘Ok we cannot understand but because we have already had such a long, good, and trusting working relationship, they are now accommodating us. I do not know, then we either have a credit on the next order or we get something transferred back or something like that’. This happens quite often. [...] We have only had litigations so far because of the food labelling ordinance. [...] But that was really the state just telling us: ‘Okay, you behaved badly, that is not right!’ And in other litigation stories, we were warned by private warning firms, so that did not end up in court and was mostly settled between the lawyers.’* (DE-4).

This story illustrates the classical knowledge about the use of courts in business and, more generally, in society. A level of tolerance for mutual flaws is needed if parties are interested in the continued chain of transactions. Hence, one prefers not to upset the working relations by involving official institutions.^p This decision also relies on direct economic calculations of the relative costs of the involvement of official institutions, as discussed by DE-1: *‘I might as well pay [the disputes]*

^o Defined as the difference between (a) % choosing the court and (b) % choosing the informal mediation divided by the sum of (a) + (b).

^p This was the major point in the classic Stewart Macaulay report on the use of law in the American automobile industry as well as in the comparison with the Polish socialist industry as studied by Kurczewski et al. (1977).

off and not have to do the work. [...] Legal protection just does not make sense because it is cheaper to pay people off than to go to court. Legal protection has never made sense to us.’ Another respondent (DE-5) also stressed the time factor: *‘However, if a wrong decision or wrong demands are made by authorities, the question always arises whether we take legal action against it or we fulfil them, although we think it is impossible to be done. And the result of the considerations is always that one fulfils the allegedly or actually unjustified demand because it is still faster than to dispute the legal process. Because the legal process takes forever. Take non-paying tenants who, according to the law, have to vacate the apartment. One strives to get this tenant out of the apartment, but it takes [...] nine months in the best case. And in the case of building authorities, that is two years because demands are made on the office for the protection of historical monuments that would not even have to be made. One could sue against it. Then an expert must come. That costs a lot of money and takes a lot of time. It is uneconomical to proceed against it now. From an entrepreneurial point of view, in my field. There are certainly also areas where it makes sense to take action against it. But I have not had to deal with that yet.’*

Critical views on the role of judiciary were also expressed by respondents in each country as a cost of entering the legal system. From PL-2: *‘Perhaps when it comes to the law, the judges are brilliant. But please believe me, when the entrepreneur comes before the court [dealing with business issues], this is truly embarrassing experience. [Judges] do not have knowledge about the economy at all yet decide. Same is true for the labour courts. I had to deal with labour courts several times and this was an embarrassing experience. It cannot be the case for somebody who deals with laws – and here I think that [rules] should be absolutely reformed though, of course, not in the way as it is done now [by the government] – [...] as if a medical doctor would know medicine in a general way and would start the surgery not knowing how to operate.[...] Not to speak of the time it takes.’* Although the professional quality of the judiciary was not questioned by other respondents, they have raised other negative aspects when discussing the meaning and functioning of the rule of law in Germany and Poland. These included costs, time, and the need for legal professionals to assist.

The mistrust in the judiciary also derives from the professional nonchalance exhibited by judges who are dealing with thousands of similar cases, each of which is important for the plaintiff and the opponent. This aspect was depicted by DE-1, a representative of a relatively small yet formerly big business, when recalling a dispute in which the opposite side’s claims had been non-verbally ridiculed by the judge who: *‘[...] put pressure on us and we agreed [...] in the end. I was totally perplexed by what happened. My lawyer then explained to me that he experienced this every day in most of his cases because in a settlement the judge dictates two sentences into his recording device: ‘Hereby party XXX agrees to the settlement, 50:50, the case is closed.’ [The lawyer] then get this again in writing, word by word because it was recorded. The case is now closed. [...] A trifle of EUR 150 is not worth it for [the judge]. He put me under so much pressure with that decision simply [...] because [the judge] shied away from the work. I do not see the judge as necessarily responsible but rather the legal system which is designed that way and with such bureaucracy. That is when I learned that getting justice and being right are two different things. [This situation] made me angry and shattered my confidence in the legal system.’*

3.2.3 *Rule of law as a condition for foreign investment*

As a final point, and one which leads into the next portion of our analysis, we were able to ask a more conceptual question: How important do you think the rule of law is for economic development? To provide for a broader discussion, we extended the question beyond the German-Polish context and included a global actor with a weak rule of law performance – China – as a case study.

