10. Market Institutions and Judicial Rulemaking

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1. Introduction and Summary

The proper functioning of a market economy requires that freedom of contract be protected effectively. This can be achieved in different ways. A major design decision concerns the rulemaking discretion that the legislator delegates to the courts. When taking this decision, the legislator should take into account the specialization advantages and transaction costs that come with more or less specialized rulemaking. Factors influencing this trade-off explain the different solutions adopted in the two main legal traditions of the West. Common law evolved keeping more rulemaking powers in the judiciary, and thus was characterized by unspecialized rulemaking. The civil law tradition, however, was transformed during the 19th century, reserving greater rulemaking power for the legislative branch and thus reducing the discretion that judges had enjoyed during the Ancient Regime.

By stressing this difference, some recent studies claim that common law legal systems provide superior solutions to those developed in the civil law tradition, in which judges have less rulemaking power. This chapter criticizes these claims by developing and testing an alternative "self-selection" hypothesis, according to which both common and civil law supported a transition to the market economy adapted to local circumstances. In particular, judicial discretion, which is seen here as the main difference between the two legal systems, is introduced in civil law jurisdictions to protect, rather than limit, freedom of contract against a potential judicial backlash. This protection was unnecessary in common law countries, where free-market relations enjoyed safer judicial ground mainly due to their relatively gradual evolution, their reliance on practitioners as judges and the earlier development of institutional checks and balances that supported private property rights.

From this adaptation perspective, we see that much of the discussion on the "efficiency" of both legal traditions (pioneered by Posner, 1973; Priest, 1977; Rubin, 1977, 2000; and further developed by Cooter and Kornhauser, 1980; Terreborne, 1981, and Katz, 1988) focuses on relevant but relatively minor matters. This is compounded in recent comparative studies by the difficulty for such empirical comparisons of distinguishing causalities from correlations and by the fact that performances are observed only for those choices that were

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effectively taken, while the relevant comparison would be between the chosen option and its unobserved alternative. Such analyses therefore provide shaky grounds for policy recommendations and this may explain the recurrent paradox that, even though these empirical comparisons support the claim that common law is superior to civil law for the development of financial markets (e.g., La Porta *et al*., 1998: 1148) and economic growth (Mahoney, 2001), both transition and emerging economies opt for statute law for creating the legal basis of such markets, following the regulatory model of developed economies, which for many decades has been based on statutes.[1]

Our discussion therefore broadens the argument by Rubin (1982) that both common law and civil law facilitated freedom of contract and were *efficient* in the 19th century. Without claiming anything regarding "efficiency," however, we argue that both common law and civil law solutions were well adapted to their particular circumstances. Considering that the value of legal systems depends not only on their specific traits but also on good environmental fit, we aim to identify the local circumstances which defined the balance of the institutional trade-off. Further work is needed, however, to develop and test the conjecture that the problem of transition and developing economies resembles the challenge of creating market institutions in 19th century Europe rather than the remote, evolutionary emergence of such institutions in common law countries.

The remainder of the Chapter is organized as follows. In Section 2 we state our hypothesis concerning the evolution of common and civil law. We argue that common law countries featured greater judicial discretion because, given their more gradual evolution away from the Ancient Regime, judges did not threaten the development of a modern market economy. Civil law reformers, in contrast, placed more rulemaking in the hands of the legislature and limited the discretion of judges in an attempt to shelter free-market relations, especially freedom of contract, from a potential judicial backlash. Both of these policies, promulgating systematized default rules and reducing judges' discretion, shared the same goal, that of protecting freedom of contract and promoting market relationships and economic prosperity in areas previously suffering from mandatory rules and judicial regulation of private contracts. We then confirm the consistency of our argument by reviewing the relevant historical evidence, in Section 3, and the alternative explanations provided in recent comparative performance of legal systems, in Section 4. In particular, Section 3 analyzes the historical evidence on the evolution of both legal traditions which seemingly culminated at the end of the 19th century. Then, in Section 4, we compare our argument with those produced in the recent debates on the comparative efficiency and performance

[1] This selection of statute law has even been interpreted as a selection of specific legal origins within civil law, as in the first of the annual *Doing Business* reports, which are based on methodologies developed within the "Law and Finance" literature and, specially, La Porta *et al*. (1998) and Djankov *et al*. (2002, 2003). In particular, *Doing Business 2004* classified 19 of the 30 jurisdictions which had formerly been considered of Socialist legal origin within that literature (La Porta *et al*., 1999) as of either French or German legal origin. At the same time, 11 of these 30 countries remained classified as being of Socialist origin, and none was reclassified as having a common law origin (World Bank, 2004, 115–117).

of common and civil law. We contend that both theoretical and empirical claims on the superiority of common law remain unproven. Legal systems are not efficient in a vacuum, but rather their performance depends on environmental conditions. Section 5 concludes offering some conjectures on viable policies, acknowledging the idea that legal systems must fit their environment.

2. The Allocation of Rulemaking Powers

In modern economies, wealth creation depends substantially on market exchange, which requires a legal environment capable of increasing the capacity of parties to define the wealth-enhancing terms of trade and to enforce their agreements. Two key elements of this legal environment are rules and courts. Rules, given by customs, previous judicial sentences and statutes, provide parties with a detailed default contract and also predetermine the terms of trade when the law so mandates. Courts fill in the gaps in the contract and the received set of rules, define the terms of exchange for all remaining unforeseen contingencies, and also provide last-resort enforcement of contractual agreements. The presence of courts thus saves on contractual and enforcement costs for all parties. They also perform various functions with respect to rules: from merely enforcing statute law to creating and modifying rules.

