TWO

# Rethinking the Relation between Legal and Economic Development

In this chapter we outline the framework of analysis that animates the remainder of the book. Our framework responds directly to the problems with the prevailing view uncovered in chapter 1. We are the first to acknowledge the simplicity of the insights that motivate our analysis. But as we will see, these insights have not made their way into the literature and policy advice that we have surveyed, and these simple insights, when assembled into a cohesive perspective, have major implications for the way we understand legal systems, legal change, and the impact of globalization on law around the world today.

The starting point for our analysis is the recognition that in reality, law is not a fixed endowment in the sense of an unchanging foundation for market activity. As Schumpeter famously noted, a crucial source of the vitality of capitalist systems is "creative destruction"—a response to challenges that arise from competitive pressures or exogenous shocks. It is hardly surprising, then, that the sustainable development of capitalist systems should depend in part on the continuous development of new governance structures to support capitalist enterprise. Law, like capitalism, is constantly evolving. Max Weber realized the potential tension between a "rational" legal system (one that generates stable expectations) and the need for legal adaptation within a rapidly developing economy, but he never fully resolved this tension in his work. The ongoing relation between economic *and legal* change has always existed and has to some extent been recognized by close observers, but the full implications of an iterative process of legal and market development have escaped sustained analysis.

We believe that a better way to approach legal and economic development in capitalist systems is to view the relationship as a highly iterative process of action and strategic reaction. Historical experience in a diverse

range of countries suggests that the path of development is something like this: Market change occurs, typically because of the introduction of new technology, the entrance of new players, a shift in consumer demand, or a scandal that reveals damaging new information about the operation of the market or its participants. Market change of any type raises new questions about, for example, the right to use new technology, the ability of new entrants to participate in the market, or the need for new rules to govern market conduct. In order to mitigate uncertainty and restore equilibrium in the market, these questions must be answered by someone. In most developed economies, many of these questions are answered by legal actors, be they legislators, bureaucrats, judges, or some combination thereof.[1] Virtually every legal response, in turn, creates new incentives (and often new uncertainties) for market players, who adapt their conduct to the new rules and push at the margins of the new legal order. These market reactions raise new questions of their own, and the process repeats itself. In short, there is a *rolling relation* between law and markets,[2] which serve as two points in a continuous feedback loop.[3]

The way in which a given legal system responds to market change, however, is likely to vary depending on how it is organized and the nature of the dominant functions it performs. We can expect that countries vary significantly along these dimensions. Understanding these differences is the next step in our analytical framework.

## Organization of Legal Systems

Not all legal systems associated with economic success are organized similarly. Some are highly concentrated, with few actors involved in the lawmaking and enforcement processes. Others are more decentralized, with greater opportunities for a range of actors to participate in lawmaking and enforcement. These differences can affect both the substance and the enforcement of law. To understand how organization affects substantive law, consider a brief example from the production of corporate law. Continental European countries tend to insulate the process from directly affected actors. The European Union closely follows this model when it assembles a "High Level Group of Company Law Experts"[4] for developing the principles for a new takeover directive or a "Committee of Wise Men on the Regulation of European Securities Markets" for developing a new framework for securities market regulation in the Union.[5] Committee members are almost exclusively drawn from academia. By contrast, drafting and reform committees in the United Kingdom and the United States typically

include practitioners from the fields of business and law—people with not only practical expertise but also a direct stake in the outcome.[6] It would be naïve to suggest that by giving academics the primary role in lawmaking continental European jurisdictions effectively insulate that process from political influence. In fact, the pool of professors recruited into the process tends to vary with shifts in political power, and draft proposals are often substantially revised in enacting a new law.[7] Nevertheless, these different law-making processes help account for the fact that there is remarkably little overlap between the directives composing the bulk of European company law and provisions typically found in state-level corporate statutes in the United States (Carney 1997).

Moreover, the content of the law may be affected by the absence or exclusion of certain constituencies from the law production process. An informative example is provided by the state of Delaware. Despite its small size and diminutive stature in virtually all other areas of the U.S. political economy, it is the most attractive jurisdiction for incorporation among Fortune 500 companies. The absence of strong labor constituencies may have given Delaware the edge over such states as New Jersey and New York in the competition for incorporation at the beginning of the twentieth century (Arsht 1976),[8] a lead Delaware has maintained in part by producing corporate law that is favorable to managers and investors rather than other organized constituencies, which still have little input into the revision or development of Delaware corporate law.