‘Well, I think it is extremely important and I think you have to give countries time to develop. So, there is also a change taking place. China of today is not China of 60 years ago. The more [China] opens up, the more other countries will invest there. And there are more international companies there today than there were 20 or 30 years ago. I think that with each step towards more rule of law, China will also attract more investments. [...] For me, that is absolutely connected. The rule of law is very important for investment and growth. So, it is also important in China. I prefer to invest when I know my investment is secure. But it can also be a strength. If they build a highway, it will be built. In Germany, they will discuss it for 15 years. Well, I see a similar situation with our constitutional state. [...] They have dragged it out so long that the proceedings have now been dropped. You lose your faith in justice.’ (DE-1).

But some, calling themselves conservatives, point to the unpredictability of the politico-legal context that would deter them from a hypothetical investment, like in the statement by DE-2: *‘I would not put these concerns aside at all, because we are very conservative here. [...] I could not imagine entering into a commitment where such [rule of law] boundary conditions are not fixed, where I have to reckon with the threat of arbitrary action by the authorities or state measures. I would not do that. [...]. But what happens when the wind changes? I follow a little bit what the automobile industry does. I used to work in the industry and there are of course big levers that are operated. There are subsidies for these and subsidies for those and then suddenly the domestic electric vehicles are subsidised and then nobody gets in. It can happen very quickly that something changes there and that would be too risky for me. [Q]: Okay, then, so to speak, the security of having laws that cannot be touched is more important than investment and a powerful state as in the case of China, for example?[A]: Personally, I would feel that way.’*

Another representative from small business is simply examining the balance of power between a foreign investor and the state: *‘I think it is very, very problematic, especially for small businesses. As a large company, I would at least have an economic power with which one could reach agreements when faced with disputes. As a small business owner, I would not want to expose myself to this risk’ (DE-3).* So only powerful (or criminal) businesses will invest in the unruly state which still must offer certainty and stability to attract foreign direct investment. And it does, as the Polish respondent with experience in a large international company comments, saying that there is hypocrisy on part of the West: *‘China [...] discovered the golden mean. They separated guarantees of safe investments from the safeguards for the whole [Chinese] society. [...] They exploited the Western hypocrisy as, on one side, there is all this concern about the rule of law and, on the other*

side, the long queue of foreign investors. [...] I think that greed is the danger for civilisation. [...] They would adapt to anything and everything will be justified.’ (DE-2).

But if we listen carefully to what another German small business representative says in terms of the international differentials of risk-taking behaviour, it is obvious that we come back to stability and certainty of law as the commonly shared attribute of the rule of law. *‘It certainly depends on the state and how it behaved in the past. Is the state structured in such a way that it is more likely to make the right decisions? Even if the rule of law is not so strong, it has its own rules. And, in the case of abuse, it also takes more drastic action than a constitutional state. In China, I believe that many companies that benefit from this cannot ignore the market. There was also the time of counterfeiting, and yet the companies invested there because the expectations of profit were significantly higher than the risk. I could not imagine anything similar in Congo, in Myanmar or anywhere else. Because there the consistency is not there.’ (DE-5).*

Respondents from Polish big businesses take this element of differentiation from the local perspective when speaking of China. *‘I think it is of colossal importance’ – says DE-1: ‘I am speaking from the perspective of somebody who worked in a global company. We had been doing what [we are doing now] as the Polish chapter of the local company. And this company left the Polish market exactly when the government changed, and the present government withdrew itself from the private-public partnership. As this global company had several foreign owners (Australians, British and then Americans), I had an experience working with different owners within the Anglo-Saxon system. And all but above all the Americans have had, I would say, a decalogue [...] of what are the indispensable conditions of business activity in a given country. And I remember that when Americans were taking over, although it was under the previous [liberal] government, Poland was at the dark end in the ranking together with South Korea and Saudi Arabia. It means that [Poland] had been treated as the high-risk country in terms for corruption [...] already then. I remember that under the Due Diligence Procedure I had to present many more documents and proofs that we are acting transparently, law-abiding, honestly, ethically etc. [...]. Already then I had a feeling that despite rankings we are seen with suspicion in the business [...] So now, especially in the present situation, I think [rule of law] is of great importance when it comes to deciding whether to invest [in Poland] and in what way [...]. Statistics show that since the PiS government assumed power, there is a fall in the long-term investments [...] and a rather ‘hit and run’ investment dominates.’ (DE-1).*

And the differential treatment of countries is reflected in another businesswoman’s comment on Western investments in China: *‘This [rule of law] is of colossal importance. Since Poland acceded to Europe [...] in 2004 there was a sudden outburst of foreign investment in Poland. The confidence in European legal order is great. The firms entering Poland had been certain that the international law is at their defence, not any local one.’* Thus, the relationship between the rule of law and investment decisions is seen in general as derivative of the economic calculus in which the rule of law itself is not the highest value unless certainty and stability are secured in any way. Otherwise, ‘hit and run’ tactics pay off.

