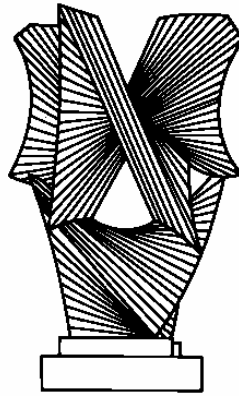


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Legal Institutions, Legal Origins, and Governance

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LEGAL INSTITUTIONS, LEGAL ORIGINS, AND GOVERNANCE

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Two legal families central to the discussion of the relationship between the rule of law and economic development are English common law and continental civil law—in particular, French civil law. An overview of these two families is warranted at the outset, if only to indicate what the concept of legal origins as a determinant of economic development entails.

Common Law

When William conquered England in 1066, he set in train a flow of events that eventually divided today's Western world between common law and civil law countries. At that time the Roman law system that had distinguished the Roman empire no longer held sway in western Europe, where law was local or at best regional. In the Eastern

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This working paper is best read as an introduction to the following previously posted working papers that discuss the relevance of the concept of legal origins to specific contemporary issues of economic development. (1) "Institutions, History, and Economic Development," U Chicago Law & Economics, Olin Working Paper No. 271 Available at SSRN: <http://ssrn.com/abstract=875026> (2) "The Judiciary and Economic Development," U Chicago Law & Economics, Olin Working Paper No. 287 Available at SSRN: <http://ssrn.com/abstract=892030> (3) "Land, Law and Economic Development," U Chicago Law & Economics, Olin Working Paper No. 272 Available at SSRN: <http://ssrn.com/abstract=876659> (4) "Equity Markets, the Corporation and Economic Development," U Chicago Law & Economics, Olin Working Paper No. 280 Available at SSRN: <http://ssrn.com/abstract=885196>; (5) "Credit Markets, Creditors' Rights and Economic Development," U Chicago Law & Economics, Olin Working Paper No. 281 Available at SSRN: <http://ssrn.com/abstract=885198> and (6) "China as a Test Case: Is the Rule of Law Essential for

empire, Roman law had been written down. But in the West the empire centered in Rome had already collapsed, and so the law was a series of customs, often unwritten, that varied from place to place.

William was crowned King of England in Westminster on Christmas Day 1066, and in the space of a few decades he and his successors and their officials had imposed Norman law, effectively displacing the existing Saxon law. The new English kings gradually established a bureaucracy complete with its own law and courts as well as a feudal system, based on Norman custom, for the holding of land.¹ Carrying out a promise to his key supporters, William seized the land of his Saxon opponents and divided it among his most important followers. Under the system he established in England, based on the continental feudal system, all land was ultimately held by those who actually worked the land in a chain of ownership leading back to the king.² In the early days English common law was largely a law of real property.³ Vestiges of the adaptation of the common law to its feudal heritage are found in common law countries to this day.

The new court system, centered in London, began using traveling royal judges to cover the country, thereby ensuring a unified common law for all of England that left only a minor role for local custom.⁴ The quick consolidation of law—a *common law* for all of England—was remarkable.⁵ A leading German comparative law text notes that France did not achieve any comparable common legal rules until the sixteenth century and Germany did not do so before the nineteenth century. Consequently, the text authors point out that “there never existed in England one of the essential motor powers behind the idea of codification, which even on the Continent rested on the practical need to unify the law as well as on the philosophy of the Enlightenment and the thinking of natural

Economic Growth?" U Chicago Law & Economics, Olin Working Paper No. 275 Available at SSRN: <http://ssrn.com/abstract=880125> .

1. Van Caenegem (1988, pp. 96–97).

2. Holdsworth (1956, pp. 17–32).

3. Holdsworth (1909, p. 204).

4. Von Mehren, Taylor, and Gordley (1977, pp. 12–13); Danziger and Gillingham (2003, p. 179). The Magna Carta required the royal courts to be held “in a certain place,” which could be Westminster (Hudson 1996, p. 224). Itinerant judges were nonetheless still sent out about the country, with important cases referred back to Westminster, thereby preserving the uniformity of the law (Dawson 1968, p. 6, n. 11).

5. Common law, in its core meaning, “applies throughout the realm” and is “territorial, applying to people because they are within the realm, in contrast with a system of ‘personal’ law, where a person’s nationality determines the type of law to which he or she is subject” (Hudson 1996, pp. 16–18).

lawyers.”⁶

Substantive English law, being nevertheless customary (albeit at root Norman custom), was not written down in a comprehensive way. Rather it was based on a series of writs (that is, writings) that were “forms of action,” one for each of the multitude of law proceedings that a plaintiff might wish to bring. But each writ presumed a particular wrong and a particular remedy, and it was up to the plaintiff to choose the right one on pain of having his remedy denied.⁷ These forms of action also lingered in English law until legal reform finally eliminated most of the last vestiges in the twentieth century.

The writs, though in writing, were not themselves statements of substantive law, and indeed the substantive law of England cannot be said to have been written down until the publication of the treatise known as Bracton.⁸ But even though its author or authors, knew some Roman law and were influenced by it, the book was explicitly based on court records, thereby recognizing a central principle of the common law that the law is at base what the judges say it is.⁹ New writs were regularly being invented to meet new felt needs, statutes were occasionally passed, and the king’s imposition of the feudal land system was in effect creating law, but common law techniques of finding and extending law had not yet developed.¹⁰

Later, common law judges began to elaborate on their rulings with written opinions. These opinions, which sought their justification in earlier cases, began to create the distinctive approach of the common law that characterizes it even today. This approach treats formerly decided cases as controlling precedent and requires judges to reason from case to case, distinguishing cases that could be said to be conflicting precedents, in order to find the controlling principles for new fact situations. It is this process of reasoning from case to case that is what most people today think of as the essence of the common law. Indeed, today the words common law are usually taken to mean judge-made law, rather than just unified law.

To be sure, the English parliament began to pass important statutes, but they were

6. Zweigert and Kötz (1992, p. 191).

7. Milsom (1969, pp. 22–32).

8. Some scholarship raises doubts about how much of the book Henry de Bracton actually wrote; see Tierney (1963).

9. Dawson (1968, p. 2).

regarded for some centuries, at least by some judges, as embellishments to the body of common law. Indeed, it was understood that statutes that contravened the common law rule were to be narrowly construed to avoid changing more than parliament had clearly intended. But in time it became customary that statutes had their own independent status, independent of the common law, and that statutes could even change common law rules. Nonetheless, judges used methods of interpreting ambiguities in statutes that echoed their methods in nonstatutory fields. In particular, judges relied on earlier decisions on the interpretation of a particular statute and generally considered these earlier rulings as binding on later courts. These characteristics, which are recognized even today by every beginning law student in common law countries as the common law method, can be contrasted with the civil law system that came to reign on the European continent.

Civil Law

The civil law system developed only slowly. In the early centuries of the common law, continental western Europe was still divided among the remnants of the Roman empire, with customary local law still governing issues involving land, contracts, torts, and the like. This remained true even with the rising importance of the Holy Roman Empire, which exercised little of the sovereign power that is normally associated with law, that power remaining in the various kingdoms and principalities within the Holy Roman Empire.

Nonetheless, over the centuries interest grew in continental western Europe in Roman law, leading to what was known as the “reception” of Roman law. This reception occurred predominantly in the German-speaking areas of Europe (which was the territory where the Holy Roman Empire of the German Peoples, as it was called, had its primary influence). But Roman law remains to this date an important influence on the law of, for example, Scotland.