For our purposes, rules may be made by a central authority, like the legislature, or by courts. In addition, judicial rulemaking becomes more centralized when low-level courts must decide according to jurisprudence exclusively produced by some higher courts. Both of these dimensions of judicial discretion—the rulemaking authority enjoyed by the judicial system versus the legislature and the decentralization of its powers—are usually positively correlated, which allows us to treat judicial discretion as a single organizational variable on which the main difference between legal systems hinges.

The idealized model of common law, as it finally emerged in the 19th century, is characterized by greater discretion for courts because statute law plays a minor role and each court is relatively free to rule, originally even with respect to precedent. Common law developed in England and was imposed on the former British colonies. It creates legal rules in a relatively decentralized and bottom-up manner. Initiatives for new rules start at the local level when a case is decided by a judge who creates a new rule, which remains local until other judges use it in their rulings. Successful rules may eventually become accepted by all courts in the state. Rules therefore result from the interaction between plaintiffs, defendants, lawyers, judges and jurors, as courts are *relatively* free to decide each case by distinguishing from, reconciling with or disapproving an earlier case.

In contrast, the civil law model, as crystallized more or less at the same time, gives priority to legislative rulemaking. Courts are instructed to enforce the received law and, even for filling gaps in rules and contracts, lower-level courts have to comply with the jurisprudence created by higher courts. Civil law is more

centralized since the starting point for most new rules is legislation that applies to the whole State territory and not only to the jurisdiction of one court. This legal tradition is based on Roman law and is dominant in Continental Europe, Japan, Turkey, and the former colonies of France, Italy, Portugal and Spain. In civil law, judges are required to apply the rules, defined both by statutes and established case law (jurisprudence). Judges also fill the gaps in contracts and rules in a manner similar to common law judges but with greater centralization, as explicit jurisprudence is only produced by repeated and consistent rulings of certain higher courts. This different scope in the rulemaking capacity of the civil law judge is not substantially affected by the fact that even the ideal civil and common law models of the 19th century share many other features. For instance, in both paradigms, courts form a hierarchy and superior courts can overrule decisions from lower courts, which in any case have substantial freedom for interpretation, as can be seen in the fact that US appellate courts defer broadly to the trial judge's and jury's findings of fact (Posner, 1998: 584–586). The presence of these common characteristics should not, however, obscure the existence of a basic difference in the extent of judges' rulemaking discretion.

Additionally, common and civil law differ in other dimensions, such as the nature of the process, use of juries and justification of judicial decisions (Cooter and Ulen, 1997: 57). In common law, litigation is led by parties' lawyers while judges remain neutral referees who only ensure that the parties follow the rules of procedure and evidence. The idea behind this "adversarial" process is that the truth will emerge in the dispute between the two sides. In civil law, however, judges take a more active, "inquisitorial" role and parties often have to answer judicial questions, on the basis that judges have a direct interest in revealing the truth in private disputes. Common and civil law also differ in their reliance on juries, with civil law making limited use of juries, a feature that ties in with the lesser discretion and the inquisitorial role of the judge. Finally, judge-made law in common law countries is justified by reliance on precedent, social norms, or rationality. Judicial rulings in civil law countries are based more on the meaning of the code, with case law and rationality playing secondary roles. This difference also affects the way that lawyers are trained. Civil law is taught by studying the code and commentaries on it, while common law is learned by analyzing case law.

All kinds of rulemaking systems are likely to fail in achieving the public good because they pursue private interests or, even when pursuing the public good, they fail to ascertain which rules are most suitable, often triggering rent-seeking by parties to private contracts. We will argue that, in the development of Western legal systems, local circumstances like institutional checks and balances and judicial education condition the degree of judicial discretion.

We assume that predispositions towards the market order may develop differently among legislators and judges.[2] Consequently, legislators will allocate

[2] See Arruñada and Andonova (2004) for details.

rulemaking discretion to the judiciary considering the specific circumstances in each country. In particular, legislators creating market institutions may restrain judicial rulemaking to avoid judges' opposition to freedom of contract and market exchange. From this perspective, both Western legal systems might therefore be understood as adaptations to specific conditions that allow the development of effective market-supporting institutions in different historical circumstances.

In particular, modern market relations were introduced sooner in England, as many feudal constraints were abrogated earlier and the Industrial Revolution also took hold earlier, as well as more slowly, without such drastic changes in property rights as on the Continent. This creeping evolutionary process, together with a generalized respect of private property, gave time for judges and the public to be cultured in an intellectual tradition more propitious to the free market. In most of Continental Europe, however, modern market relations, suppressing the constraints that the Ancient Regime imposed on trade and movement of land and people, were generalized later and more abruptly, often together with redistribution of property. Most judges were then still the intellectual product of the Ancient Regime, in addition to forming part of the former ruling elite. Their lack of understanding of the market and disrespect for the institution of private property drove defenders of contractual freedom responsible for designing the institutions for continental markets to constraint judicial discretion.[3] From this perspective, we explain the restrictions imposed on judges in the civil law tradition, whereby they had to subject their rulings to contractual terms (whether defined explicitly by the parties or tacitly by default through statute law and jurisprudence) as an institutional control designed to protect market contracting.

3. The Test of History

We will now examine in more detail the evolution of both legal traditions to corroborate that the above arguments are consistent with their history. In essence, we will confirm that institutional checks and balances and judicial training shaped the common tendency towards market-based relationships in England and on the Continent in very different ways.