4. Does it Matter? An Econometric Model of Rule of Law in Both Countries

Given these diverging ideas of rule of law, does it even matter in the long run how rule of law is perceived? To supplement the survey work of the previous section, this section extends our reach to answer this question, analysing the effect of the rule of law on economic outcomes in Germany and Poland. In order to do this, we undertake an econometric analysis on the relationship between rule of law and economic progress, fashioning a two-step approach to first estimate the drivers of the rule of law, plugging these results into a second equation examining the relationship between standard attributes, the rule of law, and economic improvement.

4.1. Towards a Theory of Rule of Law

For the first step, we are immediately hindered by the reality that there is, as of yet, no concrete economic theory of the determinants of the rule of law. A first attempt came from Hartwell (2018), who noted that previous econometric attempts at working towards the drivers of the rule of law tended to equate democracy with rule of law, and thus focused on determinants of democracy rather than the rule of law *per se*. Work such as Acemoğlu and Robinson (2005), Csordás and Ludwig (2011), and Moller and Skaaning (2014) focused on the role of economic development, political legitimacy, and general political trends globally in forging democracy. Unfortunately, many of the variables which have come out of this literature take a long and somewhat obsessively cultural view of democracy’s genesis, focusing on mostly time-invariant attributes such as dominant religion, country size, or colonial origin (while other time-invariant determinants tend to be very clustered around specific events, for example, in urbanisation).

However, while there is some overlap between the two, it is not one-to-one, meaning that a country can be a democracy but still have only a tenuous grasp on the rule of law (as voters discover they can support candidates against the rule of law). Moreover, the rule of law is a much more volatile metric than the overall presence of democracy, meaning it is more likely to be influenced by short- and medium-term drivers as well as longer-term cultural attributes. In order to separate out rule of law from democracy, we need to fashion a specification which focuses on the issues which drive rule of law specifically. Such a baseline model would be similar to Hartwell (2018) but would also allow for issues related to the availability of data for our two countries:

$$(1) RoL_{it} = \alpha + \beta POL_{it-1} + \gamma MACRO_{it-1} + \delta INTERNATIONAL_{it} + \theta \Delta MONEY_{it} + \varepsilon_i$$

The dependent variable, *Rule of Law (RoL)*, is the ‘rule of law’ indicator taken from the Varieties of Democracy (V-Dem) database (Coppedge et al., 2019). The measure itself attempts to answer the question, ‘to what extent are laws transparently, independently, predictably, impartially, and equally enforced, and to what extent do the actions of government officials comply with the law?’ (*Ibid.*: 232). In terms of practicality, it is a continuous index with values from 0 to 1 comprised of several sub-indices, including compliance with the highest court, judicial independence, transparency in laws, and other important facets of the rule of law. Given its focus on legal indicators exclusively, it makes an excellent baseline measure for measuring the extent of the rule of law in Germany and Poland.

Table 3. Summary statistics of variables.

Variable	Obs	Mean	Std. Dev.	Min	Max
Rule of law	374	0.701	0.279	0.121	0.994
Income-based capital per worker	155	1.832	1.589	0.109	5.614
Exports to GDP	262	0.127	0.139	0.013	0.626
Change in GDP	332	0.019	0.052	-0.509	0.182
CPI change	307.000	20.638	361.181	-1700.000	5140.60
Primary school enrolment per capita	284	1200.677	399.665	350.000	1799.00
Regulation of participation	320	1.931	13.162	0	5
Government crises	442	0.195	0.702	0	6
Political concentration	300	0.626	0.318	0.135	1
Polity 2	310	0.216	7.956	-10	10
EU Member	441	0.181	0.386	0	1
EU Accession	441	0.023	0.149	0	1
GATT/WTO Member	442	0.281	0.450	0	1
NATO Member	442	0.199	0.400	0	1
OECD Member	442	0.195	0.396	0	1

Extending Hartwell (2018), rule of law is presumed to be a function of four categories of independent variables, shown in *Equation 1*: political determinants, macroeconomic determinants, international organisations, and monetary regime-specific determinants. We delve into them deeper below, with summary statistics of all indicators shown in Table 3.

4.1.1 Political Determinants

The rule of law is in many ways dependent upon the current arrangement of political institutions (Hartwell and Urban, 2020), and thus it is natural to take into account these institutions in determining the level of the rule of law. Democracy and rule of law, as noted, are usually conflated due to the overlaps between the two, but there is no argument that democracy contributes to higher levels of the rule of law (De la Croix and Delavallade, 2011). We thus include the Polity V ‘polity2’

measure to capture if Poland or Germany were at that particular moment in time more or less democratic.