The interest in Roman law led to a situation in which its concepts and procedures were overlaid on local traditions, being especially influential in areas such as contracts and torts. Law still varied from place to place, but students were increasingly taught

10. Hamowy (2003, p. 249) states that more than 470 writs had been created by the end of the reign of Henry II, but that the creation of new writs “had stopped altogether” by the end of the fourteenth century because by that time “common law judges opposed the issuance of writs that had no precedent.”

Roman law; hence, a sense of continuity and unity grew in what became known as the *jus commune*—a kind of common law at least for German-speaking parts of the continent (though quite different from the common law of England).¹¹ Curiously the Roman law texts were those collected in the *Corpus Juris Civilis* of the Eastern emperor Justinian I in the sixth century, after the collapse of the Western empire. The split between the Reformation and the Counter-Reformation states and the rise of nationalism led to national codifications, the first in Denmark in 1683. By the time Napoleon came to power in France in 1799, the codification movement was well advanced. Napoleon set out to promulgate the codification of all codifications, the French Civil Code, which went into effect in 1804.

Napoleon took a great interest in his code. He personally chaired many of the meetings of the consul committee reviewing the work of the drafters. No doubt Napoleon, the man of action, insisted on the practicality of the code and perhaps its clarity and simplicity.¹² He certainly was proud of his work; after the defeat at Waterloo, he proclaimed: “My true glory is not that I have won 40 battles; Waterloo will blow away the memory of those victories. What nothing can blow away, what will live eternally is my civil code.”¹³ That was perhaps why Napoleon wanted the code understandable by the common man. But it was drafted by professors and reflected their approach, rather than that of men of practical affairs, and certainly not that of merchants.¹⁴

Being the product of professors, the French Civil Code was abstract, reflecting the “abstract reasoning [that] had characterized the French approach to law and to life in general” during the Age of Reason. But its generality and its emphasis on understandability meant that one had often to take into account a variety of provisions to determine the legal rules covering a given set of facts. Its very generality gave it staying power, with no important changes made until 1880 (except for the repeal of divorce in 1816 after the Catholic monarchy was restored).¹⁵ And indeed even today the core provisions of Napoleon’s code remain in place despite increasingly numerous statutory

11. Rheinstein and Glendon (2003).

12. Zweigert and Kötz (1998, p. 83); Rabel (1949-1950a, pp. 107–8).

13. Quoted in Aucoin (2002).

14. See Aucoin (2002) and Merryman (1985, p. 56).

15. Rheinstein and Glendon (2003).

changes. No doubt it was its generality and clarity of language¹⁶—Napoleon’s army and French imperialism aside—that made the French Civil Code so influential in much of the nineteenth century world that is spoken of today as the developing world. Alan Watson has made the point that when countries choose the law of another country, the prestige of the legal system under consideration counts.¹⁷ No doubt about it, the French Civil Code was prestigious.

The French Civil Code contrasts nicely with the German Civil Code, which came almost a century later in 1900. Why was the German Civil Code so different? Some would say that the explanation lies in the difference in the style of thinking in the two countries, but history played a big role. It was in the German-speaking territories that the greatest “reception” of Roman law occurred. This is not to say that Roman law did not have a major influence on the French Civil Code, but the influence in France was for a different reason than its influence in Germany. One of the reasons Napoleon wanted a code was to unify the law of southern and northern France. Whereas the law in the north was customary law, the law in the south, derived from Roman law, was already written down (*droit écrit*).¹⁸

In contrast, a major form of German legal scholarship in the decades between the adoption of the two codes was devoted to the study of Roman law. Out of that strain of scholarship came a group of law scholars, the Pandectists, who devoted themselves over some decades to the elaboration of a German civil code.¹⁹ The style of that code is quite different from the French code. In contrast to the French Civil Code, which was written to be understandable by a moderately literate Frenchman, no one would expect the ordinary German to read the German code, much less understand it. Concepts are carefully defined in the German code, and any given legal term is used in the same way throughout the entire code.²⁰

16. Rabel (1949–50a, p. 109).

17. Watson (1977, pp. 98–99).

18. Zweigert and Kötz (1998, pp. 77–82) and Jolowicz (1982, p. 89)

19. Dawson (1968, pp. 450–61).

20. Ernst Rabel, the foremost comparative law scholar of his generation, held a set of lectures in his new home in the United States after leaving Germany, in which he was unsparing in his comparison of the French and German civil codes. On the question of style, he described the French Civil Code: “The language, crystalline and beautiful, has not had its equal before or afterward; there have been celebrated French poets who like to read some chapters for encouragement in prose” (Rabel 1949–50a, p. 109). For the German code, he reserved pejorative descriptions: “ponderous,” “overaccurate pedantry,” “innumerable wheels and gadgets,” and “ugly” (Rabel 1949–50b, pp. 270, 275).

For the purposes of considering contemporary economic development issues in this book, the bulk of our attention on the influence of civil law can be focused largely on the French Civil Code. We can do so for quite pragmatic reasons. Putting aside the transition countries of Eastern Europe and the former Soviet Union, few developing countries are influenced by German law, and those few—such as South Korea and Taiwan—are already high-income countries. (Of course, South Korea and Taiwan had much lower incomes just a few decades ago and thus their legal development would merit investigation.) Scandinavian countries had a few colonies, but today no developing country is regarded as being part of the Scandinavian legal family. The dominant influence in private law (as opposed to, say, constitutional law) in the great bulk of today’s less developed world came from either English common law or French civil law.²¹

Legal Origins as a Theory of Development

The essence of the legal origins approach, as applied to economic development, is to use regressions to show that the origin—say, English common law or French civil law—of a particular country’s law is associated with that country’s rate of economic growth. An alternative approach to the relevance of legal institutions to a country’s economic growth looks at the role of “governance.” It includes an important role for the rule of law in overall governance. The two approaches complement each other, and I take up the governance approach below as a useful contrast to the legal origins approach.

Most of the legal origins work began in finance. An early, and perhaps still the most influential, legal origins article is “Law and Finance,” published in 1998 by four economists—Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny—whose work has become so well known that they are universally cited as LLSV.²² Even though the four authors did not set out to apply their work to economic development policies, it has often been interpreted as throwing important light on economic development outcomes.

Building on earlier work showing that stronger financial sectors led to more rapid

21. The statement in the text ignores China, which was never a colony and never felt the need to adopt Western law, as did Japan in the late nineteenth century, at least in part.

22. La Porta and others (1998).

economic growth in the economy as a whole, LLSV used a sample of forty-nine countries to show a statistical relationship between the character of legal rules concerning the financial sector and the origin of a country's laws.²³ The most interesting part of this body of research was its finding that countries whose law derived from the common law had stronger legal systems for financial development and hence faster economic growth than civil law countries. An obvious conclusion was that the common law provided a superior legal base for a country (and this was true whether new countries received their law through conquest or colonization).

Equally striking was the finding that French law was the worst among civil law systems for the development of the financial sector and that German and Scandinavian legal systems were situated between common law and French legal systems. And in a related 1997 article, "Legal Determinants of External Finance," (which was based on the same research involving the same countries), LLSV showed that common law origin countries had grown faster than French origin countries—4.30 percent per capita versus 3.18 percent.²⁴

In their "Law and Finance" article, La Porta and his colleagues looked at "enforcement variables" such as the "efficiency of legal system," "rule of law," and so forth. But mostly they looked at substantive legal provisions, particularly rules concerning the protection of shareholders and creditors, finding that the common law countries offered the most protections, followed by the German and Scandinavian law countries, with French law countries trailing. The main body of their work was in the financial sector, raising perhaps a systemic issue about the policy implications of the legal origin work (important as the financial sector undeniably is to growth, particularly in the middle-income countries). Indeed, an oddity of their work on the financial sector was that it concerned primarily the protection of minority shareholders under corporate law and the protection of creditors in bankruptcy law. Yet both corporate and bankruptcy law are legal areas where most countries—common law and civil law countries alike—rely on statutory law, much of it quite recent, rather than judge-made common law or

23. Levine (2004) reviews the considerable research, dating back to the early 1990s, showing a causal link running from financial development to economic growth. See also Beck, Demirgüç-Kunt, and Levine (2004), who find that "financial development reduces income inequality by disproportionately boosting the incomes of the poor."