The interpretation, application, and enforcement of law also are affected by organizational factors. Some of this influence is captured in the stereotypical distinction between common-law and civil-law systems. In the usual rendition, judges in civil-law systems do not make law but merely interpret the codes. In formal terms, courts are not bound by precedent, suggesting that the legislature has a mandate to monopolize legal innovation. Although there is some truth in the stereotype,[9] the operation of real-world legal systems is much more complex. Contrary to the caricature, civil-law codes are not highly specific and thus cannot be outcome-determinative in most cases. In fact, they were written to last indefinitely, and their drafters were well aware of the fact that societies change. Indeed, at the time the Napoleonic codes were enacted, France had just experienced a series of political and economic revolutions. Not surprisingly, therefore, in practice the interpretive function of courts in civil-law systems is often indistinguishable from lawmaking.[10] Moreover, though there is no formal precedent, judges are well aware that their decisions might be overturned if they are contrary to the standards set by the highest court. Consistently rendering

decisions that are overturned by higher courts is not only disruptive to the legal system but is also a poor career strategy for judges, so lower courts are highly conscious of prior rulings. In short, there are functional equivalents between the features of common-law and civil-law systems that are often said to be most characteristic of their differences.

In our view, more important than these formal characteristics are the incentives a given legal system generates to invest in innovation and adaptation of governance over time and the way this process is influenced by access to the legal system at the law-making and law enforcement stages. Some legal systems encourage litigation by providing access to law enforcement apparatus by individuals who have been adversely affected by state or private action. Others encourage participation in lawmaking by involving well-organized constituencies in the formal legislative process or by consulting them informally at the implementation stage. Some do both. Once we look beyond the caricature of civil law and common law and analyze the way legal systems are organized, we find configurations that are more varied and do not map neatly onto the legal origin hypothesis as presented in the law and finance literature.

In fact, there is often substantial organizational variation *within* countries belonging to the same legal family. The U.K. legal system, for example, is much less accessible to a decentralized process of litigation than is the U.S. legal system. The United Kingdom has no contingency fees for attorneys, and class-action suits are much more tightly restricted than in the United States. As a result, there is no interest group comparable to the American bar that constantly mobilizes adversarial litigation. Similarly, Germany and Japan differ substantially in the organization of their legal systems although both originate from the German civil-law system. On the whole, Germany is much more litigious than Japan (Ietswaart 1990)—itself a fact that is difficult to square with a strong-form hypothesis about the effects of legal origin. In key areas such as labor disputes and issues related to corporate governance, however, access to the courts in Germany has been constrained by legal rules that create entry barriers to decentralized dispute settlement in order to protect cooperative bargaining among organized stakeholders. In the Japanese system, important governance and regulatory issues were typically resolved via informal bargaining between bureaucrats and the business elite, often through more direct channels between the public and private sector than was the case in Germany. Only after the costs of litigation were reduced did litigation become an important component in the resolution of corporate governance disputes in Japan (West 2001). This has allowed Japan to shift from an economic system

that was arguably more centralized than Germany's to one that is allowing more decentralized access to law and greater contestation through litigation brought by parties to a conflict than is presently the case in Germany.

Although this trend is remarkable for what it signifies about changing attitudes toward law in the postwar period, it is not inconsistent with earlier trends. Japan has experienced considerable variation in litigation rates since it began industrializing in the late nineteenth century, with substantially higher rates of litigation prior to World War II than at any time thereafter until very recently (Haley 1978). Such dramatic changes in the use of law over time can hardly be explained by legal origin theories. Indeed, if anything, a legal origin story would predict higher litigation rates in the immediate postwar period given the influx of U.S. law during the occupation. The point is that a focus on legal origin masks more than it illuminates as a signifier of how real-world legal systems differ among themselves and change internally over time.

## The Multiple Functions of Law

Just as legal systems in capitalist countries vary in organization, law can perform a variety of functions in support of economic activity. The endowment perspective suggests that law's only role in an economy is protection of (individual) rights.[11] But this is misleading. Law, of course, does play a major role in the protection of property rights in capitalist systems. Rights need to be protected against abuse by holders of political power and by other market actors to promote saving, investment, and creative endeavor. Indeed, the clear delineation, protection, and transferability of property rights are typically deemed to be the key to economic development (for example, Hoskins 2002). Similarly, third-party contract enforcement via the courts is often viewed as key to economic performance (North 1990).[12] This protective function of law is often the justification provided for lawmaking and enforcement activity. And as we have seen, the protection of investors' rights (a specific type of property rights) lies at the heart of the law and finance literature.