The Evolution of Common Law

The commencement of what was to become the English common law system dates back to the 12th century, when Henry II (1154–89) created a professional royal judiciary and enlisted local communities to participate in the administration of justice. The further development of English common law was shaped by

[3] It is possible that judicial discretion was to a certain extent already limited in the Roman law tradition from the 12th century but this did not prevent later evolution from *additionally* constraining judges' discretion.

the political struggle and the resulting balance between Crown and Parliament. The English Parliament was one of the few to survive from the Middle Ages, constantly increasing its control over the Crown (North and Thomas, 1988; Pipes, 1999). The result was a creeping shift of power from the Crown to the Parliament, eventually culminating in the Glorious Revolution, which limited further the Crown's right to tax and thus to interfere with private property rights but was only one more step in a relatively continuous process (North and Weingast, 1989). The English Parliament, staffed by merchants and landed gentry, then used its enhanced powers to ignite a series of market-oriented reforms based on the principle of non-interference with private property (North, 1981; North and Weingast, 1989).[4]

The success of the reforms was guaranteed as the common law courts and the English judiciary shared the Parliament's appreciation of property rights and its understanding of market mechanisms. The appointment of English judgeships depended to a much greater extent than elsewhere in Europe on professional practice, as English judges were chosen from among barristers. As such, they had seen the world from the perspective of the parties they had represented and were therefore more familiar and educated on the intricacies of the incipient market economy (Duman, 1982: 29; Abbott and Pendlebury, 1993). The understanding by English judges of the fundamentals of the market economy also benefited from the early checks imposed on royal authority, as these checks limited the ability of the Crown to sell new public offices (Swart, 1980), making judgeships secure investments and converting early common law judges into defenders of private property rights. As a result, the transformation of the feudal economy spurred on by Parliament received an early ally in the English judiciary which, by making incremental changes in long-standing customs, assisted the evolutionary development of common law toward the new market order.

The expansion of market opportunities by the Industrial Revolution demanded more substantial changes in terms of both more developed and uniform rules. Common law satisfied these demands during the 19th century, mainly through the introduction of many Roman law solutions, and the strengthening of the doctrine of binding precedent, by which courts are reluctant to interfere with principles established in previous decisions (*stare decisis*). Despite these changes, however, the development of common law towards more

[4] This view has been criticized by some historians for exaggerating the role of the English Parliament in creating a market-friendly institutional environment (for example, Carruthers, 1990; Clark, 1996; Epstein, 2000). These arguments do not question, however, the fundamental point that the English Parliament exerted much greater control over the Crown. In a similar vein, researchers point out that, even in the absence of strong parliaments, there were well-developed markets on the Continent, specifically credit markets (for instance, Hoffman, Postel-Vinay and Rosenthal, 2000). The dominance of agriculture in the economies of the 16th to 18th centuries should be kept in mind, however, when considering these markets as well as that market relations for trade in goods had been well-established in some areas of the Continent, earlier than in England, as shown by the history of Italian cities in the Middle Ages, the Hanseatic League or the Champagne fairs, to give just a few examples. This also applies, in particular, for ascertaining the importance of merchant law. The challenge for those creating the institutions of the modern market was to develop institutions not only for trade but mainly for transactions among non-merchants.

market-oriented institutions remained evolutionary in nature and its courts retained a high degree of discretion, both in England and the USA. This was for two reasons. First, because the introduction of Roman law took place mainly at the level of concepts, as codification attempts did not succeed, arguably because they were less necessary than on the Continent. (This divergence in the success of codification is consistent with the argument that continental codification was driven by the need to constrain judges, more than to systematize the law, which probably was equally unsystematic in England and on the Continent). In addition, common law lawyers did not merely borrow ideas from Continental jurists, but developed and adapted such ideas in their own way. Moreover, the legal development of common law, which supported the huge economic development of the 19th century, remained almost exclusively the work of courts, with few legislative initiatives. Second, the strengthening of the doctrine of binding precedent did not divert common law from its evolutionary path, as precedents could still be overturned with relative ease by distinguishing the case at hand from the one in the precedent. Together with the right of appeal, it was, however, important in ensuring consistency and equality across increasingly wider markets (Manne, 1997: 13–19). In any case, it is consistent with our argument that the doctrine of binding precedent was introduced at this time, as cheaper transportation via canal, rail and steamship, increased the size of the market, requiring faster adoption of legal standards in a wider geographic area.

American common law, to the extent that it was independent of English law, shows remarkable similarities. Until the 20th century, the US had an arrangement similar to the English system of competing courts, with State and federal courts. Court competition, however, was not so intense and judges were not paid on a fee basis. Many judges, however, were elected and this probably served as a substitute incentive mechanism in the absence of a fee for service. American common law judges also enjoyed great discretion which was marginally reduced in the 19th century by the adoption of the doctrine of binding precedent, first for procedural and later for substantive rules (Zywicki, 2003: 22).

Continental Law

Legal history in what are now civil law jurisdictions originally resembled that of English law. The evolution of civil law, however, was influenced by a relatively different balance of powers among the main political actors, as Parliaments in Continental Europe, with a few exceptions, rapidly lost their ability to impose controls on the Crown. Most monarchies became financially independent and a considerable part of their income no longer came from taxes needing previous parliamentary approval. As a result, absolutist Continental kings enjoyed unchecked power and interfered with relative ease with private property rights, thus hampering the development of market relations based on secure private property (North and Thomas, 1988; Pipes, 1999).