24. La Porta and others (1997, p. 1138, table II).

nineteenth century civil law codes.²⁵ This circumstance raises serious questions about the leading interpretation of their results to the effect that the common law method of judge-made laws is superior to legislative enactments in building stronger financial sectors and hence in enhancing economic growth.²⁶

In 2000 LLSV followed up with another article, which referred to their earlier work and to new work by other economists. Summarizing those works, they said that “an exogenous component of financial market development, obtained by using legal origin as an instrument, predicts economic growth.”²⁷ They therefore reached the policy conclusion that “the evidence on the importance of the historically determined legal origin in shaping investor rights ... suggests at least tentatively that many rules need to be changed simultaneously to bring a country with poor investor protection up to best practice.”²⁸

A different approach is to be found in an article by Mahoney, who rejected the notion that the prime influence of legal origin on economic growth was through financial development. He favored an explanation concerning the greater role for the state relative to the individual citizen in French law. Mahoney explicitly tested the relation of legal origin to economic growth, finding that common law countries grow at least 0.7 percent faster than civil law countries.²⁹

A short narrative version of the legal origins theory, which generates the dominant view of the superiority of the common law, is that France under Napoleon adopted elegant civil and commercial codes at the beginning of the nineteenth century, which became the base for the legal systems of much of southern Europe (Napoleon made sure of that through his armies) and later for French Africa and, derivatively through Spain and Portugal, for Latin America. Thus, if those African and Latin American countries grow less rapidly—as they have been doing recently, the regressions suggest rather strongly that it must have something to do with the origin of their legal systems. Mahoney attacked the issue of African and Latin American countries’ poor showing by including dummy variables for both sub-Saharan Africa and Latin America

25. In fact, large bodies of American common law have been replaced by statutes (Cross 2005 at n. 116–119).

26. Pagano and Volpin (2005, p. 1006)

27. La Porta and others (2000, p. 16).

28. La Porta and others (2000, p. 20); see also, La Porta and others (2002, pp. 1148–49).

and found that common law countries still grew faster but to a lesser extent and with lower statistical significance, suggesting that the LLSV results on legal origin are a less important predictor of economic growth than might otherwise have been thought.³⁰

Nearly a century later, in 1900, Germany adopted its own distinctive civil and commercial codes. Those codes became the base not just for German-speaking Austria and multilingual Switzerland but also the point of origin for the codes in Japan, South Korea, and Taiwan; these countries have been growing more rapidly than most of the rest of the developing world, thereby, according to a common intuition, supporting the view that German law is superior to French law for developing countries. (We can ignore the Scandinavian countries, since their few colonies are not developing countries today, and so the Scandinavians influenced only each other.) Meanwhile, the common law countries, such as the United States, Canada, and Australia have flourished, even if the overall results in terms of growth are weighed down by the Kenyas and Zimbabwes of the world—common law countries in terms of “legal origin.” One can thus see a certain intuitive plausibility that noneconomists quickly came to attach to the LLSV regression results.

All of this work on legal origins was based on cross-country regressions with only the most general comparative law analysis. Nonetheless, the legal origins literature set forth legal and institutional hypotheses that, coupled with economic studies on the contribution of financial development to economic growth, have been taken by many scholars and policymakers as the reason why common law countries grow faster than civil law countries. These hypotheses, including the supposedly uncontroversial classification of countries by legal origin, are examined at length in this book. The choice of indicators of what substantive law provisions constitute superior protection of shareholders and creditors are examined in Part III on the financial Sector. As shown in later discussions, the LLSV choice of indicators and their interpretation of those indicators is a weak element of their legal origin work.

In the many economic articles, by LLSV and others, there is a broad recognition that the enforcement of contracts and the protection of property is vital to financial development. Although finance is an ideal sector to demonstrate this point, especially

29. Mahoney (2001, p. 516, table 2).

30. Mahoney (2001, p. 517, table 3).

because the profusion of data lends itself to econometric methods of proof, it can hardly be doubted that the same principle should apply outside the financial area. After all, economies are more than finance, even if the concept of finance is interpreted broadly to include corporate governance; in the real economy, as opposed to the financial, the same principles should apply. One of the many legal areas outside financial markets where legal origin should therefore be important, but is much less studied in cross-country regressions, is the real estate sector. It is examined in a chapter on land in Part II . This is a particularly important sector in many developing countries where more than half the population works in the agricultural sector and where the growth of megacities has made security of urban real estate, and underlying concepts of title and registry, particularly important.

Although the legal origins literature is focused on financial markets, and especially on substantive legal rules concerning shareholder and creditor protection, LLSV do recognize, as noted above, that enforcement of the rules, and hence the role of the judiciary, is important. Their approach to using legal origin to study these issues is also discussed in Part II in a chapter on the judiciary. Obviously the judiciary has a role transcending the financial sector.

Before reaching these nonfinancial applications of the legal origins analysis, quite a number of issues about the entire legal origins approach need to be fleshed out. The rest of this chapter is devoted to those questions, and the following chapters ask what history can teach about the role of legal institutions in the development of economies.

Preliminary Questions

Although my focus on the legal origins literature is not on the authors' regressions as such, I nevertheless raise some preliminary questions about the data on which the regressions are based. These questions are offered as a basis for raising more fundamental questions about the legal and policy implications for economic development and to suggest several lines of inquiry for a more qualitative analysis.

What is it about law that makes its origin important? Why should law play an important role in economic development, and therefore what differences in legal systems make a difference in rates of economic development? Many alternative qualitative questions spring quickly to mind, and in fact the economists who have conducted these

studies have not been shy about suggesting answers to these and similar questions even though their answers do not flow, strictly speaking, from their econometric work. Rather their answers are derived from their understanding of legal institutions, for which they usually cite a few legal surveys, particularly in the field of comparative law.

Whatever the methodology and the results of cross-country statistical studies, a lawyer is left with a preliminary question: Why should a common law system be superior to a civil law system. American legal scholars have not been shy about offering suggestions as to the best answer, and the American legal literature is impressively large on the subject. Mostly the proffered explanations have to do with the supposed advantages of reasoning from case to case, but there is little agreement among the authors of the essays. The reasoning, much of which suggests analogies of the case law system to Darwinian natural selection with good precedents replacing bad precedents, largely ignores two crucial points: First, most law today, especially that involving the economy, is statutory in both common law and civil law countries. And second, civil law countries have extensive bodies of case law.³¹

Cross, in a thorough review of the arguments, came to the conclusion that whatever differences there may once have been between common law and civil law systems, “it would be surprising to see a remarkable effect from the nation’s choice of common or civil law [and], surely, the convergence between the approaches would have at least muted the effect of the distinct systems.”³² Cross does find a possible difference based on a greater independence of the judiciary in common law systems. In this respect, Cross follows in the footsteps of Mahoney, whose work was briefly reviewed earlier in this chapter. Cross, however, is relying on a perception of judicial independence based on a World Economic Forum survey. His conclusion underscores again the greater importance of public law than private law in investigating legal origins.

