Law and Capitalism

What Corporate Crises Reveal about Legal Systems and Economic Development around the World

CURTIS J. MILHAUPT
KATHARINA PISTOR

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ONE

The Prevailing View: Impact, Assumptions, and Problems

The literature concerning the relation between law and market-oriented economic activity is vast and spans disciplines ranging from law, economics, and sociology to political science. Merely outlining the thinking at the level of detail it deserves would fill an entire volume; we hope simply to describe the view of this relation that has become deeply engrained in both the academic literature and the policy world and then step back to expose some aspects of this view that do not bear up under careful scrutiny. Inevitably, this sort of task risks caricature or paper-tiger slaying. To be sure, nuances in the literature exist that extend and clarify the picture well beyond the sketch that we provide (see Trebilcock and Leng 2006 for a helpful survey). But the reality is that a very simple view of the relation between law and markets has taken hold in the minds of many smart people—people whose research and policy advice carry tremendous weight. That simple view, not a deeply nuanced perspective that would follow from a careful reading of the entire body of literature, is repeated in important academic journals and the pages of World Bank publications and animates the legal reforms undertaken in many countries in the recent past.

The prevailing story goes like this: A rule of law to protect property rights and enforce contracts is an essential precondition to economic development because without it, transaction costs (in terms of unpredictability, enforcement problems, and so on) will be prohibitive in many cases. Thus, in the absence of legal order, markets will not grow and economies will falter. The one recent nuance given to this view that gets an occasional nod in the literature is that a rule of law may not be essential in early stages of economic growth but becomes essential to sustaining growth.[1] Following Sabel (2005), we call this view the endowment perspective because it treats a legal system as if it were like a highway or a dam—a fixed investment that

must be built before economic development can take off but that once in place determines the path of development without itself being subject to change. We briefly trace the intellectual history of the endowment perspective and examine its implications.

The Endowment Perspective

This perspective on law is indebted to Max Weber, who famously stated that a "rational legal system" is a precondition of the emergence of capitalism (Weber 1981). This conclusion followed from his comparison of industrializing countries of western Europe with countries that were not experiencing the Industrial Revolution. By a process of subtraction, Weber concluded that what industrializing countries possessed and the others lacked was a Protestant work ethic and a rational legal system (Trubek 1972).

A century later, drawing in part on Weber's views, Nobel laureate Douglass North extended these ideas into the realm of institutions. North (1990, 2001) argues that what separates rich and poor countries is the quality of their institutions, which he defines as the rules of the game for economic activity and their enforcement characteristics. According to North, rich nations have managed to form credible, low-cost institutions (in particular, formal, state-backed enforcement regimes) that protect property rights and enforce contracts. Poor countries lack institutions that foster market exchange. Because institutional change is path-dependent, it is difficult for countries with a weak endowment to change the foundations for their future growth. In other words, North sees institutions as playing a role in economic development similar to that of Weber's rational legal system.

Carrying this intellectual legacy a step further, a line of literature pioneered in the 1990s by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny spearheaded the empirical investigation into the legal foundations of economic growth.[2] In the original papers (La Porta et al. 1997, 1998), the authors introduced a database that codes legal indicators for the quality of shareholder and creditor rights protection for forty-nine countries.[3] The countries are classified according to their "legal origin," that is, the historical source of their legal system. The categories used are English common law and civil law, with the civil law systems subdivided into those of French, German, or Scandinavian origin. The legal indicators are regressed against economic outcome variables. The methodological approach may suggest that unlike Weber and North, La Porta and colleagues are interested in a particular set of rules rather than broad

contours of different legal systems. In fact, the specific legal indicators that enter each regression are interpreted as proxies for more substantive characteristics of the legal system. The original paper investigates the ways in which legal protections (and legal origin) affect the level of ownership concentration of firms (that is, the extent to which large blocks of shares are held by a relatively small number of shareholders), whereas subsequent papers investigate law and legal origin as determinants of external finance of firms as measured by the size of stock and credit markets (La Porta et al. 1997), securities markets (La Porta et al. 2004), and private credit markets (Djankov, McLiesh, and Shleifer 2007).[4]