But the rights protection paradigm overstates what legal systems can possibly achieve. In a Coasian world without transaction costs, legal entitlements could be clearly allocated so that parties can bargain over the optimal allocation to achieve efficient results. But as Coase himself noted decades ago (Coase 1960) and a large number of economists have come to realize in the meantime (Johnson, Glaeser, and Shleifer 2001), the real world is characterized by substantial transaction costs. The implication is

that the legal system itself is at the center of balancing conflicting interests, not only at the time of the initial allocation of rights but whenever their exercise conflicts with rights of others—neighbors, passers-by, new market entrants, or members of society at large. The allocation of rights involves value judgments and political bargains at each juncture. Not surprisingly, the nature and proper subjects of property rights protection can differ widely across societies. Important social science research has sought to identify the causes of these observed variations and has frequently traced them to the structure of the economy and the nature of economic activities. For example, societies that depend on a common pool of resources (Ostrom 1990) develop different governance structures than do those that pursue trading activities (Greif, Milgrom, and Weingast 1994; Greif 2006) or farming (Allen 2001). The extensive literature about varieties of capitalism has documented differences in the value placed on social as opposed to individual goals across systems (Hall and Soskice 2001), which may affect the nature of the protections provided.[13]

Given the limitations of rights protection in real-world legal systems, our goal is to identify the actors and interests that find protection in the legal systems of the countries we examine, particularly as markets change, and to highlight how often the protective function of law is overshadowed in importance—in reality, if not rhetorically—by other functions. For example, in chapter 3 we argue that the legal reform adopted in the wake of the Enron scandal in the United States, though publicly justified as a means of protecting investors, might more insightfully be viewed as an attempt to partly centralize legal governance over corporate activity and to signal a higher governmental priority on combating white-collar crime.

In addition to protection of rights, markets also require coordination of activity. Markets are essentially made up of relationships, which must be managed in some way in order for markets to function properly. Laws help manage relationships in a variety of ways. For example, they allocate endowments among incumbents, set the terms of access by new entrants, and determine which actors have the authority to answer questions raised by market change. Consider laws relating to defenses against hostile takeovers, which we explore in our institutional autopsy on Japan. Unsolicited ("hostile") takeovers pose genuine risks for the shareholders of a target company, who face collective action and information problems in evaluating whether to transfer control to the bidding company. Thus, in many systems, hostile takeovers are regulated in order to protect shareholders. But hostile takeovers also raise a fundamental question for the economy: Who—the bidding company, the incumbent directors of the

target company, the shareholders of the target company, or others such as employees or governmental actors—should decide whether control over the target should be transferred to the bidder and on what terms? As they have developed in Delaware, the takeover rules cede the basic authority to accept or resist a takeover bid to the board of directors of the target company, subject only to very broad constraints imposed by courts. In the United Kingdom, the rules allocate that authority primarily to the shareholders of the target company. Disputes that arise in the context of takeovers are resolved by an institution—the Takeover Panel—that has been established and is staffed by representatives of financiers, investors, and members of the legal profession. By developing general rules of behavior and enforcing them by means of consultation, the U.K. system stresses coordination rather than litigation. By contrast, in the United States, takeovers are highly litigious events, with attorneys playing a key role in developing takeover practices through contractual innovation.[14]

The rules recently developed in Japan blend the two approaches but more closely resemble the Delaware rules in permitting incumbent managers to resist unwanted bids by means of a powerful legal technology developed in the United States and colloquially known as the poison pill. Thus, although takeover rules ostensibly are designed to protect investors from coercive bids, coordination of economic activity—the allocation of power and the management of relations between shareholders and the board of directors—is either the intended result (as in the United Kingdom) or an unavoidable by-product (as in Delaware) of any such rules. Other countries' laws erect or facilitate barriers to entry by permitting pre-bid defenses such as multiple voting rights or golden shares. Rules that were either designed for or could be used as pre-bid defenses were at the core of the European battle over the future of the takeover directive, as we discuss in chapter 4.[15]