The policy “take away” for developing countries from the Cross review is thus the need to focus on how a judiciary can be made more independent constitutionally and how judges can be enabled and encouraged to behave more independently.³³

³¹ Cross (2005).

³² Cross (2005 at notes 125-126).

³³ See “The Judiciary and Economic Development,” U Chicago Law & Economics, Olin Working Paper No. 287. Available at SSRN: <http://ssrn.com/abstract=892030>.

Another preliminary question is what the policy implications of the legal origins research are for economic development? If legal origin does in fact make a decisive difference in economic growth, what policies should policymakers in the developed country foreign aid agencies, in the international financial institutions and, above all, in third world governments adopt?

No one would suggest, to take an extreme example, that Latin American countries should simply adopt U.S. or English law and legal institutions from one day to the next. Indeed, even if such adoption were possible, it would take perhaps two generations before one could reasonably expect Latin American law and legal institutions to function like those in the United States or England. Even assuming that culture, social norms, and history have little role in the functioning of a legal system, a time lag would occur for the simple fact that a legal system works through a legal profession and a judiciary. Even if law faculties could be changed overnight to meet their new function, it would still take two generations before the leaders of the profession and the senior judges trained in the old system would be replaced by those trained in a common law system.

This realistic view of how law evolves does not mean that no changes are possible in a shorter run. Quite the contrary, much of the burden of my argument is that the many changes of the past several decades, both in market economy developing countries and in communist countries transitioning to a market economy, offer quite a good deal of experience in what works and what does not work. Moreover, these experiences do not need to be discussed in the abstract but can be examined in specific fields of law. For example, following the popular “slogonized” definition of the rule of law, one can look at the enforcement of contracts and the protection of property rights. One can look at specific areas where law affects the economy in a powerful way—land law, corporate law, bankruptcy law, and the like. And especially one can look at the role of law and legal institutions in financial markets, where the legal origins research focuses.

Any inquiry into policy implications has to go beyond regression results to the underlying mechanisms through which the law, the judiciary, and the legal profession influence the economy. Therefore, it is worth deepening the understanding of the possible role of legal origins in economic development. One way of doing so is to look at some of the factual anomalies in the studies and then to look for alternative explanations of differential rates of economic growth. But the reader should be aware that the purpose of

such an examination is not to reach some final conclusion as to the validity of legal origins theory but rather to use the examination as an entry point to a deeper consideration of the relationship between legal institutions and economic development.

Some Anomalies

The legal origins literature does not purport to be a study of economic development. It treats developed countries and developing countries alike and simply asks whether certain origins are better for certain purposes. In the key legal origins article, all forty-nine countries, developed or developing, are treated as equal, including the origin countries themselves, and no consideration is given to the size of the population or to the geographical region.³⁴ The central inquiry is to determine which legal families have the best substantive law for financial development, using substantive legal criteria determined by the authors.

On the few occasions when the authors attempt to determine whether the countries differ based on their per capita income levels, they come to some surprising results. As is spelled out in a later chapter, where the legal origins authors choose to categorize countries by their stage of development, the startling result is that the poorest one-third of countries have better substantive law than the richest one-third by the authors' own definition of the crucial substantive law rules!³⁵

Even among developed countries there are some oddities if one were to interpret the legal origins literature as directly relevant to economic growth. One might suppose on a casual reading that Britain, the source of the common law, has a better growth story to tell than France, which provided what the legal origins literature says is the worst legal origin. Nothing could be further from the truth. Taking the period from 1820 to 1998 as a whole, France outpaced Britain in the rate of per capita growth. A study by Maddison showed, moreover, that this was true from 1820 to 1913 (France had an annual average compound growth rate of 1.13 percent versus 0.96 for Britain), 1913 to 1950 (1.12 percent to 0.80 percent), and 1950 to 1998 (2.77 percent to 2.10 percent).³⁶ An appendix

34. La Porta and others (1998).

35. See discussion in Kenneth W. Dam, *Credit Markets, Creditors' Rights and Economic Development*, U Chicago Law & Economics, Olin Working Paper No. 281, available at SSRN: <http://ssrn.com/abstract=885198>.

36. Maddison (2001, p. 90, table 2-22a).

to Maddison's study, however, tells a more nuanced tale: breaking the time periods differently, the data shows that from 1820 to 1870 Britain outpaced France, as it did again from 1973 to 1998.³⁷ Still, for the entire period, France came out ahead.

In fact, from 1870 to 1976 Britain grew only fourfold whereas an arithmetical average of sixteen "advanced countries" grew sixfold, stimulating a leading British financial journalist, Samuel Brittan, to note that the "lag in British growth rates goes back at least a century."³⁸ Of course, Brittan wrote in 1978, before the privatization and deregulation that began in the Thatcher period and was in place thereafter. One therefore might say that the reason Britain outperformed France in more recent years has more to do with those microeconomic policy initiatives than with any superiority of common law over French law. In 1979, the year Margaret Thatcher became prime minister, French per capita income was \$14,970, compared with \$13,164 in the United Kingdom (a difference of \$1,806, or about 12 percent). In 2001 France was still ahead at \$21,092, compared with the United Kingdom at \$20,127 (a difference reduced to \$965 and less than 5 percent).³⁹

Consider, moreover, that throughout the nineteenth century French per capita income had been much lower than British per capita income, but despite two world wars fought on French territory, by the late 1960s French per capita income was able to pull ahead.⁴⁰ Hence, if one looks at developments from the beginning of modern financial development in the mid-nineteenth century to the beginnings of Thatcherite reform, one would conclude that the French legal system is superior to the British legal system for economic growth.

Perhaps with this economic record in mind, Merryman wrote an astute article in 1996, before the legal origin literature appeared, advancing the thesis that French law may be fine for France but is unsatisfactory for former French colonies.⁴¹ His reasoning reflects the importance of separating substantive rules of law from questions of enforcement, as well as of taking a realistic view of how judicial enforcement actually

37. Maddison (2001, p. 186, appendix table A1-d).

38. Brittan (1978, p. 246).

39. Maddison (2001, pp. 276–77, table C1-c).

40. Maddison (2002, pp. 62–65, table 1c). For a detailed argument that any superiority of financial development in common law countries over civil law countries is to be explained by twentieth century economic destruction and national occupations rather than legal origins, see Roe (2006).

41. Merryman (1996).

operates. Noting that the most important aspect of the Napoleonic legal revolution was to limit the power of judges and particularly their ability to “make law,” he pointed out that limiting the role of judges to make law by interpreting ambiguities in statutes was quickly perceived to be impracticable and that a number of fields of French law are in fact principally judge made. As Jolowicz explains, in France:

Development of law through judicial decisions, though not altogether new, came to be openly recognised as a fact by all except, of course, the Judges themselves when they came to give the formal reasons for their decisions. No one denies today, either for France or for Germany, that great areas of the law are in truth the products of the courts; if any common lawyer still supposes that for the civil law systems case law does not exist, a glance at any Continental textbook with its wealth of case citations will quickly convince him of his error.⁴²

Merryman, in his critique, went on to contrast French law in France with French law in former colonies, arguing that when other countries adopted French law, they were not so practical:

The attempt to depict the judicial function as something narrow, mechanical and uncreative and to portray judges as clerks ... has had a self-fulfilling effect. Judges are at the bottom of the scale of prestige among the legal professions in France and in the many nations that adopted the French Revolutionary reforms, and the best people in those nations accordingly seek other legal careers. One result has been to cripple the judicial systems in a number of developing countries. In France, where everyone knows how to do what needs to be done behind the separation of powers façade, misrepresentation of the judicial function does not have severe consequences. But when the French exported their system they did not include the information that it really does not work that way, and they failed to include a blueprint of how it actually does work. That has created, and continues to create, problems in nations with limited legal infrastructures and fragile legal systems....⁴³ The point that enforcement

42. Jolowicz (1982, p. 93).

43. Merryman (1996, p. 116).

is more important than the substantive rules of law is one that recurs throughout this book, but for now the important point is that the legal origins literature indirectly maligns the French legal system even as it actually operates in France, and it tends to lead the casual reader of that literature to erroneous conclusions about the rule-of-law challenges facing the developing world.