Regardless of the economic outcome variable being tested, the work suggests that English common-law systems provide better protections and thus produce better economic outcomes than do the civil-law systems, particularly the French system. Shleifer and Glaeser explore the reasons for these remarkably consistent findings[5] in a paper that traces the origins of the common and civil law systems all the way back to the twelfth century, when England first established the jury system (Glaeser and Shleifer 2002). They argue that twelfth-century England's weak central control and powerful local interests led to the emergence of a jury system that insulated adjudication from powerful local magnates, laying the foundation for courts as institutions that protect private interests, in particular, private property rights. By contrast, according to this account, France at the time was already saddled with centralized political control that gave the Crown monopoly power over courts. The courts therefore tended to serve the monarch's interests and were less inclined to serve the interests of private individuals.[6] Other differences between North's work and that of La Porta et al. notwithstanding,[7] this approach to explaining differences in legal systems clearly places the major protagonists of the law and finance literature in the endowment camp.

Although for the most part the law and finance research studiously avoids the larger claim that the quality of legal protections determines economic growth (as opposed to financial market outcomes),[8] other research has investigated this linkage. Mahoney (2001a) finds that the common-law countries grew faster than the civil-law countries, at least in recent decades. Drawing explicitly on Hayek's theory of spontaneous order via bottom-up, decentralized institutional adaptation (Hayek 1944), Mahoney explains the finding as a result of the common law's support for private initiative, as opposed to the top-down governmental control associated with civil-law systems. In other words, the common law trumps the civil law because courts are better suited than legislatures to continuously adapt rules to the

needs of market participants (Hayek 1973).[9] Thus, by the end of the twentieth century, the endowment perspective had found powerful empirical support from scholars who shared the unproven assumptions of earlier generations of thinkers about the link between law and market-oriented economic institutions. The endowment perspective, in the modern-day statistical form it takes in the law and finance literature, took academia by storm. A cottage industry was created for economists all over the world, who made use of La Porta and colleagues' legal indicators and legal origin classifications to generate papers buttressing the prevailing view. The quality of law appeared to drive economic outcomes everywhere one looked, and the common-law regime appeared to systematically provide higher quality legal protections than did the civil-law regimes.

The law and finance literature has also been highly influential in policy circles. This is not surprising, because its findings confirm many of the views previously espoused by the World Bank concerning the importance of legal systems to economic development.[10] With the help of La Porta and colleagues, the World Bank established a database that assigns a numerical indicator to each country for a host of institutions ranging from shareholder and creditor rights to labor protections, the operation of courts, and so on.[11] New findings concerning the relation between law and market development are quickly reported as economic laws of nature in World Bank publications. More concretely, the endowment perspective, with the support of the law and finance literature, has driven the legal reform policies of the World Bank and other international organizations. The literature lends a scientific patina to these reform policies, although the authors of these studies would probably distance themselves from the conceptual shortcut made by policy advisors, which identifies changes in specific rules with changes in the nature of the legal system.[12] Once a legal system is reduced to the sum of legal rules found in statutes, it can be treated like a piece of technology. As a result, legal reform is a technocratic endeavor (as reflected in the World Bank's "legal technical assistance programs" [Mathernova 1995]), not a political or social one. This is extremely convenient because the World Bank and most other international organizations have no mandate for political involvement or reform in the countries they advise.

This technical approach is also highly problematic, however. First, the coding of specific legal indicators has not always withstood scrutiny, and the results have not always proved to be robust in the face of recoding efforts (Spamann 2006). Second, legal rules are embedded in a host of other complementary rules and institutions. Without a better understanding of the context in which a specific set of rules has emerged as well as the

environment in which they are to be inserted, the simple transfer of law as technology is meaningless. Third, treating proxies as the real thing may confuse symptoms with causes. In fact, legal origins turn out to have little power to explain the effectiveness of legal institutions, a variable that is closely associated with economic growth (Berkowitz, Pistor, and Richard 2003a).

