The Economic Consequences of Legal Origins

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In the last decade, economists have produced a considerable body of research suggesting that the historical origin of a country’s laws is highly correlated with a broad range of its legal rules and regulations, as well as with economic outcomes. We summarize this evidence and attempt a unified interpretation. We also address several objections to the empirical claim that legal origins matter. Finally, we assess the implications of this research for economic reform.

I. Introduction

About a decade ago, the three of us together with Robert Vishny published a pair of articles dealing with legal protection of investors and its consequences (La Porta et al. or LLSV, 1997, 1998). These articles generated a fair amount of follow-up research, and a good deal of controversy. This paper is our attempt to summarize the main findings, and more importantly to interpret them in a unified way.

LLSV started from a proposition, standard in corporate law (e.g., Clark 1986) and emphasized by Shleifer and Vishny (1997), that legal protection of outside investors limits the extent of expropriation of such investors by corporate insiders, and thereby promotes financial development. From there, LLSV made two contributions. First, they showed that legal rules governing investor protection can be measured and coded for many countries using national commercial (primarily corporate and bankruptcy) law. LLSV coded such rules for both the protection of outside shareholders, and the protection of outside senior creditors, for 49 countries. The coding showed that some countries offer much stronger legal protection of outside investors’ interests than others. Second, LLSV documented empirically that legal rules protecting investors vary systematically among legal traditions or origins, with the laws of common law countries (originating in English law) being more protective of outside investors than the laws of civil law (originating in Roman law) and particularly French civil law countries. LLSV further argued that legal traditions were typically introduced into various countries through conquest and colonization, and as such were largely exogenous. LLSV then used legal origins of commercial laws as an instrument for legal rules in a two stage procedure, where the second stage explained financial development. The evidence showed that legal investor protection is a strong predictor of financial development.

Subsequent research showed that the influence of legal origins on laws and regulations is not restricted to finance. In several studies conducted jointly with Simeon Djankov and others, we found that such outcomes as government ownership of banks (La Porta et al. 2002), the burden of entry regulations (Djankov et al. 2002), regulation of labor markets (Botero et al. 2004), incidence of military conscription (Mulligan and Shleifer 2005a,b), and government ownership of the media (Djankov et al. 2003c) vary across legal families. In all these spheres, civil law is associated with a heavier hand of government ownership and regulation than common law. Many of these indicators of government ownership and regulation are associated with adverse impacts on markets, such as greater corruption, larger unofficial economy, and higher unemployment. In still other studies, we have found that common law is associated with lower formalism of judicial procedures (Djankov et al. 2003b) and greater judicial independence (La Porta et al. 2004) than civil law. These indicators are in turn associated with better contract enforcement and greater security of property rights. Assuming that this evidence is correct, it raises an enormous challenge of interpretation. What is the meaning of legal origin? Why is its influence so pervasive? How can the superior performance of common law in many areas be reconciled with the high costs of litigation, and well-known judicial arbitrariness, in common law countries?

In this paper, we adopt a broad conception of legal origin as a style of social control of economic life (and maybe of other aspects of life as well). In strong form (later to be supplemented by a variety of caveats), we argue that common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations. In words of one legal scholar, civil law is “policy implementing”, while common law is “dispute resolving” (Damaska 1986). In words of another, French civil law embraces “socially-conditioned private contracting,” in contrast to common law’s support for “unconditioned private contracting” (Pistor 2006). We develop an interpretation of the evidence, which we call the Legal Origins Theory, based on these fundamental differences.

Legal Origin Theory traces the different strategies of common and civil law to different ideas about law and its purpose that England and France developed centuries ago. These broad ideas and strategies were incorporated into specific legal rules, but also into the organization of the legal system, as well as the human capital and beliefs of its participants. When common and civil law were transplanted into much of the world through conquest and colonization, the rules, but also human capital and legal ideologies, were transplanted as well. Despite much local legal evolution, the fundamental strategies and assumptions of each legal system survived, and have continued to exert substantial influence on economic outcomes. As the leading comparative legal scholars Zweigert and Kotz (1998) note, “the style of a legal system may be marked by an ideology, that is, a religious or political conception of how economic or social life should be organized” (p. 72). In this paper, we show how these styles of different legal systems have developed, survived over the years, and continued to have substantial economic consequences. In our conception, legal origins are central to understanding the varieties of capitalism.