Another area of promise as a key determinant of executive constraints relates to political competition, as Besley et al. (2016) and Karakas (2016) show that leaders who have a lower probability of being replaced are less likely to introduce reforms that constrain the executive with predictable and transparent rules. To examine these effects, we utilise several indicators, each capturing different facets of the political landscape: first, the Polity V ‘Regulation of Participation’ measure is used, referring to the binding rules on when, whether, and how political preferences are expressed. This indicator can proxy for the number of veto points, which has been shown to be crucial in preserving the rule of law (Tsebelis, 1995) and is coded so that higher values correspond with more regulation of participation. Additionally, a variable for political concentration is also included, constructed from data from the Cross-National Time-Series (CNTS) Data Archive. This measure is formed as the ratio of seats of the largest party in parliament to the total seats available, resulting in a percentage between 0 and 1; higher levels of concentration are expected to result in lower levels of rule of law.

Krone (2014) offers an extensive list of political and social determinants of the rule of law, including (as noted above) ethnolinguistic fractionalisation (EF), which, while theoretically sound (countries which have high levels of EF tend to have lesser-quality institutions, as in Butkiewicz and Yanikkaya [2006]) suffers from data availability issues. Instead, we focus on the role political volatility may play in disrupting rule of law, with the rapid turnover of governments inducing uncertainty and an attempt to change the rules in one’s favour quickly before being turned out again. To capture this possibility, we include the CNTS measure of ‘major government crises’, which refers to situations with the potential to bring down the current government (but stops short of events such as overthrows or *coup d’états*).

4.1.2 *Macroeconomic determinants*

Political institutions can be either the generator and guarantor of the rule of law or its destructor, but they also may be aided by prevailing economic conditions and the fiscal stance of a government. For example, democracy and rule of law tend to be associated with economic growth, and thus including a suitable proxy for economic activity could isolate these effects (Skaaning, 2010). In the first instance, we include a measure for real GDP growth, taken from the Maddison Historical Statistics database and augmented by real GDP growth data for the past decade calculated from the World Bank. Our theory is that richer countries should be correlated with higher executive constraints and higher levels of rule of law.

Human capital is also a possible determinant of the rule of law, as a more educated populace is likely to demand transparency and predictability in their dealings with authority. Given the coincidence of political participation in both countries and the move towards universal education, we utilise the per capita enrolment rates for primary education as a proxy for human capital, on the theory that it was not until widespread schooling at the most basic levels (including literacy)

took hold that substantial political change could be effected. The data here comes also from the CNTS database, supplemented in recent years with data from the statistical bureaus of both Poland and Germany.

As the last indicator in this vector, trade can be a boon to democracy: Acemoğlu et al. (2005b) note that countries which engage in free trade create commercial interests which act as a counterbalance to political institutions, creating checks, balances, and rule of law. Their analysis only applies to non-absolutist countries, however, as countries which began with relatively more free political institutions saw their opening increase, while those who had monarchies which were absolutist saw little to no gain economically from trade – and the crown was able to control trade, making it less effective in forcing the adoption of the rule of law. Indeed, highly export-dependent countries may also create a stream of rents to attract politicians, which can then aggrandise power to themselves but remain reliant on trade to maintain power; as Rogowski (1987) noted, trade-dependent developing economies often result in the most punitive of executive power (he says ‘serfdom or slavery’) in order to maintain competitiveness. Thus, while trade can have a beneficial effect on a developed economy, for a country at earlier stages of development, exports, in particular, can be associated with less executive constraints. With Poland and Germany having undergone stages of absolutism in their history, it is less likely that trade was able to contribute to the rule of law.

4.1.3 *International organisations*

Membership in international organisations may have two effects on the rule of law, both salutary: first, setting ones sight on membership of an organisation may push along the development of the rule of law, providing a goal for a country (as with EU accession for Poland as part of its post-communist transition), and second, maintaining membership might require maintaining a level of rule of law (although the EU fails here as a specific example, again in the case of Poland). On the other hand, it is possible that only certain international organisations might facilitate rule of law (such as economic ones, see Chyzh [2017]) or, even more likely, international organisations instil inertia in a country, meaning that rule of law no longer moves forward and even may backslide as the costs of removing a member is prohibitive. To capture these possible external effects on rule of law, five organisation-specific dummies are utilised in the various specifications which follow:

- *EU Accession*: A dummy taking the value of 1 for each year that a country was in Accession status (i.e. had already signed the Treaty to accede) and 0 otherwise;
- *EU Membership*: A dummy taking the value of 1 for each year that Poland or Germany was a Member State of the EU, 0 otherwise;
- *GATT/WTO*: Coded as 1 for each year that the country was a member of either the General Agreement on Tariffs and Trade (GATT) or its successor, the World Trade Organization (WTO);

- *NATO*: A 1 is recorded for each year that the country was a member of the North Atlantic Treaty Organization (NATO), 0 otherwise; and
- *OECD*: A dummy taking the value of 1 for each year that the country was a member of the Organisation for Economic Cooperation and Development (OECD).