Assumptions and Problems

Having sketched the intellectual history of the prevailing view of the relation between law and capitalism and its real-world impact, we now highlight the assumptions—some hidden, some obvious—on which it rests. First, from Weber to La Porta and colleagues, causation is assumed to run in one direction: from law to economic institutions and growth. Once law is in place it falls out of the analysis.[13] Second and in related fashion, a legal system's position in relation to markets is taken as exogenous and fixed. Law is treated as if it were imposed from somewhere outside markets and economic activity—as a precondition to them, as just noted—and then serves as a stable and unchanging foundation for economic life. From this perspective, which has been firmly reinforced in the law and finance literature, law is heavily path-dependent, in that crucial features of a country's economic structures are dictated by the historical origin of its legal system. According to this view, the development of economic institutions is channeled through law as a result of long-ago events such as colonization or military conquest. Third and more implicitly, the operative function of law vis-à-vis market activity is almost universally deemed to be *protection*—of property rights generally and of investors' rights specifically—in the law and finance literature. No serious consideration is given to the possibility that law might perform *other* key functions in support of economic activity. Finally, the prevailing view is projected as if law were the sole mode of governance in market-oriented societies. Social norms, self-regulatory organizations, best practices, and other rules for market activity that are not legally enforceable have generally found little place in the analysis of the ways law supports an economy, particularly in the law and finance literature and subsequent work.

The role of social norms and other informal mechanisms of governance has been the subject of vast recent research, of course. (Most notably, North's work on institutions contemplates a major role for beliefs and other informal constraints. Aoki [2001] and Greif [2006] define institutions as sustainable systems of expectations and beliefs; this definition does

not draw a fine line between formal and informal institutions.) Moreover, few scholars or policy makers would consciously subscribe to a completely law-centric view. Yet the obvious tension between the importance of nonlegal mechanisms of governance and the conception of the rule of law as consisting solely of legally enforceable rules has not been addressed head-on (perhaps because nonlegal mechanisms are difficult to observe and incorporate into formal models, regression analyses, and reform programs). Instead, the literature and policy programs suggest that societies either thrive economically with "high-quality law" or falter without it.[14]

Many of these assumptions stem from a deeper underlying assumption: that law is a *politically neutral* endowment. But law is obviously a product of human interaction. This basic fact rarely enters the analysis of the way in which law contributes to economic performance. As we noted above, economists are fond of saying that the rule of law must be put in place as a precondition of economic growth. We recognize that this is rhetorical shorthand, but it is telling that economists—so meticulous about certain aspects of their analysis—seem uninterested in the process by which countries acquire and use law, even when law is the explanatory variable in their analyses. The bulk of the new empirical literature about corporate governance, for example, treats law as completely exogenous to markets (La Porta et al. 1998). This is an important statistical move for the producers of this research, because it deflects criticism of multi-colinearity in the use of legal rules as explanatory variables. The methodology has been justified on the ground that many countries have transplanted their law from abroad during periods of colonization or conquest, so the legal rules used in the regressions are not the products of interactions that could simultaneously affect the dependent variables for economic institutions and outcomes. But it conflicts with a proposition that the same literature makes elsewhere, namely, that the original institutions that gave rise to the emergence of a legal system, in particular the invention of the jury system was determined by political conditions, namely, a weak monarch and powerful local interests in England. If politics matter at the outset, why should politics not matter for the subsequent development of legal systems?

We argue that whatever its original source, in order for law to perform any useful function in support of markets it must fit local conditions and thus must continuously evolve in tandem with economic, social, and political developments.[15] As we explore extensively in chapter 10, exogenously imposed law rarely fits conditions in the host country without considerable adaptation by the local law-making community (Berkowitz, Pistor, and Richard 2003a). But adaptation to create a closer fit is unlikely to occur