These institutional limitations were reinforced by the fact that Continental judges were appointed without previous practice (Doyle, 1996). In addition,

their training was based on the university study of *ius commune*, a doctrinal system developed mainly by scholars proficient in Roman and Canon law, and only secondarily affected by statutes and judicial rulemaking. It has been claimed that both the lack of practice and these doctrinal influences made Continental judges more resistant to capitalist wealth accumulation and hindered their understanding of market transactions. Market relationships, with their considerable exposure to risk and striving for profit, were hardly understood by a judiciary which derived most of its income and status from risk-free rents (Taylor, 1967). Judicial respect for property rights also probably suffered because judgeships were often expropriated by kings who were free to sell new judicial offices (Doyle, 1996; Swart, 1980). Thus, the judiciary on the Continent did not gradually erode the constraints of the Ancient Regime. Because of both institutional constraints and judicial training, civil law judges ended up constituting a barrier to the development of new market relationships. An abrupt change in both the law and the administration of justice was therefore necessary.

The Creation of Modern Civil Law

Consequently, the new legal order was mostly implemented in a top-down fashion even if it was essentially a liberal (that is, free-market-enhancing) initiative. Legislators issuing Civil and Commercial Codes in the 19th century aimed at both regulating what we would now call externalities and systematizing custom and case law, mainly through default rules. They did not promulgate mandatory rules unless they were necessary to establish basic political and economic principles of freedom, equality and property, often debasing interventionist legal doctrines (Van Caenegem, 1992). Their reliance on case law led to the codification of well-tried default rules, when available, without precluding parties from adapting contracts freely to their circumstances by writing specific clauses into them. In addition, codification benefited from the substantial convergence of doctrinal criteria that was already highly influential in courts' rulings because of the prevalent regime of judicial personal liability. As a result, 19th century codified law was mainly the distillation of customary law, and codes represented a combination of local customs, local laws and subsidiary Roman law (Sirks, 1998).[5]

In addition, most mandatory rules enacted at the time had a clear function in grounding the market economy. Probably the most important of these mandatory rules are a direct consequence of the political principles of freedom and equality, which have contractual correlates in terms of mandatory freedom of contract and mandatory equality of all contractual parties. (For example, previous law often granted higher probative status to the word of employers than to that of employees.) But this is also applicable to the emphasis of liberal reforms in avoiding the future entail of property, facilitating the emergence of a proper

[5] In particular, codifiers of commercial law, from the Code Savary in 1673 to the Uniform Commercial Code of 1970, relied heavily on the *lex mercatoria*, developed by merchant courts (Benson, 1998).

market for land.[6] Property law provides another interesting case in its treatment of a particular kind of externalities, those caused in the Ancient Regime by the proliferation of property rights and their enforcement as rights *in rem* even when they remained hidden to third parties. During the 19th century, land law reform and the creation of land registers led to a stricter policy of *numerus clausus* in most European countries—that is, the legal system started to enforce *in rem* only a limited number of rights, enforcing the rest as mere personal (in other words, contractual) rights. In parallel, publicity was increasingly required to produce rights enforceable *in rem*. Both of these constraints seem to diminish parties' freedom to produce rights *in rem* but in fact are essential for making some of them possible, reducing transaction costs in land and, in particular, making it possible to use land as collateral for credit (Arruñada, 2003), precisely the declared purpose of the reforms in this area.

Furthermore, operationally, civil law bound the judge to the law. This has often been seen only as a tool to enforce state law, disregarding the fact that, when the law set default rules, its main effect was to protect freedom of contract, because it made sure that the judge was constrained by the will of the parties. Therefore, the law protected the private legal order freely created by the parties, whereas under a system of greater judicial discretion this private legal order would have been in danger.[7] This fear drives the efforts of 19th century legislators to purge many dogmatic rules from received law, often rooted in Canon law, that were contrary to freedom of contract. A prominent example is the liberalization of credit transactions, which were still subject to substantial constraints, including the prohibition of interest and foreclosure.[8] Similarly, they often prohibited the judge from reducing the amount of penal clauses contractually established to punish the debtor for default in paying back a loan (Danet, 2002: 218). Most codes also derogated rules that had allowed courts to disregard some "unequal"

[6] Notice that, by the 17th century, common law had already developed the Rule Against Perpetuities, which enabled a court to declare void future or postponed interests in property that might possibly vest outside a certain perpetuity period. The goal was also to prevent land being tied up and to protect free markets.

[7] We pay no attention to private legal order solutions (of the type analyzed, for instance in Benson, 1989; Ellickson, 1991; Milgrom, North and Weingast, 1990; Bernstein, 1992, 1996, 2001; Greif, Milgrom and Weingast, 1994; Shavell, 1995), as we think they involve intrinsic difficulties for becoming the legal order for a modern capitalist economy. First, because the reliance of private enforcement on group membership limits its effectiveness to intra-industry trade, often on a personal level. Second, because they are only effective when state judges abstain from acting as appellate courts and they are permanently threatened by this possibility. Otherwise, private enforcement is only based on informal social sanctions, increasing its personal nature. This happened in particular with merchant courts, which, by being subordinated to royal courts in terms of appeals and enforcement, can be seen as mere local courts with an additional functional specialization.

[8] Until the 18th century, for example, French laws against usury outlawed short-term credits that were indispensable for commerce, industry and banking. Borrowers and debtors therefore had to spend substantially on circumventing the prohibition, which hindered the development of the financial market (Taylor, 1967: 480). Understandably, one of the main goals of the Napoleonic Code was to empower contractual parties to act on their own behalf, protecting them from anybody, including judges, who could alter the terms of their agreement (Mattei, 1997).

contractual clauses on the basis of scholastic "just price" arguments, such as the doctrine of "lesion."[9] More importantly, the scope of "cause" as a necessary element of any enforceable contract was considerably reduced (by reversing the burden of proof, for instance), and even fully eliminated in the "abstract" transaction of the German civil code, as well as, more generally, in the laws of mortgages and bills of exchange. This pruning of the concept of cause curtailed notably the possibilities of constraining contractual freedom with moral principles that the canonist interpretation of the original Roman concept had previously offered.