Factual Anomalies

Once one goes into the details of the legal origins literature, some important factual anomalies also emerge. Two stand out. The first is that, at least in the early studies, the focus was heavily on private law—especially corporate and commercial law—rather than what might seem far more important to economic growth, namely, public law—that is, constitutional law bearing on the powers of the government, administrative law bearing on the powers of the bureaucracy, regulatory law bearing on the way in which the government regulates business, and the like.⁴⁴ As Schlesinger and his comparative law colleagues stated: “The economic and social changes which have taken place during the [twentieth] century ... mostly are reflected in the growth of such public law fields as administrative law, labor law, social security, taxation, nationalization, and public corporations. Many of these changes, therefore, are only faintly reflected on the face of the modern private law codes.”⁴⁵

It is important to understand that the French and German civil codes dealt with private law, as opposed to public law. Indeed, those two civil codes are primarily concerned with what are referred to in common law circles as contracts, torts, property, family law, and inheritance. Because its focus is on the financial sector, much of the legal origins literature has to do with corporate and commercial law, which is found largely in the French and German commercial codes. Neither the civil nor the commercial codes have much at all to do, especially today, with the relationship between the state and the

44. See, however, Kenneth W. Dam, *The Judiciary and Economic Development*, U. Chicago Law & Economics, Olin Working Paper No. 287, available at SSRN: <http://ssrn.com/abstract=892030>, for an analysis of an important article on judicial checks and balances; three of four authors were LLSV authors. La Porta, Raphael, Florencio López-de-Silanes, Cristian Pop-Eleches, and Andrew Shleifer (2004). More recently, the same three LLSV authors have turned their attention to securities regulation (La Porta, Lopez-de-Silanes and Shleifer 2006).

45. Schlesinger and others (1998).

individual citizen or enterprise. This is not to say that the details of corporate and commercial law are not important to economic growth; on the contrary, their importance is stressed in later chapters. But they are arguably less important to the concept of the rule of law, which in the economic sphere has much to do with the protection of property rights and the enforcement of contracts. Lack of enforcement of property rights in the developing world has more to do with public law than with private law. The biggest threats to property rights are the state itself and favoritism toward friends of the government. Difficulties in enforcing contracts do not normally arise from weaknesses in substantive law.

The Coding Question: The Latin American Example

A second anomaly is that in the process of applying regression analysis—the coding of particular third world countries as, say, French law countries—is quite an oversimplification.⁴⁶ To see this point most easily, one has only to consider Latin America, which represents more than 40 percent of the French civil law countries in the LLSV legal origins database.⁴⁷

First of all, Spain did not adopt its civil code until 1889, and until that time its private law was based on Roman law (although it did adopt a commercial code applicable to merchants' transactions in 1829). Hence, the law of property and contracts in Spanish- and Portuguese-speaking Latin America (not only during the colonial period but also during the years when the newly independent countries were establishing their legal systems) was based on Roman law—which is exactly what the French civil code system was intended to replace.⁴⁸ Even after 1889 the Spanish Civil Code followed the French Civil Code only in the law of obligations (roughly, contracts and torts). In other words, well after the legal die had been cast in most of Latin America, the Spanish Civil Code codified indigenous Spanish rules, especially in family law and inheritance. While those legal areas are arguably not crucial for commercial growth, those countries maintained the family law and inheritance rules that kept together the traditional great families with

46. The authors recognized that their reliance on a standard legal source led to difficulties in some countries, but apparently the requirements of regression studies—necessitating that each country be assigned one and only one legal origin—required the oversimplification. See La Porta and others (1997, p. 1138, table II).

47. For similar points about other regions of the world, see Siems (2006).

their vast estates and hence may not have been the best model for economic development in Latin America.⁴⁹

Thus the Latin American codes in force today, while indisputably based on a civil law rather than a common law approach, certainly did not follow the French Civil Code down the line. As the president of the Spanish Supreme Court, seeing as many Spanish and Portuguese elements as French elements in Latin American law, observed:

The influences that have acted on the law of the countries of Iberic origin have been many and varied, but they have not been able to erase its own and original characteristics nor blot out the Spanish origin. It is a mistake to include in the French group, as many times has been done, such Iberic-American legislations as Chile, Peru, Argentine, Colombia, Brazil, Venezuela and Mexico, just because in these civil codes of these, and the other American countries, there can be seen directives and norms that come from the French Civil Code, because they are also influenced by the Spanish, the Portuguese, and the Italian laws, and even by the German and Swiss Codes.⁵⁰

Take Mexico as an example: According to its code commission, the 1871 Mexican Civil Code was based on, “principles of Roman law, our own [Mexican] complicated legislation, the codes of France, Sardinia, Austria, [and] Portugal ... in addition to past drafts completed in Mexico and Spain.”⁵¹ In the area of commercial codes, one finds that until 1884 Mexican bankruptcy law was based on the 1737 Ordenanzas of Bilbao. From 1890 to 1943 the source of Mexican bankruptcy law was the 1829 Spanish commercial code. And even the 1943 Mexican bankruptcy law was drafted by a Spanish lawyer; it was based on Spanish law and on a 1665 Spanish book, although for the first time “Italian and French influences” could be found in Mexican bankruptcy law.⁵² Yet Mexico is unambiguously coded as being of French legal origin with respect to bankruptcy law.

As for Brazil, Zweigert and Kötz explain: “In addition to the Code civil [of

48. Berkowitz, Pistor, and Richard (2003b, p. 180).

49. Mirow (2004, pp. 150–54).

50. Castan Tobeñas (1988, pp. 105, 140).

51. Quoted in Merryman, Clark, and Haley (1994, p. 467).

52. American Law Institute (2003, pp. 21–23).

France] it [Brazil] was able to draw on the Portuguese and Italian codes, as well as those of Germany and Switzerland. The structure of the Code, especially its ‘General Part,’ is largely traceable to German influence.”⁵³

The case of the Chilean civil code of 1857 is perhaps the most instructive, because it was subsequently adopted in Colombia, Ecuador, El Salvador, Ecuador, Honduras, Nicaragua, and Venezuela and was the main source for the civil codes of Guatemala, Mexico, Paraguay, and Uruguay. The draftsman of the Chilean civil code, Andrés Bello, was born in Caracas in 1781 and lived in England from 1810 to 1829, when among other things he worked on the papers of Jeremy Bentham. After moving to Chile in 1829, he taught Roman law and became a citizen and a senator in Chile. His code “successfully wove together modern European codes, particularly the French Civil Code of 1804 (the *Code Napoleon*), the medieval Spanish law of the *Siete Partidas*, and Roman law.... Numerous factors played into Bello’s construction of the code, including the works of von Savigny [German], the French commentators on the civil law and the French civil code, the writings of Jeremy Bentham, and various European codes of civil law.”⁵⁴

The story of the civil code of Argentina is essentially similar, except that the draftsman’s name was Ocampo rather than Bello. Ocampo was an Argentine, who had studied law in Spain and later taught law in Chile. In addition to colonial Spanish law and the *Ordenanzas de Bilbao*, he based the Argentine commercial code on “the commercial codes of France, Spain, Portugal, Holland, Brazil, and Wurtemberg, as well as many treatises on commercial law.”⁵⁵