We anticipate that all of these may have a positive effect, although EU membership may be the most problematic, given Poland’s opposition to the EU in the post-2015 era.

4.1.4 Monetary regime-specific determinants

Finally, as shown in Hartwell (2018), monetary policy can also have a massive impact on the rule of law, as profligate monetary policy leads to an increase in non-market transactions and increases the power of the state (see also Koyama and Johnson, 2015). To capture these effects on rule of law, included in the regressions is the change in inflation rates (as measured by the consumer price index in each country); it is hoped that this variable will proxy for overall monetary policy stance in a country, albeit likely with a lag.

4.2 The Model

The estimator utilised for the baseline regressions (with the RoL variable) is a standard fixed-effects regression with the country (Poland or Germany) as the absorbing variable to capture time-invariant country-specific attributes. As the time series for each country runs for over a hundred years, the well-known biases in fixed-effects regressions are alleviated. Additionally, given that these econometric methods are being utilised in an environment where endogeneity may be an issue (given feedback among institutions and to/from macroeconomic variables), we also include a series of Granger causality tests to ascertain in which direction the Granger causality may run. The standard caveats apply for the interpretation of Granger causality – not strict causality but instead, as Granger himself preferred, an explanation of ‘precedence’ in sequential relationships – but more important for this examination, the Granger tests allow us to check for the strong exogeneity of the variables. Put more simply, the Granger causality test acts as a block exogeneity test, confirming if our variables are exogenous within this specification. This is crucial, as Plümpert and Troeger (2019) remind us, fixed-effect specifications are unbiased only under a strict exogeneity assumption (which Granger causality, being modelled through a vector autoregression [VAR], tests for).

As the ultimate question we are interested in solving is the effect of the rule of law on economic outcomes, for the second step, we utilise a modified version of the Two-Stage Residual Inclusion (2SRI) approach, which utilises residuals from our initial regression of determinants of rule of law as additional regressors in the subsequent, second-stage regression relating our economic outcome of interest with rule of law and other covariates (see Terza et al. [2008] for an excellent discussion of the benefits of 2SRI). For this examination, we take productive investment as the metric of economic success, given that every growth model has investment as either the core driver of the

economy (neoclassical growth models) or as a key driver of growth (endogenous growth models). For this model, however, we focus on productive investment, which is calculated (as in Van Leeuwen and Földvári [2013], where the base of this data comes from) as ‘income-based capital per worker’, or the capital accrued over the lifespan of a worker whose income increases over time. Thus, with this measure of investment as a dependent variable, we have a specification which can be shown as:

$$(2) Y_{it} = \overbrace{\vartheta RoL_{it-n}} + \mu MACRO_{it-1} + HumanCapital_{it} + \varepsilon_i$$

Where Y is our per capita capital measure, RoL is the residuals from the rule of law equation (1), and $MACRO$ is a vector of macroeconomic attributes drawn from the literature. Data is particularly difficult to come by for the 19th century in Germany or even the early 20th century in Poland on investment, and thus this specification will be parsimonious indeed. In particular, under the Macro vector, we will include real GDP growth, electricity production (to proxy for industrial manufacturing), growth of exports (to proxy for demand for serving markets beyond one’s own, as well as to alleviate any non-stationarity), and increases in the currency in circulation (to proxy for inflation).⁹ The *Human Capital* vector takes an additional measure, secondary school enrolment per capita, to proxy for the demand for the specific type of capital which we are measuring. It would be ideal in this situation to also have financial sector measures to capture the supply of capital, including interest rates or measures of financial depth; unfortunately, in order to utilise such data, we would have entailed substantial losses of observations, as information such as domestic credit is only available starting in the 1990s for Poland (and the 1970s for Germany). Additional work needs to be done in obtaining data of a longer time series to make this feasible.

As with the first specification, and in the absence of suitable instruments across the two countries, we eschew the use of dynamic panel models in favour of a fixed-effects specification. Given that we are utilising fitted values from the first stage, standard errors are calculated using bootstrap methods with 500 repetitions.