if nonlegal substitutes are available to perform the needed functions at lower cost or if the legal transplant was motivated by factors not closely related to the functional, social, or political needs of the host country (Kanda and Milhaupt 2003). In other words, the economics literature implicitly considers only the "supply" of law in a given society, completely neglecting the role of demand.[16] This is true even when political analysis explicitly enters the discussion. In a paper that builds on the law and finance literature, Djankov et al. (2003) develop an analytical framework for assessing the likely impact of transplanting common law or civil law to developing countries or transition economies. In this framework, a country's legal system is the intersection of the transplanted legal system with a country's "institutional possibility frontier" (IPF), which in turn is a function of a country's location on a continuum between autocracy and disorder. This framework denies the possibility that the preexisting institutions and the transplanted law both are moving targets and that the dynamic interplay between the two may produce outcomes that are well beyond the schematic predictions of this model. A good example of how transplanted private law can be transformed into mechanisms of state control is Russia's bankruptcy law, discussed in chapter 8.[17] Treating a legal institution as a black box implies that the core of any legal system, in particular the strategic use of law by key players, is ignored. In short, because the economics literature poorly conceptualizes where law comes from, its explanations for variations across countries in the use of law to govern economic activity are not very convincing.[18]

We address the problems with these assumptions in considerable detail throughout the book. For now, simply consider some facts about law and economic growth that are deeply problematic for the prevailing view with its emphasis on institutional endowment. All of the law and finance literature is based on recent economic performance—mostly using data from the 1990s, with the most expansive research based on the period from 1960 to 2000. Viewed through a broader historical lens, however, the link between legal origin and economic growth falls away. Our research shows that origin of a legal system has poor predictive power with respect to high and low rate of economic growth for a large sample of countries over long periods of time. We examined data from 1870 to 2000, and divided it into four widely recognized periods of economic history. In every period, countries belonging to at least one civil law family have grown faster than the common-law countries, and in the three most recent periods, spanning virtually the entire twentieth century, either the Scandinavian or the German civil-law countries have grown faster than

Table 1.1 Legal Originas and Economic Growth

Average annual per capita growth rate	1870–1913 (1)	1913–1950 (2)	1950–1973 (3)	1973–2000 (4)	1870–1913 (5)	1913–1950 (6)	1950–1973 (7)	1973–2000 (8)
Common law	−.00081	.00036	−.00585	.01318	—	—	—	—
	(.00289)	(.00333)	(.00937)	(.00809)				
Civil law	—	—	—	—	—	—	—	—
English legal origin	—	—	—	—	—	—	—	—
French legal origin	—	—	—	—	.00043	−.00078	−.00354	−.02112***
					(.00313)	(.00319)	(.00863)	(.00762)
German legal origin	—	—	—	—	−.00016	−.00721	.06187***	.03078**
					(.00427)	(.00435)	(.01450)	(.01279)
Scandinavian legal origin	—	—	—	—	.00471	.01403**	.00645	−.00670
					(.00523)	(.00533)	(.01823)	(.01608)
Constant	.01596***	.01292***	.05023***	.02267***	.01514***	.01328***	.04437***	.03585***
	(.00156)	(.00180)	(.00523)	(.00452)	(.00247)	(.00251)	(.00689)	(.00608)
Observations	48	48	77	77	48	48	77	77
R^2	0.0017	0.0003	0.0052	0.0342	0.0202	0.2301	0.2397	0.2289
Adjusted R^2	−0.0200	−0.0215	−0.0081	0.0213	−0.0466	0.1776	0.2085	0.1973
F-test of overall significance	0.08	0.01	0.39	2.65	0.30	4.38***	7.67***	7.22***

Standard errors in parentheses.

****, **, * indicate significance at 1%, 5%, and 10%, respectively.*

the common-law countries, at a high level of statistical significance (see table 1.1).

After controlling for a variety of other factors that may influence growth, such as a country's initial GDP in a given period, population growth, and educational attainment, legal origin still has weak predictive power for growth over a long sweep of time. Moreover, our research shows that numerous countries have made the leap from low to high growth, frequently in succeeding periods of economic history, suggesting that the origin of a country's legal system does not pose a significant constraint on its prospects for growth. This research is consistent with the findings of Hausmann et al. (2005), who find more than eighty "growth accelerations" in countries around the world after World War II. Few of these accelerations have been sustained. Most important, existing economic theories only weakly predict when growth accelerations are sustained and when they fizzle out.