Understandably, legislators also tried to shelter legal reform from any reactionary backlash, including the possibility that judges would exert their discretion to issue sentences on the basis of abstract principles and against the new rules,[10] thus rendering the reform ineffective and hindering development towards the market economy. Legislators therefore subordinated the judiciary to the law and to jurisprudence, and restructured the professional career of judges.

Not only were codes and statutes given priority as a source of law, but the production of binding precedents was allocated to the higher court of appeals, which was conceived, at least originally, more as a court-controlling body than as a proper court. Its function was to supervise the legal interpretations given by lower courts, guaranteeing uniformity, making sentences predictable and enhancing legal security. Furthermore, no court had powers to question the constitutionality of legislation. In the French model, even controlling the legality of governmental action was assigned to a quasi-governmental body, the Conseil d'Étát.

In parallel, the practice of purchasing judicial offices was abolished and judges were converted into civil servants. They started their judicial career young and inexperienced, by passing specific exams after law school. Even today their promotions and salaries increase with seniority and sometimes with discretionary governmental appointments to the higher courts and other public offices. This meant that judges could lose substantial quasi-rents if they opposed the government or, even worse, were expelled from their positions. Compliance was further constrained in some countries by modifying their liability, making judges personally liable if they issued sentences contrary, not to dominant doctrinal opinion, as before, but to the statute law and formally established jurisprudence.

Summing up, our explanation as to why pro-market reformers in civil law countries reduced the discretion of the judiciary lies in the fact that in such

[9] Ascribing the doctrine of lesion to "the civil law," without warning of its removal or reduction by 19th century codifiers (as made, for example, by Cooter and Ulen, 1997: 191, 253), exemplifies the ambiguities that complicate comparisons between legal systems. See, for a detailed analysis, Abril Campoy (2003: 42–70).

[10] For example, Hayek (1960), among many others, emphasizes that the revolutionaries distrusted judges and their desire to control judicial discretion led them both to issue codes and to adopt more formalized legal procedures. This is confirmed by recent empirical evidence showing that civil law countries regulate the judicial process more thoroughly (Djankov *et al.*, 2003).

countries the transition to market economies was more revolutionary than in those under common law. Institutional change in England did not suffer the radical transformations that took place in Continental Europe at the end of the 18th and during most of the 19th century but followed a relatively smooth, evolutionary process, which started much earlier. In contrast, judiciaries in Continental Europe were structured with greater central control with a view to achieving and enforcing an intended change.[11]

4. A Critique of Alternative Explanations

Our interpretation of 19th century civil law as an adaptive top-down introduction of the market has important consequences for the arguments given in debates on the comparative efficiency and performance of common law versus civil law. The first of these debates started when part of the American "law and economics" school argued in favor of the efficiency of the solutions being used in 19th century common law. Later, the quest for institutional explanations of differences in economic performance has led to quantitative comparisons of multiple performance indicators across legal systems. Even though both of these explanations involve evolutionary arguments and path-dependency, they differ in an important way from our hypotheses, as they do not consider the possibility of adaptation to local circumstances as the main force behind divergent legal systems. Moreover, these alternative explanations fail to prove the universal superiority of common law arrangements which many of them more or less explicitly advocate. Consequently, they can lead to flawed policy when they neglect local circumstances which might strongly limit the feasibility of legal reforms.

The Efficiency Debate

The Efficiency of Common Law

The efficiency of common law was first suggested by Posner (1973), based on the metaphor that the decentralized creation of common law mimicked how the market worked, leading judges to unconsciously pursue an efficiency standard. This hypothesis has been successfully used to explain many common law rules, related to negligence, contributory negligence, strict liability, restitution and

[11] The evolutionary versus revolutionary nature of the transition was not the only historical accident having an influence on the adaptiveness of legal systems. Technological innovation after common law became entrenched may have also reduced the comparative advantage of judicial discretion. The conjecture is that, in common law jurisdictions, the market economy was established before the emergence of national markets, which mostly waited until the development of railways. Most codification in Europe took place when, thanks to the impact of rail transport, it became clear that markets would become much wider in scope. Understandably, legislatures strove to provide unified legal standards for the whole of the national market, as local rulemaking made less sense after the development of national markets.

collateral source, to name just a few (Posner, 1998). For instance, Landes and Posner (1987) illustrate the argument by examining the application of the Hand Formula, a special type of cost and benefit analysis applied in the field of torts, and conclude that judges do actually, even though not necessarily consciously, use this method when assessing liability and thus take efficiency-enhancing decisions. This kind of argument has been criticized, however, for its lack of verifiability. In particular, there is no evidence that judges consciously perform this calculation. Furthermore, the information needed to apply the rule is not readily available. In addition, even if a rule in common law is shown to be efficient, it does not follow that it is the common law system that has produced such efficiency, as many of these rules were developed in older legal systems (Simpson, 1998) and are also applied in civil law jurisdictions (Faure, 2001) or, when different, differences are functional and fit well into other design features of legal systems (Rubin, 1982).