However one characterizes the origins of Latin American private law, it is certainly true that in recent decades North American influence on private law has grown. The Anglo-Saxon device of the trust has taken deep root in Latin America.⁵⁶ Usually used for family financial matters, the trust also has found abundant use in secured lending and corporate finance in the United States and potentially therefore is of considerable relevance, particularly in the financial sector, for those many Latin American countries

53. Zweigert and Kötz (1998, p. 118).

54. Mirow (2004, pp. 137–38). See also Valencia (1958).

55. Mirow (2004, pp. 158–59).

56. Schlesinger and others (1998, p. 291); Eder (1950); Kozolchyuk (1979); Clagett (1952).

that have imported this legal device.⁵⁷ As Mattei has commented:

It is no wonder therefore that, despite the very peculiar institutional background in which the [English and American] law of trust has developed, as soon as its potential became clear to the economic and legal community, this institution became very fashionable.... Many South American civilian systems have adopted the institution of trust by legislation [The] trust has obtained an easy and well-deserved victory in the competition in the market of legal ideas.⁵⁸

In the area of public regulation of corporate transactions, U.S. notions of securities regulation have been important influences on the financial sector, starting with Mexico's legislation in 1953 based on the U.S. securities legislation.⁵⁹ But even much earlier than this, Latin American had been heavily influenced by U.S. and British law and practice, whatever the underlying commercial codes might provide.⁶⁰

Sometimes these two anomalies—the emphasis on private law (civil and commercial) and the multiple origins of particular third world countries' law—interact. As we have seen, the coding of the Law and Finance studies somewhat misrepresents the private law legal heritage in some important countries, and it certainly is based on a misconception when it comes to public law.

Legal Origins and Public Law

In Latin America there are two major public law influences, one from the United States and one from the Iberian peninsula. Indeed, certain characteristics of Latin American public law are special to the area, perhaps best explained as products of the history of the region.

The first and perhaps predominant influence on Latin American constitutions is the U.S. Constitution, which was certainly more important than the successive French constitutions. As Schlesinger and his colleagues noted: “Yet, common law ideas (especially the elements of common law entrenched in the U.S. Constitution) have had a considerable impact on Latin American legal systems, primarily in the area of public law.

57. Mirow (2004, p. 212).

58. Mattei (1997, p. 124).

59. Mattei (1997, p. 169).

60. Eder (1950, pp. 438–39).

The notions of due process and habeas corpus, for example, have been incorporated into the constitutions and statutes of a number of Latin American nations.”⁶¹ Merryman, Clark, and Haley put it this way:

In the structure of the various branches of government, in the idea of the nature and function of a constitution, in the approach to review of the legality of legislative, administrative, and judicial action, Latin America was strongly affected by the United States model. This feature of Latin American legal systems can be simply, with only partial accuracy, summarized by saying that Latin American public law is more North American than European in character.⁶²

A second influence comes from the Iberian peninsula rather than France. Spain and Portugal were authoritarian countries, both during the period before the nineteenth century Latin American revolutions that created the present-day nation states and throughout the period of initial constitution writing, and even well into the second half of the twentieth century. In Wiarda and Klein’s view:

Political theory in Iberia and Latin America, in contrast, views government as good, natural, and necessary for the welfare of society. If government is good, there was little reason to limit or put checks and balances on it. Hence, before we fall into the trap of condemning Latin America for its powerful autocratic executives, subservient parliaments, and weak local government, we must remember the different assumptions on which the Latin American systems are based.⁶³

Douglass North emphasized the influence of European ideas, probably more Iberian than French, that shaped nineteenth century Latin America and were carried over into the twentieth century—“a long heritage of centralized bureaucratic controls and accompanying ideological perceptions of the issues.”⁶⁴ The results were unfortunate. In Mexico, “centralized, bureaucratic traditions carried over from its Spanish/Portuguese heritage” were “perpetuated.” North wrote:

The interventionist and pervasively arbitrary nature of the institutional

61. Schlesinger and others (1998, p. 291).

62. Merryman, Clark, and Haley (1994, p. 463).

63. Wiarda and Kline (2000, p. 59).

64. North (1990, p. 103).

environment forced every enterprise, urban or rural, to operate in a highly politicized manner, using kinship networks, political influence, and family prestige to gain privileged access to subsidized credit, to aid various stratagems for recruiting labor, to collect debts or enforce contracts, to evade taxes or circumvent the courts, and to defend or assert titles to lands. Success or failure in the economic arena always depended on the relationship of the producer with political authorities—local officials for arranging matters close at hand and the central government of the colony for sympathetic interpretations of the law and intervention at the local level when conditions required it. Small enterprise, excluded from the system of corporate privilege and political favors, was forced to operate in a permanent state of semiclandestiny, always at the margin of the law, at the mercy of petty officials, never secure from arbitrary acts and never protected against the rights of those more powerful.⁶⁵

From the standpoint of enforcement of contracts and protection of property, these nineteenth century conditions of governance in Latin America have little to do with the French tradition of a strong bureaucratic state or with the principles of the Code Napoleon. The constitutional structure of France coming out of the French Revolution was far from devoted to perpetuating the power of local economic and social interests. The new French constitutional arrangements were based on the sovereignty of the legislative branch. Indeed, that was the central theory of French constitutional theory until De Gaulle came to power in 1958, when the French constitution was amended. This amendment was a condition of his willingness to assume the helm of the French state. The new 1958 French constitution granted the executive the power to make law in certain areas by decree.

Yet the theory of Latin American constitutions has traditionally been the opposite of the pre-1958 French constitution; these Latin American constitutions granted great power to the executive. And, as North points out, Spain was the source of these Latin American institutions: “There was a centralized monarchy and bureaucracy in Castile, and it was Castile that defined the institutional evolution of both Spain and Latin

65. North (1990, pp. 116–17), quoting from Coatsworth (1978, p. 94).

America.”⁶⁶ As Wiarda and Klein further explain:

“Virtually all Latin American constitutions have provided for the historical, three-part division of power among executive, legislature, and judiciary. However, in practice the been largely outside Latin American legal tradition.”⁶⁷

With regard to judicial review—that is, the power of the courts to declare acts of the legislature unconstitutional—it is quite wrong to code Latin American countries’ law as based on French law. Indeed, the institution of judicial review has recently become more common in Latin America. Yet in France, judicial review is not available at all, except in a special, essentially nonjudicial council in advance of enactment (and even that review became available only in 1958, many decades after judicial review became common in Latin America).⁶⁸

In the case of administrative law, while French law provides for acts of government administration to be reviewable, that review takes place only in specialized administrative courts and not in the regular judicial system (that is, administrative law is not reviewable by the ordinary courts that also handle cases among private parties).⁶⁹ Just the opposite is true in most of Latin America. Many Latin American countries have developed a remedy, usually called *amparo* (similar to but broader than the English and American writ of habeas corpus) that can be used to attack a broad range of administrative acts. In fact, unlike most European countries that allow administrative acts to be reviewable only by a specialized administrative court, *amparo* can normally be brought in the ordinary court system.⁷⁰ One therefore could ask why Latin America is not coded for regression purposes in the same category as the United States, at least to the extent that the underlying theory of the rule of law in economic development depends on the relationship between the state and the economy.

