

How Judicial Independence Encourages Entrepreneurship

Thinking of setting up a new business? Look beyond the usual concerns -- potential talent, tax benefits -- says IESE's Giovanni Valentini, there's another factor that could make or break your start-up: judicial independence in your chosen region.



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In 2013, 87 percent of Americans believed that powerful established companies held sway over court rulings. Such beliefs are not unfounded, say Raffaele Conti and IESE's [Giovanni Valentini](#), in a paper that examines the effects of judicial independence on U.S. states' business environments, published in *Management Science*.

When a new business tries to establish itself, it faces strong competition from incumbents in that state. And when the incumbents have connections to the judiciary system, barriers to entry are greatly increased.

Incumbents with influence over court proceedings may be less likely to comply with costly laws, such as pollution-reduction or product-safety measures, as they expect not to be sanctioned in court. Likewise, they feel more confident suing new entries, secure that the judge will rule in their favor. Ultimately, such environments dissuade new businesses from entering, limiting the founding of new companies and thus competition.

Such findings should send an important message to business leaders and policy makers. When considering where to locate a nascent business, entrepreneurs may wish to steer clear of states where incumbent firms exert more influence over the judiciary. On the other hand, large powerful firms could ostensibly strengthen their competitive position in those very same states. Policy makers should take note of how shifting to greater judicial independence in court systems may positively impact social welfare.

Keep Your Friends Close and Their Money Closer

"It's pretty hard in big-money races not to take care of your friends," admits Richard Neely, a retired chief justice of West Virginia Supreme Court of Appeals. In fact, established business groups account for nearly half of all donations to judicial campaigns. They also tend to be the largest contributors in state supreme court races. The second largest contributors are law firms, which are also traditionally tied to influential incumbent firms.

That money buys influence. As former Texas Supreme Court Justice Bob Gammage says, "People don't go pour money into campaigns because they want fair and impartial treatment. They pump money into campaigns because they want things to go their way."

This sentiment underscores what the authors set out to prove: that the manner of selecting judges -- whether through partisan or non-partisan elections on the one hand, or appointment on the other -- has a significant impact on upholding or limiting entry barriers for new businesses.

Ostensibly, laws and regulations apply to all businesses equally. However, whether or not an incumbent ends up winning a dispute with a former employee or incurring fines for breach of environmental regulation has more to do, in practice, with whether the state selects its judiciary through appointment or elections.

Elect or Appoint?

Collecting data from Longitudinal Business Database (LBD) for the period 1977-2011, the authors analyze many factors, including the litigiousness of particular states and industries, election versus appointment systems, and reform in the institutional environment shifting between one and another system.

Judges can be selected in a number of ways: through partisan elections with the support of a political party, by non-partisan elections, or by appointment by a bipartisan or independent commission. Judges need money to win elections, and parties back judges who they expect will protect their interests.

The study confirmed that when selection shifted from partisan to non-partisan elections, incumbents' ability to connect with and influence judges was reduced, while appointed judges were the most independent of all.

"Judges who must win partisan elections to gain and remain on the bench are those most likely to be influenced by pressure from business interest groups which, in fact, are the largest contributors to judicial campaigns. Parties naturally select candidates prone to protect the interests of their financial supporters and exclude them from the next race if they have not done so once on the bench," write Valentini and Conti.

As states moved away from partisan selection systems, the authors observed a reduction in barriers to entry for entrepreneurs, which resulted in a 14 percent increase in firm entry following the changes.

Independent judges are a clear plus for new business startups, but Conti and Valentini argue that they are a positive influence all around: money not spent influencing elections can be funneled into innovation by incumbent firms, while the economy as a whole is likely to become more competitive with fairer judicial representation.

Methodology, Very Briefly

The authors assess longitudinal variations in firms' ability to establish influential connections with judges and measure this against judicial selection systems in different states, with particular attention paid to those states whose judicial selection systems have changed over time. To measure new business entry, they analyze data from the Longitudinal Business Database (LBD) for the period 1977-2011, providing data on annual employment for almost

every private-sector U.S. establishment with a payroll.

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