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THE RISING POWERS:
WHAT ROLE DOES
LAW HAVE TO PLAY IN THE
ECONOMIC DEVELOPMENT OF
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➤ THE RISING POWERS: WHAT ROLE DOES LAW HAVE TO PLAY IN THE ECONOMIC DEVELOPMENT OF THE BRIC COUNTRIES?

Clifford Chance is supporting a research project which examines the role of law and legal institutions in economic development in Brazil, Russia, India and China. The project is being led by the Centre for Business Research at Cambridge University, which brings together economists, lawyers and other social scientists to study the role of legal institutions in economic growth, development and innovation.

This research will be of interest both to our clients and to lawyers working with BRIC countries and should enhance our understanding of other growth economies and developed markets where the causal relationship between the legal and economic systems is still inadequately understood. This opportunity to study different countries at comparatively early stages of their development should contribute to a better understanding of stable market systems. This briefing introduces the project, explains why Clifford Chance is supporting it and looks at some of the themes of the research.

What is the project about?

The primary aim of the project is to examine the role of law in economic development in the BRIC countries. The project has received funding from the Economic and Social Research Council (ESRC). The causal relationship of law and economic growth is one of the big outstanding questions for economists and has acquired greater impetus since the financial crisis. The research will specifically consider (i) the role of formal institutions such as the courts and regulatory bodies in providing the conditions for growth, (ii) the effectiveness of reforms aimed at improving the legislation governing the rights of creditors and shareholders, (iii) the role of the state and (iv) the extent to which formal institutions are complemented by prevailing legal and business culture.

The research team comprises lawyers and economists from leading British universities, collaborating with institutions in the countries themselves. The team is led by Simon Deakin, Professor of Law at Cambridge and Director of the Centre for Business Research. Other members of the team include John Armour, Professor of Law and Finance at Oxford, Matthias Siems, Professor of Law at Durham and Kristin van Zwieten, the Clifford Chance Associate Professor of Law and Finance at Oxford.

Why is Clifford Chance supporting this project?

Clifford Chance is providing technical input on the relevant legal systems and access to our contacts with knowledge of the legal and business environment in the countries concerned. In addition, John Hamilton, a Consultant in Clifford Chance's Moscow office, who is also a Senior Research Fellow at the Centre for Business Research, is conducting research on the Russian dimension of the project.

John says "This research will give us and our clients a deeper understanding of the role of law in the markets in which we and they operate. In collaborating with local institutions we will create valuable links which will enhance our expertise and capabilities in these markets.

Supporting the project will also bring the research to a wider audience and enhance the scope for future projects.”

‘Law and economics’ – why is it important? An introduction to the themes of the research

The importance of law and legal institutions in the economy is a subject which has been comparatively neglected, although it has been of interest to agencies such as the World Bank and the EBRD for some time, and more generally since the financial crisis of 2007 and 2008. The field is dominated by economists, with academic lawyers and practitioners in an essentially reactive role; this may have contributed to inaccurate characterisations in some of the economic literature of different types of legal system and the role of legal rules in economic activity. Economists essentially see law as a system for altering incentives in a general way, whereas lawyers see it as a set of rules and procedures applying to a particular set of facts.

A better understanding of the optimal design for law and legal institutions would not only help growth economies to achieve sustainable and stable development but would also be likely to yield insights into the way in which more established markets and legal systems function. The ability to track legal and economic change in rapidly evolving systems such as the BRIC countries enables correlations to be observed and inferences drawn about causal relations. These insights would not emerge from the observation of comparatively static systems in economies which have developed organically over several centuries. The need for a better understanding of the role of regulation in markets (or on a larger scale, the law in the economy) has been highlighted by the financial crisis and the subsequent attempts to improve the regulatory framework.

Project Research methodology

The research methodology is both qualitative and quantitative, as objective data-based analysis can be effectively complemented by more finely grained interview-based information gathering. More specifically, the quantitative methods involve ascribing values to types of legislation in the relevant jurisdictions, as it evolves over time, according to whether it appears to be more or less supportive to shareholder and creditor rights, and comparing this with economic data over the same period. This kind of objective data on its own may fail to capture significant features of the legal environment, such as attitudes to law, the level of compliance, the quality and reliability of the courts and regulators and the role of the state, all of which will be explored in interviews. Interviews are being conducted with a range of business people, lawyers and where available, regulators, lawmakers and policy makers. Clifford Chance is providing access to our lawyers and to our contacts in each jurisdiction who will be interviewed by the researchers.

At a theoretical level the research will take account of the literature which has emerged in recent years in the field of law and economics.



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John Hamilton Consultant, Clifford Chance

How has academic theory in this field evolved?