If one looks to legal culture, it may be the case that even in public law, the legal culture of many Latin American countries leads to different results in public law controversies than one would anticipate by looking only at the rules on the books. And it

66. North (1990, p. 114).

67. Wiarda and Klein (2000, p. 60).

68. Bell (1992, pp. 29–56).

69. Schlesinger and others (1998, p. 552).

may be that the Latin American legal culture in some way can be said to reflect a French approach to the legal profession and the judiciary. But a defense of the legal origins approach on this subtle ground merely leads to a second set of questions that may be the most important ones when one begins to look for policy implications for developing countries.⁷¹

Still a different kind of anomaly arises from treating Anglo-Saxon countries as in the same box simply because they adopted the common law. Insofar as public law is concerned, one can ask—for example—why Britain and the United States should be placed together. As a continental European legal scholar puts it: “[I]t is clear enough that British and American constitutional law are not part of the same ‘family.’ ... For the study of public law ... the idea of legal families does not work.”⁷²

While the reasoning of courts in both countries places more emphasis on judicial precedent than is normal in many civil law countries, Britain has never recognized judicial review of statutory enactments.⁷³ Parliament is sovereign (just as the French Assembly is sovereign) and has been since the Glorious Revolution of 1688–89. (Before 1689 neither Parliament nor the king—the latter being generally recognized as sovereign—would recognize judicial review.⁷⁴) As a matter of fact, Britain—unlike France, Germany, and nearly all other countries in the world—does not even have a written constitution. To the extent that Britain has a constitution—based on legislation and conventions and practice going back to Magna Carta—it is not just subject to many interpretations but is considered more a question for Parliament than for the courts. Indeed, Parliament can change the constitution by its enactments, just as it can change a statute, without any special constitutional amendment procedure.⁷⁵

70. For a discussion of amparo in Latin America, see Merryman, Clark, and Haley (1994, pp. 740–45) and R. Baker (1971). See also Clark (1975, pp. 432–34).

71. The question of culture as an alternative to legal origins in explaining economic growth is discussed in a forthcoming book, Kenneth W. Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (see <http://www.brookings.edu/press/books/lawgrowthnexus.htm>).

72. Koopmans (2003, pp. 39–40).

73. A species of judicial review is now required to a limited extent by UK membership in the European Union, but this exception is based on an interpretation of Parliament’s will as expressed in the EEC Act of 1972; see Carroll (2003, pp. 97–98).

74. Lord Coke suggested in *Bonham’s Case* in 1610 that legislation could be set aside if it was contrary to the common law, but that concept of judicial review proved to have no future in England; see Van Gerven (2005, p. 105) and Koopmans (2003, p. 39).

75. The canonical citation for this proposition remains Dicey (1893); see Carroll (2003, pp. 79–80).

Governance as an Alternative Theory

The governance approach to explaining the rate of economic growth, though useful as a contrast to the legal origins literature, has in common with it the use of econometric techniques by economists. The governance work has been done largely by economists at the World Bank Institute, a research component of the World Bank. The original legal origins work, in contrast, was almost entirely the product of economists in academia, although some offshoots from it have been funded and extended by the World Bank. An important reason for the difference in where the work is done is probably that the governance work had to be preceded by the collection of a great deal of special survey data. The administration of the survey questionnaires involves more than 200 countries, and their continuation year after year is obviously easier for an international organization than for academic researchers.

The governance work has several advantages over the legal origins literature in explaining comparative economic growth. The larger number of countries included allows many more interesting comparisons. Moreover, many more developing countries are included in the governance studies than were considered in the original Law and Finance literature. Especially noteworthy are the number of common and civil law countries in Africa, compared with the Law and Finance literature, which had no African civil law countries (other than Egypt, which is quite different in most respects from sub-Saharan Africa). The governance indicators suggest some obvious and practical modifications to development strategy beyond the law on the books and especially beyond legal origin, which by definition cannot be changed. The amount of data collected over an eight-year period allows judgments about how changes in governance may have affected countries' growth. Kaufmann noted, for example, that "a simple review of recent data suggests a much higher correlation between FDI [foreign direct investment] and governance than between FDI and macroeconomic variables," leading him to the conclusions that "maintaining macroeconomic stability ought to continue to be regarded as a necessary precondition for growth and for FDI, yet it is far from sufficient," and that "particular emphasis on governance factors is warranted, since at the present juncture it appears to constitute a binding constraint."⁷⁶

Another important difference is that the governance inquiry has been much

broader than the legal origins approach. In the minds of the governance analysts, there are three dimensions of governance of a country, each of which is in turn broken down into six dimensions: “voice and external accountability;” “political stability and lack of violence, crime, and terrorism;” “government effectiveness;” “lack of regulatory burden [sometimes abbreviated as regulatory quality];” “rule of law;” and “control of corruption.”⁷⁷

The core of the analysis in the succeeding chapters of this book is thus the fifth component, the rule of law, although elements of the other five components also play a role in some legal origins work. In turn, the governance research implicitly looks to factors other than legal origin, although it does provide some insight into the legal origins work product.

One aspect of the governance research is that it permits one to rank countries by “rule of law” and, to the extent that the research results are based on surveys, to chart progress between compilations of the surveys, not just for countries but for regions of the world. So, for example, the surveys provide quantitative evidence of what one normally finds in qualitative writing, such as the extent to which judicial independence varies by region. The surveys show that judicial independence is greater among the members of the Organization for Economic Cooperation and Development (OECD) than in the East Asia industrialized countries, which in turn rank higher than the transition countries (Eastern Europe and the former Soviet Union), with emerging market countries slightly lower than the transition countries. The surveys also show that the Eastern European countries have done much better in judicial independence than the countries of the former Soviet Union.⁷⁸

Looking at changes from one compilation to the next, one finds the less obvious and more worrisome fact that, from 1998 to 2003, judicial independence deteriorated slightly in all regions (other than the East Asian industrialized countries).⁷⁹ And still more interesting, judicial independence is no higher in Latin America and the Caribbean’s emerging countries than it is in Eastern Europe’s transition countries, despite

76. Kaufmann (2004, p. 139).

77. Kaufmann (2004, p. 142).

78. Kaufmann (2004, p. 143, table 1).

the pernicious influence of Communist parties on judicial independence until the early 1990s.⁸⁰

Similarly worrisome is the major deterioration experienced by low-income countries in all six governance dimensions from 1996 to 2003. A number of low-income African countries, such as the Central African Republic, Cote d'Ivoire, and Zimbabwe suffered "significant" deterioration in all six categories, including the rule of law. In contrast, some low-income countries made significant improvements in five or six categories, showing that improvement even in the lowest-income countries is definitely possible.

Another insight comes from survey questions such as, "In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with influencing laws and policies, regulations, or decrees to favor selected business interests?" (with seven possible answers ranging from "common" to "never occurs").⁸¹ Of course, surveys depend on questions, and it is common knowledge that different individuals interpret questions differently, and that this is especially true with regard to individuals in different countries. For example, some individuals, and probably even more so some cultures, tend to be more pessimistic than others about the state of values of other people and hence are inclined to assume that corruption is more common among other firms than perhaps is warranted. A comparable reservation about comparisons with regard to judicial independence is prudent. Trends over time within regions, and especially within countries, may thus be more important than cross-country and especially cross-regional comparisons. Still, the general cross-regional results from the surveys support, rather than contradict, judgments commonly expressed in qualitative commentary.

The findings showing sharp differences between developed and developing countries on rule-of-law issues raise the same problem that plagues the legal origin studies, namely, the direction of causality. Do more independent legal institutions cause higher incomes? Or is it a case of reverse causality? In other words, do higher incomes

79. Although one may have statistical doubts about whether a deterioration has been conclusively shown, Kaufmann (2004, p. 139 n. 8) points out that the "statistical confidence in the statement that there is no evidence of a positive trend in any governance dimension is very high."