China's recent rise as an economic power poses another major challenge to the prevailing wisdom (F. Allen, Qian, and Qian 2005; Clarke, Murrell, and Whiting 2006). China's GDP has grown at an annual rate of more than 9 percent for two decades, yet its legal system is highly underdeveloped, its corporate governance is problematic, and its capital market is small. As Clarke, Murrell et al. (2006, 26) conclude, "[T]he experience of the reform era in China seems to refute the proposition that a necessary condition for growth is that the legal system provide secure property and contract rights." Yet China is simply the most recent and most dramatic illustration of the fact that numerous high-growth economies throughout the twentieth century lacked the type of legal protections associated with economic growth according the prevailing view. If the prevailing theory cannot explain some of the most remarkable growth stories in history (which, as we will see, include the experience of Korea and arguably Japan as well as China), it may be time to readjust our thinking about the relation between law and capitalism.

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.

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

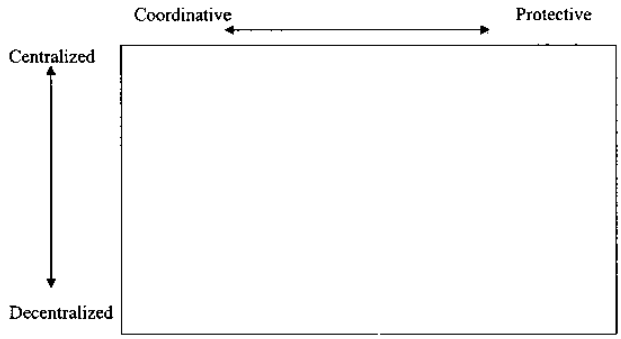

Figure 2.1. Legal systems matrix

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.

13. As discussed in chapter 1, the notion that mechanisms of governance may be more or less centralized is not new, but the implications of the relative centralization of legal systems have not been consistently explored.
14. Note that we do not claim that the legal system is actually capable of a complete and clear allocation of rights. Instead, we are referring to the aspirations of legal systems as reflected in substantive law and in the legal mechanisms available for enforcement of rights.
15. See Banner (1998).
16. Characteristically, Weber defined "law" not by reference to some commonly accepted usage of the term but according to his own conceptual framework. Weber believed that social conduct has validity to the extent that it complies with legitimate order. He calls that order "law" when violation is likely to be met with coercion of some kind exercised by a group of people who stand ready to perform that role. This conceptual framework studiously avoids exclusive reference to state-created law enforced by agents of the sovereign. Rheinstein (1954), lxiii.

CHAPTER ONE

1. Chen (2003) includes this nuance after reciting the prevailing view.
2. These authors' article, "Law and Finance" (1998), provided the name by which this line of research would come to be known.
3. Because the focus of these studies was financial market development, they excluded countries that had not developed a meaningful stock market. Subsequent studies, however, include a larger set of countries.
4. For a full list of publications by this group (with various others), see Rafael La Porta's home page at http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/publications.html.
5. Note that in some regressions the negative impact of the French legal system disappears, but the overwhelming evidence produced by this line of scholarship places common law above (French) civil law systems in relation to financial market development.
6. In fact, the notion that legal institutions can be separated from a country's sociopolitical governance structure distinguishes modern-day endowment theorists from Max Weber, who was deeply concerned with the interaction between legal and sociopolitical structures and the institutions they produced (Weber 1968). To be fair, La Porta and colleagues have not openly endorsed the exportation of the legal indicators that, their studies suggest, are conducive to development—but neither have they objected to others (Levine 1999), including the World Bank, using their work to this end.
7. In particular, Djankov et al. (2003) criticize North and others for excluding politics from their analysis.
8. For an exception see La Porta et al. (1999).
9. Legislatures still have a role to play in a system dominated by courts that hear cases brought by individuals. Their role, however, is confined to correcting case law gone astray. Clearly, this argument assumes a benevolent legislature, the existence of which is denied in Hayek's critique of centralized law-making patterns.
10. See, e.g., World Bank (1996), in particular chap. 5, p. 87 concerning legal institutions. See also chapter 3 (esp. p. 48) regarding property rights and enterprise reform. The World Bank has funded much of the group's subsequent research.
11. http://www.doingbusiness.org/.