As the above examples suggest, law can be consciously structured to achieve coordination among key players by ensuring that they share decision-making powers. A major example is the German co-determination regime. By mandating employee representation on the supervisory board, which appoints the management board, the law forces shareholders and management to bargain with employees over corporate strategies, not merely specific measures that might affect employees at their workplace. Like law with a protective function, a law that seeks to coordinate may well give rise to legal arbitrage or be used primarily as a signaling device rather than for ensuring effective coordination. In the case of German co-determination, for example, the introduction of the law appears to have

reduced the power of the supervisory board and enhanced that of top management (Gerum, Steinmann, and Fees 1988; Pistor 1999). Moreover, as the analysis of the Mannesmann case (chapter 4) reveals, the interests of employee representatives are not always perfectly aligned with those of their base. Still, the critical point is that the design of legal systems can be used to reflect social and political preferences for collective bargaining and coordination as opposed to individualized rights enforcement.

Although we stress the importance of protection and coordination as characteristics of different legal systems, we recognize that the tasks of law in any society cannot be reduced to these two functions. Law also supports economic activity by playing auxiliary roles such as signaling and credibility enhancement. Quite apart from its direct consequences, law sends a signal or makes a statement about the type of conduct lawmakers desire (Sunstein 1996). Such a statement may be an effort to manage social norms or to bring about behavioral change in other ways. Signaling is an important function of any economic governance regime because markets rely on information. Law not only helps set the rules by which market activity takes place, but it also makes a larger statement about governmental priorities, the future direction of policy, the relative strength of interest groups concerned with a specific issue, and other information that may be useful to market actors. Often, the signals sent by law may be more potent or novel than the legal provisions themselves. This is one of the major conclusions we draw from our study of the Enron scandal. The Sarbanes-Oxley Act, passed in response to the scandal, appears to have energized law enforcers and reassured investors by signaling a more proactive governmental stance toward financial crime and poor corporate governance, but the law itself is largely a mixture of preexisting or arguably ineffectual legal concepts that may have added little to existing investor protections (see Romano 2005). It also signaled to courts and lawmakers in Delaware that the federal government was ready to step in and further centralize legal governance of the corporate sector unless state institutions took up the task (Roe 2002). We will argue that much of the legal development that has taken place in China since the early 1980s falls into this category: it is of little protective value but is salient to market actors for the signals it sends about government policy and the future direction of reforms.

A signal often can be sent by important actors taking measures that fall short of legally enforceable statutes or regulations—what legal scholars somewhat ambiguously call "soft law." An example is the voluntary adoption of a code of conduct by an international organization, governmental actor, or firm. The announcement of such adoption alone may

trigger behavioral change by the recipient of the signal (at least if the signal is perceived to be credible, a factor we consider below). We will explore a recent example of this phenomenon in Japan, where two government ministries in 2005 jointly promulgated guidelines for corporate takeover defenses endorsing the poison pill. Although the guidelines lack the authority of law, they immediately triggered a host of responses in the private sector because they signaled the policy views of important governmental actors. Courts immediately took note of the signal as well, incorporating the guidelines into their judgments and ensuring that the "soft law" would influence development of the "hard law."

Signaling works only if the signal is credible. Another important function that law performs in the economy is enhancing the credibility of state-supplied governance structures. This reduces the overall cost of governance and enhances its effectiveness by mitigating a major source of political uncertainty (Maxfield and Schneider 1997). According to Schneider and Maxfield, "[c]redibility in this context means that capitalists believe what state actors say and then act accordingly" (11). In the absence of such governance structures, each outcome must be bargained for and implemented anew. Moreover, even optimal ad hoc solutions to economic problems may be subject to time or dynamic inconsistencies (Kydland and Prescott 1977). That is, without credible hands-tying measures, state and private agents may adjust their behavior over time in ways that undermine government policy.

Several features of law make it well suited to the role of credibility enhancement. Law is an *authoritative* statement about desired or required behavior, backed by formal sanctions for noncompliance. It is also generally more difficult to change than other governmental pronouncements, in part because legal change typically requires the coordination of several state actors, a point that we return to below. Backing a policy or norm with law reinforces the signal that society (or at least a powerful subset thereof) deems a given type of behavior to be important, deterring conduct that could undermine the policy or erode the norm. Germany's approach to executive compensation provides a powerful illustration. For reasons we discuss below, lavish executive compensation like that in the United States is inconsistent with postwar German social and corporate governance institutions. Although those institutions are now under considerable stress as a result of the greater interdependence of financial markets and the infusion of different practices into the German system, German criminal law provides an avenue by which legal actors—prosecutors and courts—can intervene to resist movement toward U.S. compensation practices.