4.3 Results

The results of the various models for the first stage regression, delving into the determinants of rule of law, are shown in Table 4, with the results of the Granger causality tests shown in Table 5. Starting with the dependent variable of RoL (Table 4), we have six different models, one which includes each international organisation in a stepwise manner and one which has all of the international organisations brought together. As can be seen across the six models, countries which have more open political systems consistently have a higher level of rule of law, as higher regulation of participation results in lower results on the RoL index for both Poland and Germany. The incidence of government crises is also statistically significant, with each crisis resulting on average in a two-percent drop in the rule of law index; political concentration also correlates negatively with rule of law, although it is only marginally significant in half of the specifications

⁹ As change in the consumer price index (CPI) was utilised in constructing the fitted rule of law, we shift to a more immediate indicator of monetary policy, namely currency in circulation. Such a measure is likely to be far more responsive to demand for investment and also more immediate in terms of central bank monetary policy, and thus is superior in this specification.

(including the final one, including all international organisations). Finally, the statistical significance of democracy in determining rule of law is consistently large, with each increase in the Polity 2 indicator corresponding to an additional two percentage point increase in the rule of law index.

With regard to the macroeconomic variables, for the most part, the variables behave as anticipated, although exports are insignificant in most specifications and growth of GDP (rather than its level) is associated with lower levels of rule of law, while more urban countries also tend to see more constraints on the executive. Primary school enrolment was perhaps the strongest statistical correlate with rule of law (albeit with a small economic influence), subject to caveats noted below. Similarly, the monetary variable has a consistently negative effect on rule of law, albeit at a similarly small level of economic significance.

The final vector of determinants, international organisations, are shown across each specification: taken singly, only OECD and NATO membership appear to be correlated with rule of law, with both EU accession and EU membership not significant and GATT/WTO membership having almost zero effect. When all organisations are included, however (Column 6), OECD membership retains its significance but there is also an effect of being an EU accession state, likely capturing Poland’s experience in the 1990s and early 2000s. Both of these effects are significant at the 5% level, but the possible overlap between organisations should give some pause on the definitive nature of these relationships.

The Granger causality tests for these variables are shown in Table 5, confirming the exogeneity of the right-hand side variables; in particular, democracy and political concentration appear to Granger-cause rule of law, rather than the other way around. The only problematic variable that emerges from this examination is primary school enrolment per capita, which shows as weakly endogenous (being Granger-caused by rule of law at the 10% level). However, when this specific variable is eliminated from the regressions (not shown for reasons of space), the relationship among the other variables of note does not change, with the only shift being in the OECD regression, where the OECD variable appears to pick up the effects of high levels of education. Otherwise, the weak endogeneity of school enrolment does not appear to bias the results unduly.

Choosing the model to base our second stage on can be done in a number of ways, but we rely on tried and true methods and utilise commonly referenced information criteria. In particular, we examine which model in the first stage minimises the Akaike Information Criterion (AIC). Of the six models shown in Table 3, the AIC (as well as the Bayesian Information Criterion) is minimised for model 3, including the OECD dummy. Thus, we save the residuals from this regression and utilise them in the second-stage regression, shown in Table 6.

Table 4. First-stage results, rule of law as the dependent variable.

	1	2	3	4	5	6
<i>Political variables</i>						
Regulation of participation	-0.003	-0.003	-0.003	-0.003	-0.003	-0.003
	6.54***	6.01***	6.15***	5.30****	5.84***	5.32***
Government crises	-0.03	-0.02	-0.02	-0.03	-0.02	-0.02
	3.47***	3.45***	3.16***	3.58***	3.18***	2.82***

Political concentration	-0.02	-0.03	-0.03	-0.03	-0.04	-0.04
	1.22	1.53	1.76*	1.31	1.79*	1.82*
Polity 2	0.02	0.02	0.02	0.02	0.02	0.02
	8.80***	10.29***	9.64***	10.21***	10.17***	9.62***
<i>Macroeconomic variables</i>						
Change in exports/GDP	0.49	0.51	0.48	0.51	0.50	0.47
	1.54	1.68*	1.63	1.59	1.66*	1.50
Real GDP % change	-0.39	-0.37	-0.37	-0.38	-0.38	-0.38
	2.41**	2.35**	2.34**	2.27**	2.37**	2.38**
Primary school enrolment per capita	0.0001	0.0001	0.0001	0.00009	0.0001	0.0001
	2.75***	2.59***	3.10***	2.25**	2.82***	2.72***
<i>Money</i>						
CPI change	-0.00005	-0.00004	-0.00004	-0.00005	-0.00004	-0.00005
	2.13**	2.09**	2.32**	2.32**	2.11**	2.37**
<i>International Organisations</i>						
EU Accession	0.03					0.04
	1.51					2.18**
EU Member		0.02				0.01
		1.35				1.02
OECD Member			0.05			0.02
			2.90***			1.99**
GATT/WTO Member				0.006		0.004
				0.33		0.23
NATO Member					0.04	0.02
					2.02**	1.63
F stat	218.57	159.21	163.23	172.4	157.71	176.28
R-squared	0.807	0.807	0.81	0.806	0.808	0.811
N	217	217	217	217	217	217