80. Kaufmann (2004, p. 140, figure 1b).

81. Kaufmann (2004, p. 160, table A2).

provide the resources that lead to a higher rule-of-law level? One can see, for example, that with more money, judges can be paid more and be provided with more computers and better libraries, thereby insulating them better against political pressures and the temptation of bribes.

In dealing with the issue of reverse causality, legal origins studies can rely on the analytical point that because the legal origin of a country was determined more than a century earlier, the country's current income level cannot determine its legal origin.⁸² Governance studies have no such recourse. However, governance researchers have used a different approach that allows them, in their judgment, to find not just that there was no reverse causality but “a *large direct causal effect* from better governance to improved development outcomes.”⁸³

The governance literature provides a platform for evaluating the legal origins literature. Specifically, the governance surveys, together with expert assessments from a wide variety of governmental and nongovernmental groups, provide country-by-country data on the state of the current rule of law. These country results can then be run back to see how different origins rank on the rule-of-law criterion. This cross-methodology exercise does find, “controlling for other factors, on average a small advantage for countries with common law over civil law origins.”⁸⁴ But it also raises a number of reservations about the utility for public policy of the common law–civil law distinction. If one divides countries into two categories, high-quality and low-quality rule of law, one can further sort by legal origin and current income levels and then can see how many of the civil law developing countries actually enjoy high-quality rule of law and how many of the common law developing countries suffer from low-quality rule of law. French law countries include, for example, Chile and Costa Rica, countries that are usually considered to rank relatively high on rule of law. And the common law countries include many lower-quality rule-of-law countries, not just in Africa (such as Kenya, Liberia, Nigeria, and Somalia) but also in Asia (Bangladesh and Pakistan). German law is not found to any great extent in the developing world because of the lateness and weakness of German colonial expansion, but it includes high-quality rule-of-law countries such as

82. See La Porta and others (1998, pp. 1150–52) on the use of instrumental variables.

83. The World Bank Institute approach to reverse causality is explained in Kaufmann (2004, p. 145).

84. Kaufmann (2004, p. 147).

Korea and Taiwan in Asia and Estonia, Hungary, and Slovenia in Eastern Europe.⁸⁵

A further virtue of the governance literature is that it includes some two hundred countries, whereas the key Law and Finance article included data on only forty-nine countries. Although forty-nine countries may be enough for an academic paper aimed at a general conclusion (and at the time a new perspective), serious problems arise when one is attempting to arrive at policy recommendations for a subset of those countries—namely, developing countries.⁸⁶ Then questions about the selection criteria become important. The governance literature uses data from essentially all developing countries.

Furthermore, the difference by legal origin among the governance literature's seventy-five low-income countries (which are especially important for economic development policy) provides a common law–civil law comparison on governance indicators as a whole (that is, all six dimensions and not just the rule-of-law dimension). The results show, for example, that in those countries, common law countries come out slightly ahead of civil law countries on three components (voice and accountability, government effectiveness, and rule of law); even with civil law countries on regulatory quality; and slightly behind civil law countries on political stability and control of corruption.⁸⁷ From this perspective, the public policy problem to be addressed in low-income countries is governance across the board and not just the legal origin aspects of governance.

Even with respect to legal origin as such, Kaufman found that while there was, “evidence of a small but significant correlation between legal origins and governance” in the complete set of some two hundred countries, when he focused on the seventy-five lower-income countries, “the differences between common law and civil law essentially

85. Kaufmann (2004, p. 147).

86. The LLSV (La Porta and others 1998, p. 1117) criteria for inclusion required that the country have at least five domestic, nonfinancial, publicly traded firms with no government ownership in 1993. These criteria made sense for a study of the development of financial sectors without special focus on special issues involving developing countries but left out information that would be important if one were primarily interested in developing countries. The legal origins authors have somewhat increased the number of countries in their database over time; see, for example, Djankov and others (2005), in which seventy-two countries are used. But the LLSV Law and Finance database remains much smaller than Kaufmann's governance database. Some of the legal origins authors, particularly Djankov, who did not participate in the original Law and Finance studies, have participated in the World Bank Doing Business series, but that series is focused on regulatory issues that are beyond the scope of this book. Some of the LLSV author's later work uses larger data sets to analyze other issues. La Porta, López-de-Silanes, Pop-Eleches, and Shleifer (2004); La Porta, López-de-Silanes, and Shleifer (2006).

87. Kaufmann (2004, p. 148, figure 3b).

disappear.” Yet, as Kaufmann points out, it “is precisely within this group of countries, many of which exhibit dysfunctional governance, that the most daunting governance challenges lie.”⁸⁸ In short, the concept of legal origins is interesting from a scholarly point of view, but from the point of view of public policy formation for the poorer developing countries, legal origin appears to be of dubious relevance.

In trying to understand these governance results, one must consider subjectivity and related survey issues. Kaufmann’s answer to the subjectivity concern is that subjective measures of governance contain important information often not captured by objective indicators, particularly in emerging economies.⁸⁹ This answer is no doubt correct in view of the serious shortcomings of the LLSV “objective” indicators reviewed in this and later financial sector chapters, but there is still reason to consider the shortcomings of subjective measures.

For example, a judicial corruption question was: “In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with getting favorable judicial decisions?” A score of 1 means “common” and a score of 7 means “never.”⁹⁰ Here, as in the legal origins work, policy implication issues arise: Bribes have both a supply and a demand side, and the research gives little insight into how to work to lower the incidence of judicial corruption. Especially when one is talking about judicial corruption, it is unclear how enforcement of anticorruption legislation can be achieved in those countries where it is most needed.

In the case of judicial independence, the respondents were asked to what extent they agreed with the following statement: “The judiciary in your country is independent from political influence of members of government, citizens, or firms.”⁹¹ These types of questions were asked of six thousand enterprises in more than one hundred countries, and therefore the answers are primarily a business view of the judiciary, which is certainly not the only view that counts and perhaps not even the most important one.

One therefore might be inclined to object that perceptions do not necessarily

88. Kaufmann (2004, p. 147). See also Kaufmann (2003).

89. Kaufmann, Kraay, and Mastruzzi (2005).

90. Kaufmann (2004, p. 141, figure 1c).

91. Kaufmann (2004, p. 140, figure 1b).

reflect reality, and to some extent that is no doubt true.⁹² But perceptions can have independent force. If business firms believe that the courts are not independent, they are likely to make less use of the judiciary to resolve disputes. And if the dispute is with a governmental institution, they may be more likely to choose bribery as less expensive and more certain than litigation.

Although one might quarrel with the choice of business respondents, an important by-product of focusing on business perceptions is that Kaufmann and colleagues were able to construct an index of “crony bias”—defined as the business respondents’ assessment of the special influence of firms close to the government as compared with the influence of their own trade association. Among the nonobvious results was that crony bias was substantially higher in Latin America than in the sub-Saharan Africa and the Middle East–North Africa regions.⁹³

What should one conclude to be the relative merits of the legal origin and governance approaches? The governance work suggests that the public policy implications in the rule-of-law area are complicated and that rule-of-law performance may well depend on institutions and organizations unrelated to the law; voice and accountability seem particularly important and can be influenced by legal rules, such as a constitutional guarantee of freedom of speech and press. But at least one can say that while legal origin cannot be changed, the governance work adds greatly to our understanding of what rule-of-law problems need to be worked on in the developing world whatever the legal origin of the countries involved.

92. K. Davis (2004, p. 150), who provides a critical review of efforts to assess the rule of law in developing countries, has pointed out that some business respondents in surveys may not have been residents of the country in question and therefore their perceptions may not have been based on personal and direct knowledge.

93. See Hellman and Kaufmann (2002).

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