German norms and policies about acceptable levels of and motives for executive pay have greater credibility and stickiness than they would in the absence of legal backing.[16] And the prosecution of an executive for approving "unreasonable" compensation sends a powerful, credible signal about the continued viability of social norms.

We have separately analyzed four roles that law can play in support of economic activity, in contrast to the usual focus on property rights protection alone. Of course, a given law may have all, some, or none of these functions. At the same time, the four functions are interrelated and may be mutually reinforcing. For example, coordination provides a form of protection for those whose actions are coordinated via legal authority, because they are at least assured a seat at the bargaining table. Conversely, protective law might play an important coordinative function by serving as the focal point around which negotiations or strategic adaptations to the law take place. The important point is that we lose considerable analytical traction when law's many contributions to markets are lumped under the heading of "property rights protection." Most important, it obscures our ability to see that some of these functions may be in tension with other crucial attributes of a successful economic system, such as adaptability and innovativeness.

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So far we have argued that understanding the organization of legal systems and distinguishing the various functions of law provide a powerful way of understanding the *varieties* of legal systems associated with capitalism in the real world. Figure 2.1 provides an illustration of this concept. The graph is two-dimensional and thus cannot fully account for the multiple functions of law that we have described. We explore these other functions and how they map onto the two dominant functions in our case studies. In Part III we show how this matrix helps explain their quite different institutional trajectories in the relation between law and capitalism in each system.

We are not the first to develop an organizing concept that is an alternative to the conventional divide between civil law and common law. Analyzing differences in criminal procedure across countries, Mirjan Damaška has developed a model that links features of the legal system to structures of authority (Damaška 1975). He distinguishes between "hierarchical" and "coordinate" models for organizing the criminal justice system, which he links directly to different ideas and practices of state authority. He argues that classic English liberalism gives rise to diffuse government control and a preference for a coordinative as opposed to a hierarchical model. By

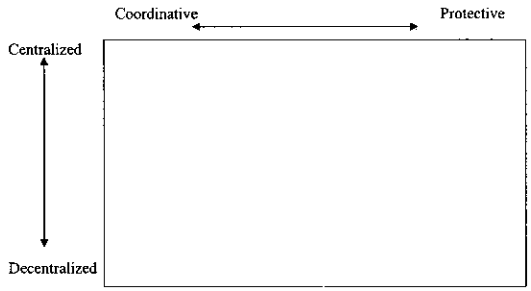


Figure 2.1. Legal systems matrix

contrast, hierarchy became the dominant organizing principle in Continental Europe after the centrifugal forces of feudalism had been overcome. Our distinction between centralized and decentralized legal systems bears obvious resemblance to this model. The main difference is that our focus is on the organization of legal systems as it relates to market activities. Embracing principles of market-based economic activities by definition implies that direct state control plays a less prominent role. The spectrum of governance that we describe therefore begins with coordination and ranges all the way to decentralization, where the making and enforcement of law depend on the willingness of private parties to mobilize the legal system.[17]

Our model also differs from a more recent attempt to link legal systems to political structure. In "The New Comparative Economics," Djankov et al. (2003) argue that any system faces the challenge of designing institutions that effectively protect property rights and creating a strong state capable of enforcing property rights, while constraining the temptation of a strong state to infringe on these very rights. They describe this as the "conflict between the twin goals of controlling disorder and dictatorship" (597). The design of legal systems, in their view, is directly related to the political challenges that a given system faces. Where disorder is the actual or perceived major challenge, a legal system that prefers regulation to litigation is the answer. Conversely, where dictatorship is the threat, (decentralized) litigation will trump (centralized) regulation. In our view, the Hobbesian dilemma may indeed have been relevant in determining certain early choices in the evolution of legal systems. The model has little traction, however, in explaining the continuous evolution of law in capitalist systems today as most countries find themselves somewhere in the middle between disorder and dictatorship. Moreover, the model internalizes law and political processes,

but it treats law as exogenous to the process of economic change. By contrast, in our model law is an integral part of adaptation and change as depicted in the rolling relation between law and markets.