Note: Absolute value of t-statistics under coefficients. *, **, *** denote significance at the 10%, 5%, and 1% level respectively. Panel fixed-effects regression with robust standard errors.

Table 5. Granger causality tests of all variables in Model 1 (RoL as the dependent variable).

Null Hypothesis:	Obs	F-Statistic	Prob.
Regulation of Competition does not Granger Cause Rule of Law	301	0.04671	0.9544
Rule of Law does not Granger Cause Regulation of Competition		0.02552	0.9748
GDP Growth does not Granger Cause Rule of Law	285	3.06207	0.0484**
Rule of Law does not Granger Cause GDP Growth		1.56722	0.2104
EU Membership does not Granger Cause Rule of Law	364	0.07609	0.9268
Rule of Law does not Granger Cause EU Membership		2.14073	0.1191
EU Accession does not Granger Cause Rule of Law	364	0.04244	0.9584
Rule of Law does not Granger Cause EU Accession		0.22669	0.7973
Exports to GDP does not Granger Cause Rule of Law	254	0.66665	0.5143
Rule of Law does not Granger Cause Exports to GDP		1.84821	0.1597

GATT/WTO membership does not Granger Cause Rule of Law	364	1.16651	0.3126
Rule of Law does not Granger Cause GATT/WTO Membership		0.81678	0.4427
Change in CPI does not Granger Cause Rule of Law	294	0.30099	0.7403
Rule of Law does not Granger Cause Change in CPI		0.05193	0.9494
Democracy (Polity 2) does not Granger Cause Rule of Law	295	136.077	0.000***
Rule of Law does not Granger Cause Democracy (Polity 2)		1.15484	0.3166
Political Concentration does not Granger Cause Rule of Law	285	17.1707	0.000***
Rule of Law does not Granger Cause Political Concentration		1.24023	0.2909
Primary School Enrolment does not Granger Cause Rule of Law	267	0.29451	0.7451
Rule of Law does not Granger Cause Primary School Enrolment		2.62654	0.0742*
NATO membership does not Granger Cause Rule of Law	364	0.13137	0.8769
Rule of Law does not Granger Cause NATO membership		2.30286	0.1014
Government Crises does not Granger Cause Rule of Law	364	1.91611	0.1487
Rule of Law does not Granger Cause Government Crises		0.92462	0.3976
OECD Membership does not Granger Cause Rule of Law	364	0.11189	0.8942
Rule of Law does not Granger Cause OECD Membership		2.23678	0.1083

Note: *, **, *** denote significance at the 10%, 5%, and 1% level respectively. Pairwise Granger causality tests performed with 2 lags, chosen from an unrestricted VAR and standard information criteria.

Table 6. Second-stage results, rule of law and investment.

	1	2	3
<i>Political variables</i>			
Rule of Law (-1)	0.92		
	3.02***		
Rule of Law (-2)		1.01	
		2.68***	
Rule of Law (-3)			0.89
			1.51
<i>Macroeconomic variables</i>			
Real GDP % change	-1.12	-1.21	-1.07
	1.30	1.15	1.01
Electricity production	0.00003	0.00004	0.00004
	11.87***	12.01***	12.49***
Change in currency	-0.15	-0.18	-0.17
	0.93	0.97	0.95
Growth of exports	12.49	12.25	11.89
	3.36***	3.17***	3.00***
Secondary school enrolment	0.002	0.002	0.002
	6.97***	6.63***	6.96***