The efficiency hypothesis has also been grounded in more detailed models of the judicial process. Adapting Harold Demsetz's (1967) seminal argument on property rights, Rubin (1977) argued that inefficient rules tend to be abolished as an unintended by-product of litigation between self-interested parties who share a common interest in changing the rule. To encompass cases in which parties do not share such a common interest, the argument has been extended to model common law as an evolutionary process (Priest, 1977; Terreborne, 1981; Katz, 1988). Litigation, however, is often unable to produce the same legal rules as the ones that the parties would have introduced if they had explicitly agreed ex ante on the issue being litigated ex post, because litigation does not aggregate over all parties' interests and it can therefore aspire to achieve only local instead of global efficiency (Wagner, 1998). Taking this critique into account and extending the argument, Rubin (1982) argues that ingrained, albeit different, mechanisms drive both common law and civil law to efficiency. He claims that this drive to efficiency lasted until well into the 19th century and that the susceptibility to interest group pressure that characterizes the later evolution of rulemaking institutions corrupted both common law and civil law. This idea has been further explored by Crew and Twight (1990), Bailey and Rubin (1994) and Osborne (2002), among others; it remains silent, however, on why the two centuries differed so drastically on the extent of rent-seeking.[12]

Furthermore, common law understood as judge-made law may be imperfect for deeper reasons. Its nature is retrospective and thus unsuitable for creating completely new rules or for making rapid legal changes. As with any design produced in an evolutionary process, it suffers path dependency because innovations are introduced not by designing them from scratch but by tinkering with a received solution. Paraphrasing Tooby and Cosmides, common law then evolves "like the proverbial ship that is always at sea. The ship can never go into dry dock for a major overhaul; whatever improvements are made must be implemented

[12] For an extensive review of the literature on the efficiency of judge-made law, see Rubin (2000).

plank by plank, so that the ship does not sink" (Tooby and Cosmides, 1992: 60). Statute law, in contrast, is produced in what can be described as a rational process, benefiting from planning and foresight, and it is less constrained by the previous legal order. It suffers from rent-seeking, but the severity of this varies greatly and the evolutionary processes in common law are not free of their own versions of it as, for example in the case of politically-motivated judges, who implement their own version of morality (Bork, 1990). Even Richard Posner (1973: 569) concedes that "legislative law-making is apt to be more efficient than judicial law-making" because the litigation of cases often fails to raise the pertinent questions for initiation of a legal reform. As argued by Wagner (1998: 315), common law can probably pass the test of local efficiency but is bound to fail the test of global efficiency.

Lastly, the claim that case law is more efficient than statute law remains unproved because most of the discussion has been on the internal consistency of common law and not on its advantages with respect to civil law. Internal consistency, however, is not exclusive to common law, as many rules in civil law also seem to reflect or lead to efficiency (Faure, 2001: 179; Harnay, 2002: 237). Robert Cooter (1994), for example, suggests that the efficiency of common law depends on the enactment of efficient customs by judges. This is as much a characteristic of common law as it is of civil law. According to this argument, judges make common law efficient when they find customary law and raise it to the level of law. However, the selection of social norms is also frequently carried out in the codification process. For example, the most successful US code, The Uniform Commercial Code, was built by identifying and systematizing the best business practices, and most of the rest of the common law of contracts has also been codified in the Restatement of Contracts published by the American Law Institute and state statutes revising the Statute of Frauds (Cooter and Ulen, 1997: 205, 378). This argument leads us to the debate of the efficiency of statute law.

The Efficiency of Civil Law

Work asserting the economic efficiency of common law often suggests, more or less implicitly, that statute law does not achieve the same degree of efficiency. This claim has been opposed, however, by scholars arguing that civil law also strives towards efficiency through both of its sources of rules—legislation and judicial activity.[13]

Legislation may produce superior rules because its centralization provides an advantage in terms of standards and innovation. Industrial organization shows that markets do not always provide universal standards and do not fully guarantee that the surviving standard is the best. A possible solution is an industrial

[13] In a survey among members of the American Law and Economics Association, Moorhouse, Morriss and Whaples (1999) find that 84% of respondents believe that common law is generally efficient and 42% consider it more efficient than civil law.

agreement or some kind of coordination mechanism guaranteeing the compatibility of all elements of the network. By analogy, Harnay (2002) sees legal codes as standards within a social network, providing legal coordination in a setting of adoption externalities. Codified law can then avoid the emergence of inefficient legal rules in the process of decentralized litigation that characterizes common law systems. The argument has been applied to explain codification as a conscious effort to systematize and organize previous statutes and customs.[14] Civil law is also thought to have some advantages, perhaps being more innovative than common law. It is grounded on legal rules, which may be easier to create than social norms (Garoupa, 2001). Although this argument obviously begs the question as to whether or when such creativity is desirable, it also indicates that civil law has the potential to be flexible despite often being perceived as rigid.

The concept that civil law is more concerned with distribution than with efficiency has also been opposed by pointing out the extent to which civil law principles rely on a logic of economic efficiency (Faure, 2001). For example, even though French tort law does not use a Learned Hand test to evaluate the standard of care, it does not exclude the use of costs and benefits analysis. Furthermore, it is questionable whether judicial practice strays away from economic efficiency and favors redistribution more in civil than in common law. For example, it has been argued that case civil law tends to apply strict liability when this application is more consistent with compensating victims than with economic efficiency, perhaps reflecting different social priorities (Faure, 2001). However, the scope of strict liability has also been taken in common law to probably inefficient extremes (Priest, 1985).

The capacity of civil law judges to modify and adapt inefficient legal rules is also greater than might be imagined because judges retain some normative capacity (Michelman, 1980). It has been observed on numerous occasions that, when the efficiency of a codified rule is doubtful, civil law courts end up circumventing it, usually by stretching the interpretation of flexible standards such as "good faith," "reasonably," "fairly" and so on. This happened, for instance, in areas as diverse as encroachments, ostensible possession and formal contract requirements. For example, according to the Spanish Civil code, encroached constructions should be demolished if the two neighboring owners do not reach an agreement, which would be inefficient in cases of minor good-faith encroachments; consequently, the jurisprudence came to enforce a liability rule (Paz-Ares, 1995: 2860–65). It is also common for land registration laws to deny property (that is, real or *in rem*) status to mere possession. However, case law often interprets good faith requirements extensively, considering ostensible possession as proof of bad faith on the part of a third party acquiring from a registered owner without possession.[15] As a last example, the requirement of

[14] See, for instance, the analysis of the French civil code by Josselin and Marciano (2002).