Our attempt to reconceptualize different legal systems in response to the outpouring of law and finance literature bears some resemblance to the trajectory of the "variety of capitalism" debate (Hall and Soskice 2001; Streeck and Thelen 2005). As in the legal origin literature, the proponents of a particular classification system—corporatist models as opposed to market models—first sought to identify indicators that could be used to classify and map countries once and for all. This proved to be futile, however, because few countries actually displayed the precise indicators that were identified in the literature, or the mapping did not generate the results that the theory or classification system predicted.[18] The next step in the debate, therefore, was to characterize the differences between systems using a broader brush. Thus, the literature about varieties of capitalism introduced the notion of "liberal" and "coordinated" market economies (Soskice 1990; Hall and Soskice 2001) by identifying essential characteristics without attempting to enumerate specific expressions thereof. In a similar vein, we want to move away from the law and finance literature's reliance on specific indicators to differentiate common-law from civil-law countries and instead explore the organizational features of legal systems irrespective of their origin.

But we have a broader goal as well. We intend to push the analysis beyond descriptive categories of legal systems. The purpose of the institutional autopsies in Part II is to analyze systems at a moment of great challenge or crisis that could be system-transformative. When analyzing the relevant players and their use of law or alternative governance structures prior to the crisis or in response to the crisis, we observe the microprocesses by which different systems are reorganized, adapted, or reinvented. We propose that these *processes* of change—rather than static indicators—are critical for understanding the relation between legal and economic development.

## Substitutes for Law

If we disaggregate the functions of law and internalize the processes of legal, economic, and political change, we not only deepen understanding of the way law supports markets but also help illustrate why law is often *not* used to support economic activity, even in successful markets. In any economy, nonlegal substitutes are potentially available to perform each of these functions. There is a substantial literature about the central role of

nonlegal rules (for example, norms)[19] in the governance of a vast array of human activity. Exactly why most people abide by norms most of the time is not well understood, but several theories exist, and these theories dovetail nicely with our discussion of the functions of law above. One theory is that compliance with norms signals cooperative behavior, which is beneficial to the complier because it triggers cooperation by the other party (Axelrod 1984). Another is that, as with law itself, compliance or noncompliance is rewarded or punished in ways that people find meaningful. It is evident that norms, like law, evolve over time and often in tandem with stimuli that bring about market change (Ellickson 2001).

Historical experience suggests that a priori, law is not superior to such "nonlaw" as a device for governing economic activity, at least across all stages of development and all markets.[20] The high growth experienced by many countries—including South Korea and Japan in the 1960s and 1970s and China today—indicates that norms and other extralegal devices can serve as a foundation for economic success, at least to a point. Although the Asian cases are often treated as enigmas or exceptions to the conventional wisdom (Trebilcock and Leng 2006), they simply provide the most dramatic illustration of the point that nonlaw can sometimes perform the roles of law at lower cost. The illustrations, however, are not limited to "catch up" economies. The experience of Silicon Valley in the United States in the 1990s, for example (Saxenian 1994), is equally supportive of this point.

We elaborate on these historical experiences in subsequent chapters. At this stage, we simply note that alternative development models, elaborated in a growing body of literature, confirm the intuition that both law and nonlaw can support economic activity. Ongoing relationships and repeated deals can provide protection for economic interests. Coordination and credibility enhancement can occur via pacts between political leaders and business groups (North and Weingast 1989) or among members of a network based on ethnicity or kinship (Greif, Milgrom, and Weingast 1994; Greif 2006; Rauch 1999). These pacts simultaneously help facilitate information flow and policy transmission throughout the economy. Guidelines and best practice codes can send signals about desired behavior to targeted communities of market actors. As exemplified by the high-growth East Asian economies, political leadership can engender credibility in economic policy and enhance compliance with its goals. Elite bureaucracies such as that of Japan in the postwar high growth period can also generate credibility and foster coordination.

## The Political Economy: Supply and Demand for Law

Recall that one of our criticisms of the endowment perspective is its fixation on a rather simplistic view of the supply of law and complete neglect of demand-side factors. In order to understand why some countries and some markets rely more heavily on law as a mechanism of governance than do others, and to better understand how legal systems change, the supply and demand for law must be considered in greater depth. This, in turn, requires stripping away another assumption of the endowment perspective: that law—though its original form and substance might have been shaped by politics—is a *politically neutral* endowment.[21] Contrary to its typical portrayal in the economics literature and the policy world, law is a political product not only at its inception but in the way it affects and is shaped by the interests of political, social, and economic actors.[22] It is impossible to understand where law comes from and where it is going without venturing into the realm of the political economy.