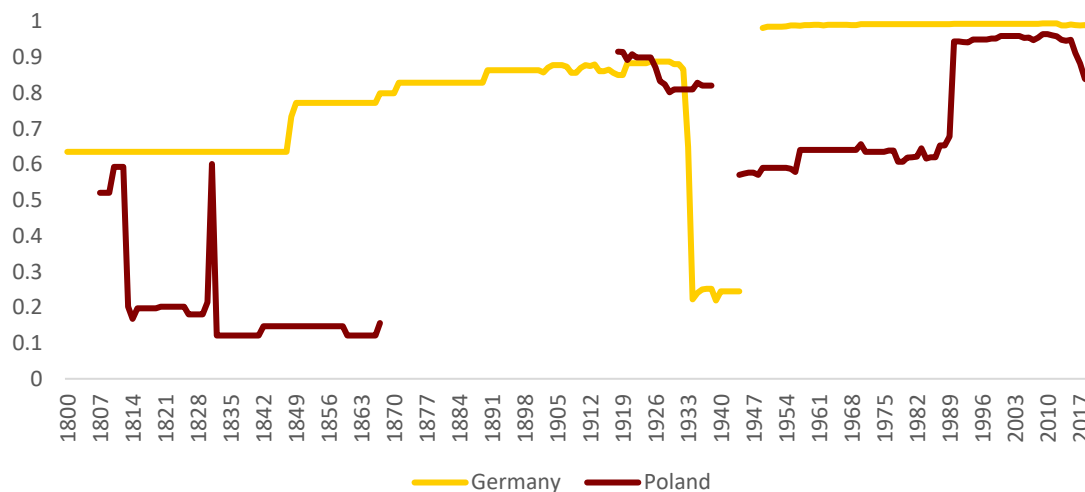
C	0.56	0.57	0.57
	7.57***	7.16***	7.06***
R-squared	0.95	0.95	0.95
n	124	121	118

Note: Absolute value of t-statistics under coefficients. *, **, *** denote significance at the 10%, 5%, and 1% level respectively. Panel fixed-effects regression with predicted rule of law from the first stage regression. Standard errors are done by bootstrapping, 500 replications for each model.

The results of the second stage, as noted, relate investment (as measured by income-based capital per worker) to a number of macroeconomic metrics in addition to our constructed rule of law measure. Shown in Table 6, the results of the fixed-effects model show the importance of the temporal element of the rule of law in determining investment, as both the first lag of the rule of law and the second lag have a significant effect on investment in the following periods. Given the scaled nature of the investment variable and the fitted rule of law variable, the effects here need some interpretation.

Considering the historical performance of both Poland and Germany (see Figure 9), the shift from the current level of rule of law in Poland to its historical maximum (i.e. 0.964 in 2009-2010) would result in an increase in its income-based capital per worker of an additional USD 3,216.40 (in 1990 constant USD). A further increase to the maximum level of rule of law experienced in Germany (i.e. 0.994 in 2012 Germany) would result in an additional USD 6,720.95 per worker. Similarly, if rule of law in Germany was to increase from its current level (i.e., 0.989 in 2018) to its 2012 maximum, the country would see a gain in capital of about USD 1,190 per worker. Conversely, if Poland and Germany were to suffer lower levels of rule of law, their workers would see a sizable decrease in capital. In the case of Poland, the shift to its 1986 level would lead to a loss in capital of USD 11,240.12 per worker. Similarly, German workers would see USD 7,911.78 less capital if the current level of rule of law in the country would decline to today’s performance of Poland.

Figure 9. Historical levels of rule of law in Poland and Germany, 1800-2019.



Source: Varieties of Democracy (V-Dem) dataset.

The effects on income-based capital per worker begin 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.

5. Conclusions

Our examination of the perceptions of the rule of law in Germany and Poland showed that ‘*certainty and stability of the law*’ and ‘*independence of the judiciary*’ were most often recognised as the most important components of the rule of law, independent of the country and business size. More importantly, however, we find a significant degree of criticism towards the state of the rule of law in both countries. The representatives of the small and big businesses in Germany, in particular, stand out with about one-third of them stating that ‘*none*’ of the listed rule of law elements is being fulfilled in the country. At the same time, it is apparent in both countries that official institutions and courts are often associated with high costs in terms of time and money. For small businesses, in particular, this tendency results in a higher inclination to resort to informal mediation and negotiation. The respondents also noted a need to improve the economic expertise and professional diligence of the judiciary.

One of the most important findings includes a high inclination to strictly abide by the law among Polish firms, especially big business representatives. This underlines the structural differences in the perception of the rule of law and its role in society. As confirmed by the interviews, Polish firms perceive the rule of law and its execution by the state in a restrictive if not punitive perspective, which contributes to insecurity. The responses of the German interviewees, however, showcase the supportive and transaction cost-reducing properties of the rule of law, hence a more positive reception and higher trust in the state.

Finally, using a novel estimation technique on a new database of Polish and German variables, we found that level of rule of law in each country can be predicted strongly by both political and macroeconomic conditions; using these results in a second-stage 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 of a worker and almost immediately, in line with the perceptions of businesses. 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.

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