The protection of rights to private property has long been regarded as an essential condition for commercial activity and the notion has become further embedded through the development of the idea in the 1960s that when goods and services are traded it is really rights to those goods and services that are being bought and sold.¹ The importance of property rights was emphasised in new institutional economics², as was the importance of informal rules in the functioning of society, although the role of the legal system in providing the rules for the orderly conduct of economic activity has been somewhat neglected in the economic literature.

The emergence of law and economics as a discipline can be traced back to a paper published in 1960 by the economist Ronald Coase, who argued

that allowing parties to negotiate an appropriate level of compensation for the commission of a nuisance leads to a more economically efficient economic outcome than a fine imposed on the party responsible by the state.³

From the mid 1970s, under the influence of Richard Posner, an academic at the University of Chicago and judge at the US Court of Appeals, the focus of law and economics moved away from Coase's interest in the implications of legal rules for economic efficiency towards the use that can be made of economic theory to explain the common law. In this analysis, laws are seen as prices, with the behaviour of economic agents, who are assumed to be rational and self-interested, being influenced by the perceived cost or benefit of breach of or compliance with applicable laws.⁴



The approach started in the sphere of economic relations, but has been extended to criminal and even family law, in the belief that simple market economics has explanatory power across a broad range of human activity.⁵ Although the theory claims to be descriptive rather than normative, it is implicit that the law evolves towards greater economic efficiency with inefficient laws being amended or replaced by those which are more economically efficient, tending to reinforce the self-interested rational actor model of human behaviour on which the approach is predicated.

Posner does not say much about growth economies as such, but he does argue, as a natural extrapolation of the idea that the law evolves towards greater efficiency, that provided that some basic institutions have been created, the existence of a class of private property owners creates a demand for law, which will lead to wealth creation and better institution building, in a virtuous circle of reform.⁶

What is the 'Legal Origins Theory' and why is it controversial?

The economic analysis of law has not been particularly well received in civil law jurisdictions, where law may be seen as having a more autonomous status inherently less capable of influence by forces of the market, and where it is objected that the organic process of evolution through jurisprudence is less significant than in common law jurisdictions.⁷

However a more fundamental limitation of the approach of economic analysis, both at a theoretical level and as a tool for policymakers, is that it is essentially concerned with causation in one direction – from the economy to the legal system.

In the late 1990s a team of economists led by Andrei Shleifer, a Harvard economist who had a key role in

advising the Russian government on privatisation in the early 90s, proposed a method of evaluating legal systems by ascribing values to laws according to the degree of protection they provided to shareholders or creditors. The research, which was based on a survey of 49 countries, concluded controversially that common law jurisdictions performed better than civil law jurisdictions in terms of conduciveness to economic growth.

It was this line of research that led to the World Bank's *Doing Business* Reports which have also proved controversial, particularly in civil law jurisdictions where they have been accused of having an inherent common law bias, with some developed civil law jurisdictions, such as France, being initially ranked very poorly.⁸ A positive effect of the *Doing Business* reports has been to encourage a number of countries to examine their legislation carefully to see how it could be improved.

The research mentioned above, which has come to be known as the Legal Origins Theory, has attracted criticism for the quality of data, the criteria used in the tests, and for being a snapshot of the position at a given time, as opposed to a time series which demonstrates a trend over a period of several years and from which it is easier to infer causation as opposed to just correlation.⁹

More recent research done by a number of the members of the team working on the 'rising powers' project has looked at data over a period of time for a number of the countries in the original survey, and concluded that there is no inherent superiority of the common law over civil law in terms of economic growth, and that civil law and transitional systems which were once seen to lag behind common law systems in terms of shareholder and creditor protection, have been catching up.¹⁰

A more recent restatement of the Legal Origins Theory by the founders of the field places less emphasis on the content of legal rules and associates the legal origin of a country with a 'style of social control of economic life' with the common law seen as inherently more adaptable and pro-market and the civil law as more rigid and statist.¹¹ As far as the BRICs are concerned, Brazil and Russia are both civil law systems, and India is a common law system. China does not belong entirely to either category, but, at least according to the criteria of the Legal Origins Theory, is closer to a civil law jurisdiction.

If the claims of the Legal Origins Theory in its original or restated form are true, it means that the trajectory of economic development of a country is to some extent determined by the type of legal system (civil or common law) it has, whether freely adopted or imposed by conquest or colonisation.

A limitation of the methodology of Legal Origins is that the causation is also one way – this time from the legal system to the economic system, although this is mitigated to some extent by the time series approach which permits inferences of causation in either direction. The 'rising powers' project assumes that the interaction between the legal and economic systems is a two way process, with the market exerting influence on legal evolution, and the legal system having an impact on economic growth.