On the supply side, many commentators now recognize the obvious point that enforcement, not simply the law on the books, must be taken into account. But it is important to expose the major reasons for the frequent divergence between formal law and law as enforced. One reason is related to the division of labor on the supply side of the legal system. Two largely (though not completely) distinct groups of actors are involved in the separate processes of enacting rules and enforcing them. Legislators and bureaucrats make ex ante rules in the form of statutes and regulations, and legal professionals (judges, prosecutors, and lawyers) interpret, apply, and enforce them ex post. In order for law to play a role in support of markets, different actors must coordinate their activities in the law production process. But coordination may fail. The actors whose coordination is required may not share similar interests with respect to the law or may understand the law differently. Even if the interests and understandings of the actors are aligned, other constraints (for example, budget limitations, higher priorities) may reduce the scope of action of an essential actor.

The demand for law as a device for governance in the economy is a function of many factors, of course, including the structure of government, the nature of the political system, and the level of educational attainment in the society. We focus on three factors that are directly relevant to our discussion. First, all else being equal, the existence of effective, lower-cost nonlegal alternatives will reduce demand for law. (By "effective" we mean "capable of protecting or coordinating the interests of those with veto power over the contents of law and access to legal enforcement mechanisms.") This is

why it is so crucial to account for nonlegal alternatives in any model of the interaction of law and markets. However effective the legal system may be at performing market-supporting functions, actors can be expected to opt out of the legal system whenever nonlegal alternatives are available at lower economic or social cost to them. Although in the postwar period Japan's legal system was highly developed (no insurmountable supply problems existed), demand for law was dampened by the highly relational structure of the dealings between Japanese business groups and bureaucrats (Milhaupt 1996). Interests were protected and market activity was coordinated by repeated interactions between the public and the private sectors. Credibility was enhanced by the central role of elite bureaucrats and by the very fact of economic success under the informal model. The state successfully signaled its policy goals through "administrative guidance."[23] Law was not irrelevant to this system—indeed, many of the nonlegal mechanisms of governance were facilitated by the legal structure, so law played an important coordinative function in the economy (Milhaupt 1996). But overt and extensive reliance on the legal system for protective purposes could be avoided in many areas of economic activity.

Second, not only is the supply of effective law influenced by demand, but conversely, the demand for law is affected by supply. Some countries, particularly those experiencing rapid transitions toward economic growth, simply lack the technical capacity or political inclination to produce a legal system that performs crucial governance functions. In these systems, market actors have no choice but to pursue nonlegal alternatives. In today's world a late developer seeking to catch up with economically more advanced countries has at its disposal *legal* technology as well as commercial technology developed elsewhere. Legal solutions, like other technological solutions, can often be borrowed at lower cost than they can be developed from scratch, although the effectiveness of this form of legal development is open to question (see chapter 10). Nonetheless, the low-cost supply of standardized legal solutions to governance problems helps explain the increasing outward similarity of law in market-oriented economies around the world today.

Supply can affect demand in a more profound way: the relative influence of different agents (legislators and bureaucrats, bureaucrats and courts) in the law-making and law enforcement processes may change over time. From 1960 to 1990, the period that has come to be known as the East Asian Miracle, for example, policy guidance announced and enforced by a highly regarded bureaucracy, not legislation, was dominant (Pistor and Wellons 1999). Courts were sidestepped to an important degree because

bureaucrats used their own enforcement devices to achieve policy goals, as in the case of Japan's administrative guidance. By contrast, during the 1990s Japan launched large-scale institutional reforms to create a more flexible and "participatory" legal system consistent with the maturation of its economy. For example, barriers to the use of courts for enforcing investor rights were lowered, triggering a substantial increase in litigation rates (West 2001). The bureaucracy lost credibility owing to a series of policy mistakes and scandals, while legislation enacted via the parliamentary process and judicial decisions gained in importance. Thus, a shift in the relative power of the bureaucracy and of political and judicial actors in the law production and enforcement processes coincided with and was influenced by a major shift in the demand for law (see Milhaupt and West 2004). Changes in the relative power of economic actors may have similar effects. As our case studies demonstrate, the increasing importance of foreign investors has put substantial pressure on domestic constituencies and the ways in which they resolved problems in the past. The uncertainties created by these new configurations have created a greater demand for law—not only by new entrants but also by incumbents.