12. In the original law and finance paper, the authors avoid this shortcut by pointing out that "France and Belgium, after all, are both very rich countries." See La Porta et al. (1998), 1152.
13. For an attempt to conceptualize the endogenous evolution of institutions, see Aoki (2001) and Greif (2006).
14. See, e.g., Eiras (2003, 3): "The rule of law is the only mechanism that a society has to punish crime, protect private property, enforce contracts, and maintain reforms."
15. See also Aoki (2001) and Greif (2006).
16. As discussed in chapter 10, demand has entered the existing analysis only in very general evolutionary theories of legal change.
17. Russia's 1997 bankruptcy law was modeled on the new German version, which in turn had been inspired by the U.S. bankruptcy law of 1978. See Black and Tarassova (2003).
18. The literature about economics provides no explanation for in-country variations in the use of law to govern markets. Variations of this sort are very problematic for the canonical view.

CHAPTER TWO

1. The extent to which they are addressed by the legal system in a given country requires a further level of analysis, which we provide below.
2. Some scholars have coined the terms "rolling rules" and "rolling regulation" to describe a recent trend toward using ongoing benchmarking and information exchange as a regulatory approach, in contrast to the command-and-control style of regulation (Dorf and Sabel 1998). We borrow the term "rolling" but use it to describe the larger phenomenon of ongoing, mutual influence that has always characterized the development of law and markets. A more technical approach is to describe institutions as endogenously created. See Greif (2006).
3. This relation does not mean that we exclude the possibility that legal change might be triggered by factors other than markets. In fact, legal change frequently occurs to correct problems encountered with existing law (that is, endogenously) because of poor drafting, because the legislature originally failed to anticipate the ways a law might be applied to real-world cases, or because the law proved ineffective.
4. Winter et al. (2002).
5. Lamfalussy (2001).
6. In the United Kingdom, the Department of Trade and Industry typically assembles committees comprising legal practitioners and business people for the purpose of reforming the country's company law. In Delaware, changes in corporate law are proposed by a legislative committee, which includes members of the bar with great expertise in matters of corporate law.
7. A prime example is the Takeover Directive. The High Level Group of Company Law Experts' proposals were substantially watered down in the directive as finally enacted.
8. Yet Delaware does not enjoy a monopoly on the regulation of corporate affairs. Its dominant role in corporate law has been checked to some degree by the massive growth of securities regulation at the federal level, from the enactment of the securities laws in 1933 and 1934 through the passage of the Sarbanes-Oxley Act in 2002 (Roe 2002). These major federal interventions were triggered by a severe market downturn and a major corporate governance scandal, respectively, which empowered interest groups that have little or no influence in the lawmaking process in Delaware (Roe 2005).

9. According to art. 4 of the French Civil Code, judges have the obligation to interpret the law; art. 5 prohibits them explicitly from making law. Article 5 states : "Il est défendu aux juges de prononcer par voie de disposition générale et réglementaire sur les causes qui leur sont soumises." (The code is available in English and French at http://www.legifrance.gouv.fr/html/index.html.) For a discussion of judicial interpretation of the code in France, see Germain (2003).
10. The most famous examples are typically drawn from the area of torts, in which courts have reinterpreted the provisions of the code—arguably *contra legem*—in order to respond to the needs of an industrializing country with growing numbers of car accidents and increased product liability. The famous case that introduced essentially strict liability into French tort law is *Jand'heur v. Les Galeries Belfortaise*, Cass. ch. réun. (February 13, 1930), 1930 D.P. I. 57 (Cours de Cassation).
11. When we say "protective," we do not mean that such a legal system necessarily provides greater substantive protections than does a coordinative legal system. We use the term to characterize legal systems that specify desired substantive rights or outcomes and allocate residual enforcement rights to private parties.
12. Although monitoring of property rights and enforcement of contract rights are sometimes analyzed separately in the literature, we view the two as subspecies of the protection function of law.
13. The varieties-of-capitalism literature has come under substantial critique lately, mostly because the explanatory variables used to characterize the system have lost much of their power. See, e.g., Siaroff (1999). For a more comprehensive reassessment see Streeck and Thelen (2005).
14. For a comparative analysis of the U.K. and U.S. takeover regimes, see Armour and Skeel (2006).
15. For a review of the range of pre-bid defenses available in legal systems across the European Union, compare Winter et al. (2002).
16. Note that the legal dispute in the Mannesmann case, which we discuss in greater detail below, was not so much about absolute pay levels but the ability of a board or committee to grant extra compensation ex post. The public debate, however, focused on the amounts that changed hands.
17. As discussed in chapters 8 and 9, Russia's legal practice at times resembles hierarchy more than coordination. But among the countries we analyze this is the exception, not the rule.
18. See Kenworthy (2000) for the corporatism debate and La Porta, Lopez-de-Silanes, and Shleifer (2006) for the legal origins debate, wherein the proponents of the legal origin classification system concede that the "French effect" disappears in some of the specifications when one tests the quality of securities regulations.
19. A useful definition is provided by Posner (1997, 365): a norm is simply a rule that is not promulgated by an official source nor enforced through legal sanction, yet is regularly complied with.
20. Note that the tendency to define governance devices that are not legally enforceable principally in contradistinction to their legally enforceable counterparts—as "non-law," "soft law," and so on—implicitly suggests their inferiority. Posner (1996) uses game theory to argue that norms are often inferior to formal law as a means of dealing with social dilemmas of coordination and cooperation. We note only that every society, from the most to the least economically successful, uses a wide array of governance devices. Like a discussion of whether a hammer is a better tool than