The paper is organized as follows. In Section 2, we describe the principal legal traditions. In Section 3, we document the strong and pervasive effects of legal origins on diverse areas of law and regulation, which in turn influence a variety of economic outcomes. In Section 4, we outline the Legal Origins Theory, and interpret the findings from that perspective. In sections 5-7, we deal with three lines of criticism of our research, all organized
around the idea that legal origin is a proxy for something else. The three alternatives we consider are culture, politics, and history. Our strong conclusion is that, while all these factors influence laws, regulations, and economic outcomes, it is almost certainly false that legal origin is merely a proxy for any of them. Section 8 briefly considers the implications of our work for economic reform, and describes some of the reforms that had taken place. Many developing countries today find themselves heavily over-regulated in crucial spheres of economic life, in part because of their legal origin heritage. Legal Origin Theory, and the associated measurement of legal and regulatory institutions, provides some guidance to reforms. Section 9 concludes the paper.

IX. Conclusion

Since their publication about a decade ago, the two LLSV articles have taken some bumps. We now use different measures of shareholder protection, and are skeptical about the use of instrumental variables. Our interpretation of the meaning of legal origins has evolved considerably over time. But the bumps notwithstanding, the basic contribution appears to us to still be standing, perhaps even taller than a decade ago.

And that is the idea that legal origins – broadly interpreted as highly persistent systems of social control of economic life -- have significant consequences for the legal and regulatory framework of the society, as well as for economic outcomes. The range of empirically documented legal, economic, and social spheres where legal origins have consequences has expanded over the past decade.

At the end of our overview, we believe that four propositions are correct, at least given the current state of our knowledge. First, legal rules and regulations differ systematically across countries, and these differences can be measured and quantified. Second, these differences in legal rules and regulations are accounted for to a significant extent by legal origins. Third, the basic historical divergence in the styles of legal traditions – the policy-implementing focus of civil law versus the market-supporting focus of common law – explains well why legal rules differ. Fourth, the measured differences in legal rules matter for economic and social outcomes.

The fact that the outlines of a coherent theory have emerged over the last decade does not mean that all, or most, of the empirical issues have been settled, or, for that matter, that the theory will survive further scrutiny. From our perspective, the crucial open questions deal with the evolution of legal systems: How do they deal with crises? How do they enter new spheres of regulation? How do they approach reforms? We have offered many illustrations from the historical record, but a comprehensive account of legal and regulatory evolution under common and civil law does not exist.

Such an account might clarify an issue that has generated tremendous heat, and not much light, throughout this research, namely the circumstances under which each legal tradition “works better.” Legal Origins Theory does not point to the overall superiority of common law; to the contrary, it points to the superiority of civil law and regulatory solutions when the problem of disorder is sufficiently (but not too) severe. On the other hand, our attempt to find evidence for the commonly made defense of civil law that it provides greater fairness or better access to justice have failed; the data suggest the opposite (Djankov et al. 2003b).

A deeper understanding of the dynamics of legal traditions may also inform the crucial question of whether the differences between common and civil law will persist into the future. Since we have shown legal origins to be closely related to the types of capitalism, this question can be rephrased as follows: what kind of capitalism is likely to prevail in the long run? Will it be the more market-focused Anglo-Saxon capitalism, or the more state-centered capitalism of Continental Europe and perhaps Asia?

There are many arguments for convergence. Globalization leads to a much faster exchange of ideas, including ideas about laws and regulations, and therefore encourages the transfer of legal knowledge. Globalization also encourages competition among countries for foreign direct investment, for capital, and for business in general, which must as well put some pressure toward the adoption of good legal rules and regulations.

The convergence is working both by civil law countries increasingly accepting common law solutions, and vice versa. In one area where heavy regulation appears patently absurd – the entry of new firms – countries are rapidly tearing down the barriers. In Europe at least, there are some reductions in labor regulations, as well as gains in shareholder rights. At the same time, common law countries are increasingly resorting to legislation to address social problems, the Sarbanes-Oxley Act being the most recent example of such financial regulation in the U.S. Mediating against convergence is the fact that civil law countries continue to resort to “policy-implementing” solutions to newly arising problems. The bias toward using state mandates to solve social problems, such as the 35 hour workweek in France, is huge.

All this, of course, leaves open the question of what legal rules and regulations the countries are likely to move toward, even if they do not converge. So, in conclusion, let us again rely on theory to make a prediction. The world economy in the last quarter century has been surprisingly calm, and has moved sharply toward capitalism and markets. In that environment, our framework suggests, the common law approach to social control of economic life performs better than the civil law approach. When markets do or can work well, it is better to support than to replace them. As long as the world economy remains free of war, major financial crises, or order extraordinary disturbances, the competitive pressures for market-supporting regulation will remain strong, and we are likely to see continued liberalization. Of course, underlying this prediction is a hopeful assumption that nothing like World War II or the Great Depression will repeat itself. If it does, countries are likely to embrace civil law solutions, just as they did back then.