[15] The judicial proclivity to transform "crystal" property rules into "muddy" liability rules, originally analyzed by Rose (1988) in common law but also present in civil law (Arruñada, 2003).

written form established for debts by the French civil code was rapidly abrogated by judges for business contracting (Danet, 2002).[16]

It therefore seems clear that efficiency and departures from it are not exclusively a common law or a civil law trait (Rubin, 1982) but respond to deeper causes. Mattei (1997) suggests, for instance, that changes in the role of both common and civil law courts have resulted in substituting social organization by contract for what he describes as "government by judges". The result of this shift and the risks involved in it show remarkable similarities across legal traditions. In civil law countries, jurisprudence soon reintroduced moralistic views by interpreting more or less freely the original "intent" of the legislative rulemaker. In a recent example, court rulings on cases of workers' dismissal in Italy have been shown to be influenced by conditions in the local labor market—the probability of a ruling in the worker's favor increases with the unemployment rate in the court's jurisdiction, which is consistent with greater consideration of "fairness" in such rulings (Ichino *et al*., 2003). Similar events take place, however, in most areas of common law. Even US federal judges have been severely criticized for implementing their own views and disregarding the constitutional and statutory constraints they are supposed to be bound by (Bork, 1990).

The Comparative Performance Discussion

The debate on the efficiency of legal systems, confined for decades to law and economics, has recently reached wider audiences, when some related hypotheses started to be tested empirically by Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Paul Mahoney, Andrei Shleifer and Robert Vishny (La Porta *et al*., 1997, 1998, 1999; Mahoney, 2001; Djankov *et al*., 2002, 2003). These works classify a sample of countries according to the historical origin of their legal system as common law; French, German and Scandinavian civil law; and former Socialist countries; and then test through statistical regression the explanatory power of these "legal origin" variables on diverse indicators of countries' institutional and economic performance, ranging from stock ownership concentration to economic growth. The first studies explored the relevance that this classification criterion had on the development of financial markets and companies' ownership dispersion (La Porta *et al.*, 1997, 1998). Five-scale indices of investor and shareholder protection were elaborated after inspecting the commercial code and bankruptcy regulation in each country and these were assumed to reflect the degree of legal protection that the law was providing to minority investors. A statistically significant positive correlation was found between the shareholder and investor protection, on the one hand, and the common law tradition, on the other. The analysis was later extended in a series of

[16] Even if this judicial overruling of statutes is a powerful force, we are not arguing that it equates the position of civil law judges to their common law counterparts. Furthermore, such overruling is not always efficient, as shown by the judicial treatment of possessory rights.

works that showed significant correlations between belonging to a particular legal system and the measured level of regulation, property rights protection, the efficiency of government, the level of political freedom, economic growth and judicial independence. The punch-line in all these works is that the civil law tradition and, in particular, its French version, shows consistently worse performance than the common law tradition.

This line of research is valuable because it is a pioneer effort in quantifying differences in performance across the legal institutions that sustain modern economies, and this motivates further discussion and allows it to proceed in a more systematic, albeit some would claim distorted, fashion. It suffers substantial weaknesses, however, related to selection bias, measurement difficulties and questionable causation.

First, even if performances were perfectly measured, their comparisons suffer from an intrinsic self-selection problem because actual observed levels of performance result from those choices that were effectively taken in the past, and we lack information on their alternatives. If we recognize that not all legal systems perform well in all contexts, the relevant comparison is between the performance of the chosen option and that of its alternatives, but these alternative performances are by definition never observed. For example, even if someone demonstrates that the economic performance of the US is better than that of France because France has a civil law system, this would not prove that it was a mistake for the French to mold their Ancient Regime legal system in the direction of what is now known as civil law. To show that such a move was a mistake, one would have to compare the actual performance of France with the performance France would have exhibited under common law.[17]

Second, the value of measurement is not greater than its accuracy, and measuring institutions is hampered by methodological difficulties. Thus, most findings are based on indices that capture only a few of many relevant dimensions, such as the index of shareholders' rights in La Porta *et al.* (1998), which does not distinguish between the mandatory or default character of the rules, a major issue if they are to be properly understood. In addition, they measure shareholders' rights along dimensions that do not necessarily capture the real degree of protection. For example, the index considers the fact that German shareholders cannot vote by mail as a shortcoming of German corporate law, disregarding

[17] La Porta *et al*. (1998, 1999) claim that their studies do not suffer endogeneity because in most cases the actual origin of the legal system is imposed by conquest. This is doubtful, however, because it is applicable neither to colonizing powers nor to former colonies, which often enacted their codes after independence—in the case of former Spanish colonies, many decades later. In addition, even when introducing new legal institutions, there was a choice of system and the decision was often to delay its introduction in the colonies, thus implicitly opting for temporarily maintaining the older system, which provided greater judicial discretion. Furthermore, as a version of this self-selection problem, the legal origin variables fail to consider the indigenous legal institutions (Berkowitz *et al.*, 2001). The prior strength of indigenous institutions, which made it unnecessary, more costly and less effective to introduce Western law, has also often been disregarded as an explanatory factor. See, however, Acemoglu, Johnson and Robinson (2002) about the potentially negative effect of pre-colonial institutions in long-run economic growth.

the fact that most German shareholders send their instructions by mail to their banks and that banks do vote (Roe, 2002). The problem is even worse, however, as what is lacking is a global measure of institutional performance that takes into account interactions among a number of institutions, determining what we define as present-day common law or civil law jurisdictions.[18]

More generally, advancing causation arguments is dangerous in the absence of theory. For example, concluding from a correlation that concentrated ownership is due to allegedly weak legal protection of investors' rights might look intuitively correct but it is nevertheless superficial. As Roe (2002) shows, a complex mix of economic, social and political conditions affects managerial agency costs and determines the degree of ownership dispersion.