How will the Rising Powers project improve our understanding?

The 'rising powers' project will be testing some more recent ideas about the way in which growth economies develop and which challenge some earlier assumptions. In the heyday of neoclassical economic theory (from the demise of Keynesianism in the late 1970s to the financial crisis of 2007-2008) it was assumed that the market had a primary role in economic

development and the state a relatively passive 'night-watchman' function.

In Russia the neoclassically inspired reforms, which placed reliance on the market rather than the state as the prime mover behind legal and economic transformation ran into difficulties. Research on Chile, South Korea and China seems to show that an 'economically benevolent' authoritarian regime can actually be better, at certain stages of development, than a market system supported by a system of property rights, with the state substituting for both the market and the legal system.¹² The view that a strong state is important in a period of transition has been gaining ground in recent years, and cautions against attempts to impose the Western paradigm of liberal market democracy on developing countries at too early a stage of their development.¹³

In relation to China, South Korea and Taiwan, it has been argued that, at least in the early stages of development, economic activity may be best served by not relying on the legal system but by relying on reputation, relationships and trust. The formal legal system in China has been criticised for being unwieldy and slow to accommodate the changing needs of economic activity.¹⁴

In India the challenge is said to lie not so much in reforming the law but in getting the court system to work more efficiently and reliably. In Brazil the new stock exchange (Novo Mercado) seems to function effectively as a source of finance for new listings, which are required to opt into a corporate governance regime which emphasises the protection of minority shareholders, although established firms are not required to move over to this regime. The reason for the success of this model and whether it is capable of being transposed to other growth economies, is something that will be considered as part of the project.

Conclusion

The rising powers project promises to provide new insights into the role that legal systems play in economic development. Clifford Chance's support for this project means that we will be able to share these insights with our clients and develop a deeper understanding of the markets in which we operate. Further briefings will present the findings of the research and explore what this means for those investing and doing business in growth markets.

¹ See for example H Demsetz, (1967) 'Toward a Theory of Property Rights', *American Economic Review*, Vol. 57, No2 (May 1967) pp. 347-359.

² D. North, *Institutions, Institutional Change and Economic Performance* (1990) Cambridge University Press building on his earlier work. *The Rise of the Western World, A New Economic History* (1973) Cambridge University Press. For more recent restatement of the importance of property rights in economic activity, H. de Soto (2000), *The Mystery of Capital*, Basic Books.

³ R. Coase (1960) 'The Problem of Social Cost', *Journal of Law and Economics* 3:1-44. The approach in this paper also underlies the rationale for emissions trading where the state allows the market to penalise heavy polluters by forcing them to buy additional emissions permits at the prevailing market price which is sensitive to demand, rather than imposing fines.

⁴ R. Posner, (2003) *Economic Analysis of Law*, Aspen Publishers.

⁵ G. Becker (1992) 'The Economic Way of Looking at Life', *Law and Economics Working Paper N° 12 (2D Series)* University of Chicago Law School.

⁶ R. Posner (2004) 'Law and Economics in Common-Law, Civil-Law and Developing Nations', *Ratio Juris* Vol. 17 N° 1, March 2004.

⁷ A. Bernard (2010) 'Law and Economics, une science idiote?' *Revue de Droit Henri Capitant*, N°1, 30 December 2010.

⁸ C. Valcke (2010) 'The French response to the World Bank's Doing Business Reports', 60 *University of Toronto Law Journal*.

⁹ R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, R. (1997) 'Legal Determinants of External Finance', *Journal of Finance*, 52, 1131 and R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny (1998) 'Law and Finance', *Journal of Political Economy* 106(6) 1113-54.

¹⁰ J. Armour, S. Deakin, P. Lele, and M. Siems (2009) 'How Do Legal Rules Evolve? Evidence from a cross-national comparison of shareholder, creditor and worker protection', *American Journal of Comparative Law* 57:579-630.

¹¹ R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, (2008) 'The Economic Consequences of Legal Origins', *Journal of Economic Literature* 46:2, 285-332.

¹² Gilson, R., and C. Milhaupt (2011), 'Economically Benevolent Dictators: Lessons for Developing Democracies', *The American Journal of Comparative Law*, Vol. 59 227-288.

¹³ Mau, V. (2011), 'The role of the state and creation of a market economy in Russia', *BOFIT Discussion Papers* 23/2011.

¹⁴ F. Allen, Jun "QJ" Qian, and Chenying Zhang, (2011), 'An alternative View on Law, Institutions, Finance and Growth', SSRN.

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