Third, as markets grow in size and complexity and as market actors become more heterogeneous, demand for law appears to increase. Social theorists including Karl Marx and Adam Smith long ago noted that changes in economic systems, including growing economic complexity, coincide with changes in the ways in which economies are governed. A simple explanation is that as markets increase in size and transactions take place beyond the reach of informal governance structures based on mutual monitoring, trust, and reputation, formal law may be needed to fill the vacuum.[24] In particular, actors who lack access to informal mechanisms of governance seek legal tools with which to participate fully in economic markets.[25] But this explanation says little about types and functions of law for which there might be increasing demand. Our institutional autopsies reveal the importance of the allocation of enforcement power in shaping the law. The targets of enforcement activity, the choice of criminal or civil action, and the use of procedural mechanisms to encourage mass private enforcement actions by investors are all politically charged. As we will see, countries vary enormously in their approaches to these questions, with major implications for the role that law plays in their respective economies. Occasionally, as in the Yukos case, law enforcement is blatantly used in service of political ends. More often, the political choices underlying enforcement decisions take more subtle forms but have equally important consequences. To cite another example, procedural roadblocks to investor lawsuits in

China—reflecting not only limited institutional capacity but also concerns for social stability and the ambiguous role of the courts in the communist government's regulatory hierarchy—limit the universe of responses to the acute corporate governance problems posed by existing ownership structures in China. The United States, with its plethora of activist attorneys, incentive fee arrangements that encourage suits, procedures for facilitating mass litigation, and multiplicity of forums (state and federal) for law production and enforcement, stands at the other extreme.

As elaborated in many of the succeeding chapters, global market development has increased demand for *protective* law, particularly in systems in which informal relationships have largely supplanted widespread enforcement of legal rights. Contrary to the Weberian perspective, however, legal systems at the forefront of this development appear to be moving away from detailed rule making in favor of open-ended, flexibility-enhancing standards, thereby modifying the nature of protective law. For example, in corporate law, there has been a movement (at least among developed market economies)[26] away from highly regulatory or mandatory law toward a more "enabling" approach epitomized by Delaware law.[27] With this approach, essentially any deviation from the state-supplied set of default rules is permitted, subject only to policing of outrageous conduct by the courts at the behest of aggrieved investors. Related examples are the replacement of rule-based accounting practices with standards-based practices in the United States and the endorsement of the open method of coordination as an alternative to top-down legal harmonization in the European Union (Scott and Trubek 2002).

Why do we observe this movement? The reason is that law's ability to provide stable and predictable solutions to future contingencies declines as economic complexity increases. Put differently, socioeconomic and technological change renders law incomplete (Pistor and Xu 2003b). A major role of legal systems in a world of incomplete law is to allocate lawmaking and enforcement functions to the agents that are best able to resolve disputes over unforeseen and unforeseeable contingencies, thereby facilitating continued change. Thus, a growth in economic complexity increases demand for law that provides flexibility and adaptability at the expense of predictability.

Viewing law as a neutral (protective) institutional endowment also masks the political realities of law's impact on those it affects. Whatever the motivation of the producers of law, it often has disparate impacts on incumbent stakeholders and challengers in the economy. Law may reallocate control and decision-making rights from one constituency (for

example, management) to another (for example, investors or employees). Legal change may also signal a change in policy direction with potentially redistributive effects, triggering a host of responses by those who expect to benefit or lose from the change. The responses do not depend only on the purpose and language of the statute. Equally important is the way legal change is perceived by relevant constituencies (Sunstein 1996). Thus, law potentially shapes demand for legal governance even when little attempt is made to control outcomes for specific constituencies, which are often unforeseeable or unintended.

Bringing our analytical perspective full circle, the demand for law as a governance device is likely to be affected by the extent to which potentially affected constituencies are allowed to participate in lawmaking and law enforcement. Centralized legal systems by definition do not provide as many ports of access for participants, and outsiders who lack access must find nonlegal governance devices to order their affairs. By contrast, decentralized legal systems foster mechanisms of legal enforcement. The courts, as the ultimate demand-driven law producers, are likely to play a more important role in decentralized than in centralized legal systems. Similarly, the demand for law is likely to be greater where law plays a predominantly protective function in the economy. Where law is used principally to coordinate relations among insiders, actors are more likely to resort to nonlegal governance mechanisms to advance and protect their interests.