In the same way, legal systems are imbedded in a complex network of political structures and social preferences that cannot be studied in isolation, which apparently La Porta *et al.* (2004) do, when they take as a symptom of inefficiency of the legal procedure their finding that courts in civil law countries are slower to decide a case of eviction of a tenant or collection of a bounced check. Suggested inefficiencies, however, are difficult to substantiate without considering factors such as the incidence of these events, the complementary enforcement mechanisms that are at work and the costs incurred in each system for a comparable level of quality.

Within this literature, the superior economic performance of common law countries has been attributed not only to the statutory protection of property rights but also to the greater judicial independence supposedly enjoyed by common law judges (La Porta *et al.*, 2004). The benefits of greater judicial independence and, as a consequence, the inferred relationship with economic performance, however, have been severely questioned in a period where politically-motivated judges implement their notion of fairness and morality in an institutional setting in which they are not accountable to a considerable degree to anybody (Bork, 1990: 5).

Lastly, causation is also in doubt when superior performance is attributed to common law in legal fields which are everywhere based on statute law. This happens not only in corporate law but also in regulation and administrative law, as well as with some specific indicators, like eviction time. With this in mind, it is unsurprising that these legal origin variables also "explain" such phenomena as sports success,[19] showing once more that correlation does not imply causation.

[18] Some steps towards a more detailed analysis have already been taken. See, for example, Beck, Demirgüç-Kunt and Levine (2003), who defend the importance of the legal system's adaptability to evolving economic conditions; Acemoglu, Johnson and Robinson (2002), who defend the primary importance of local conditions for the development of strong property rights institutions; and Acemoglu and Johnson (2003), who show a statistical relationship between growth and protection of property rights against state expropriation but not between growth and the quality of contracting institutions, a variable that other works link to legal origin.

[19] West (2002) finds that FIFA rankings of national soccer teams correlate in a statistically significant manner with countries' legal origins.

The Need for Further Detail

More generally, both the efficiency and performance debates opposing common law and civil law have been formulated at a high level of abstraction that may lead to a focus on ambiguous categories and to mistaken conclusions. This abstraction takes place both vertically and horizontally.

Vertically, because the various "civil law" labels are defined by country and are therefore applied to related but separate and historically variable phenomena, such as statute, codified and systematic law versus case law, mandatory rules versus default rules, judicial dependence versus judicial discretion, and even rigid versus flexible rules of judicial procedure. These dimensions are better seen as variables in institutional design. All legal systems use them as ingredients but mix them in different proportions and manage them differently through history. Comparison among systems should aim to consider the weight of each ingredient and their interdependencies. In doing so, the analyses should ideally incorporate the institutional determinants that lie beyond the legal system and are frequently found in the nature of the political process (Backhaus, 1998; Wagner, 1998, 1992; Andonova, 2003), as well as wider economic factors relevant in specific fields of law, such as, in the field of property, the expected number of transactions, the risk of political opportunism and regulatory consistency (Arruñada, 2003).

Something similar happens horizontally, as legal systems often adopt structures pertaining to foreign traditions. This is also clear in the field of property law, in which legal traditions do not explain the adoption of the most relevant institutions. For example, until recently England had a system of private transactions akin to that of the Romans, but moved in the last century to the German system of registration, the same as Australia and most of Canada. Most of the US, however, introduced early a system of publicity by recording that is typically French (Arruñada, 2003). Similarly, the *numerus clausus* of property, *in rem*, rights is now almost unrelated to the common versus civil law divide. It remains to be documented to what extent this institutional cross-breeding also happens in other fields of law.

5. Concluding Remarks

It is time now to present some policy considerations, which aim to be pertinent for the unsolved problem of how to build market institutions in transition and developing economies.

In previous sections we argue that the evolution of both common and civil law in the 19th century was instrumental in protecting freedom of contract and developing market economies. We also explain the different degrees of discretion granted to courts in both systems as optimal adaptations to particular circumstances. In this way, greater judicial discretion in classic common law courts emerges more as a historical and perhaps unique exception than as a replicable solution.

This casts an additional doubt on the normative interpretation of some results on the efficiency and performance of legal systems which, asserting the superiority of common law, seemingly recommend applying it. We have sketched above why such superiority is open to question and likely to depend on environmental factors. But, more clearly, even if common law were shown to be superior today, the normative consequences of such superiority might be insignificant. Both common and civil law were probably well adapted to their original circumstances. Those creating the institutions of the market in Continental Europe did not opt for constraining judicial discretion to control the market but to protect it.

In line with this interpretation, our analysis does not advise any specific system for transition and developing economies in general but instead suggests that institutional development and academic research should aim at identifying the contextual circumstances which affect the costs and benefits of the different solutions. The problems of these economies may, in some cases, be more similar to those faced on the Continent at the demise of the Ancient Regime than to those enjoyed by England more or less at the same time. If so, restraining judicial discretion may be now necessary in developing economies in order to guarantee freedom of contract.

Lastly, if we are correct in considering both legal systems as adaptations to local circumstances, our analysis points out the risk that the debates on the relative efficiency and performance of common and civil law may be sterile because the comparison does not take place between viable alternatives.

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