a screwdriver, there does not seem to be much point in debating whether law is superior to nonlaw as a means of governing the economy.

21. One of the great internal contradictions of the literature that follows from the work of La Porta et al. is that while it recognizes the political origins of legal systems as in Djankov et al. (2003), it fails to incorporate this insight into the analysis of the operation of legal systems.
22. This point is not novel (Upham 2002), and the impact of politics (in the sense of left or right political preferences) on law has been used to explain differences in economic outcomes, specifically corporate governance structures, around the world (Roe 2000). Gourevitch and Shinn (2005) argue that political preferences determine law, which in turn drives corporate governance.
23. We want to emphasize that we are not claiming, as was fashionable in the 1980s, that "industrial policy" set by smart bureaucrats created Japan's economic success. Quite to the contrary, we are arguing that the ground rules for economic activity emerged from intense interactions between the public and the private sectors in which bureaucrats played an important coordinating role that is sometimes played by legal institutions in other systems. Nor do we claim that the informal ground rules developed in Japan were always optimal for economic activity. As with law, sometimes the informal ground rules lacked predictability or provided poor incentives for market actors.
24. Note that the reach of informal mechanisms of governance is, to considerable extent, a function of information costs. Advances in information technology have dramatically reduced information costs, suggesting that the demand for legal governance should have declined, at least in some markets. Arguably, the development of the relatively "law-free" environment of the Internet is consistent with this prediction.
25. By contrast, incumbents may be slow to realize the growing discrepancy between the prevailing institutional setup and what is feasible or even necessary. See Greif (2006, 338). Our institutional autopsies of the Mannesmann case and the SK case illustrate this point.
26. Black and Kraakman reject a purely enabling model for Russia's corporate law. Instead they opt for what they term a "self-enforcing model"—somewhere between the extremes of an enabling model and mandatory law. See Black and Kraakman (1996).
27. In the European Union in particular, a growing chorus is advocating a change in mandatory capital maintenance rules that were the hallmarks of the early directives that harmonized law. See Wymeersch (1999). This, however, has not yet been translated into actual changes to these directives.

CHAPTER THREE

1. Readers who desire detailed accounts of the scandal itself can turn to a host of other sources (e.g., Rapoport and Dharan 2004).
2. Several years later, the Supreme Court overturned Arthur Andersen's criminal conviction—far too late to save the firm.
3. For example, a single book of collected works about Enron (Rapoport and Dharan 2004) contains a number of conflicting hypotheses advanced by various commentators: (1) "Enron is more a tale of greed and ego run amok than it is a tale of why certain business models fail" (89); (2) "The Enron meltdown is a result of massive failure of corporate control and governance" (122); (3) the "problem with viewing