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LEGAL ORIGINS AND MODERN STOCK MARKETS

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Legal Origins and Modern Stock Markets

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Abstract

Legal origin — civil vs. common law — is said in much modern economic work to determine the strength of financial markets and the structure of corporate ownership, even in the world's richer nations. The main means are thought to lie in how investor protection and property protection connect to civil and common law legal origin. But, I show here, although stockholder protection, property rights, and their supporting legal institutions are quite important, legal origin is not their foundation.

Modern politics is an alternative explanation for divergent ownership structures and the differing depths of securities markets in the world's richer nations. Some legislatures respect property and stock markets, instructing their regulators to promote financial markets; some do not. Brute facts of the twentieth century — the total devastation of many key nations, wrecking many of their prior institutions — predict modern postwar financial markets' strength well and tie closely to postwar divergences in politics and policies in the world's richest nations. Nearly every core civil law nation suffered military invasion and occupation in the twentieth century — the kinds of systemic shocks that destroy even strong institutions — while no core common law nation collapsed under that kind of catastrophe. The interests and ideologies that thereafter dominated in the world's richest nations and those nations' basic economic tasks (such as postwar reconstruction for many) varied over the last half century, and these differences in politics and tasks made one collection of the world's richer nations amenable to stock markets and another indifferent or antagonistic. These political economy ideas are better positioned than legal origin concepts to explain the differing importance of financial markets in the wealthy West.

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INTRODUCTION

Do legal origins — common law vs. civil law — largely determine whether capital markets develop strongly? Many finance economists have concluded, in an explosion of influential articles in the past decade, that legal origin is indeed central.[1] Common law institutions effectively protect outside shareholders, it is said; civil law ones do not. This differing legal capacity to protect outside shareholders explains why some rich nations' capital markets are strong while others' are weak.

The stakes aren't just academic. The developing world and international agencies are told that "transplanting the correct legal code (i.e., the common law) will enhance economic development."[2] This new legal origins view has in key circles elbowed aside the view that (a) economic function propels stock markets: stock markets develop when technology demands large enterprises and capital must be gathered from many sources, and this process works when (b) policymakers or private players build the institutions that support stock markets and (c) have enough political support that the polity does not attack finance. The last element — that national politics can confine policymakers' institution-building — has increasingly found theoretical support and evidence. Here I assess which approach — legal origin or political economy — is the better bet for future research and show how political and policy theories for the richer nations tie into systematic differences in how those nations experienced the turmoil of the early twentieth century. Differences in corporate finance in the wealthy West in the second half of the twentieth century could well be due more to the differing consequences of the earlier World Wars than to subtle differences between civil and common law.

There's a powerful normative reason to get this assessment right. Many policymakers and some academics see strong financial markets as propelling economic development.[3] Thus, if we better understand what makes for strong financial markets, we can better understand how to engineer economic growth, or at

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[1] See, for example, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998), and follow-on articles, some by these authors, many by others. I cite a representative sample *infra* notes 2, 4–7. For important contrary views, see *infra* section III.B.

[2] Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165, 166 (2003) (summarizing and criticizing the legal origins theory); *see also* Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8 (1999).

[3] *See, e.g.*, THE STATE, THE FINANCIAL SYSTEMS AND ECONOMIC MODERNIZATION (Richard Sylla et al. eds., 1999); Frederic S. Mishkin, *Is Financial Globalization Beneficial?* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 11891, 2005), *available at* http://www.nber. org/papers/w11891.pdf ("[T]he financial system is like the brain of the economy: it is a coordinating mechanism that allocates capital to building factories, houses and roads. . . . No work ethic can compensate for a misallocation of capital."). The contrary idea, that industrial structure calls forth finance, is associated with Joan Robinson. *See* JOAN ROBINSON, THE RATE OF INTER-EST AND OTHER ESSAYS 86 (1952) ("[W]here enterprise leads finance follows.").

least provide a necessary tool. Important policymakers at international development agencies such as the World Bank — staffed with economists trained under the new thinking about legal origins' centrality[4] — denigrate civil law–style institution-building, such as regulation, codification, and public enforcement. Yet, by accepting the academic thinking positing the power of traditional common law tools, they may miss other needed tools not traditionally associated with the common law. And if financial markets succeed only where there's a supportive polity, then building the legal structures in the midst of a hostile polity would waste resources and risk disappointment. Development dollars would be better spent elsewhere.

This is not to say that focusing on corporate law isn't important. It is. But it is important in the right context. The first-order condition is a polity that supports capital markets. It's only then that law becomes important and getting it wrong becomes costly. Getting corporate law right in the United States is important and worthy of the attention it receives. It is important here because the American polity supports capital markets. In other nations — even wealthy ones like France, Germany, and Italy — the polity did not support capital markets in the immediate postwar decades. When such a polity changes and becomes receptive to markets, especially capital markets, policymakers can make finance-friendly rules fall into place, and neither of the two major legal origins would much impede those rules from being efficacious. Legal origin doesn't stop a nation from developing the institutions, legal and otherwise, that capital markets need. When we see a nation that doesn't do so, it's not that its legal origin bars it. Something else is in play.

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Thus, the domain here is the wealthy West, and the problem to explain is why well-developed financial markets prosper in some nations and not in others. The background idea — which I take for granted but some might question — is that greater financial possibilities for firms make economic growth easier. If businesses cannot raise outside capital, that inability hinders economic development.

So we must first understand the legal origins proponents' views. How could legal origin affect finance? One way, it's been said, is that common law, by using fiduciary duties, better protects distant investors than civil law does. This common law specialty can, in the hands of savvy judges and juries, be central, early thinking on the means of protection ran. Further, later thinking runs, civil law systems overregulate the economy and stock markets, thereby stunting both, while common law institutions respect markets and private contracting. Getting either legal channel — protecting investors or respecting markets — wrong stymies financial development. The handicap might be surmountable but is nearly hardwired into all too many legal systems, the theory runs. The normative implication is that developing nations should seek those tools that work — like market-oriented private lawsuits decided by judges using common law–style fiduciary duties — to build

[4] Cf. Ass'n Henri Capitant Des Amis De La Culture Juridique Francais, Les Droits de Tradition Civiliste en Question: À Propos des Rapports Doing Business de la Banque Mondiale 14–15 (2006), available at http://henricapitant.org/ IMG/pdf/Les_droits_de_tradition_civiliste_en_question.pdf (describing the influence of legal origins thinking, especially in the World Bank).

markets and advance economically. And they conversely need to avoid those tools that do not work well — like too much rule-based regulation.

In other words, the original creation of legal systems centuries ago created legal and decisionmaking structures that continue today to facilitate or impede market outcomes. The civil law — by relying on codes, narrow judicial intervention, high regulation, and market directives instead of market solutions — impedes financial markets. The common law — by relying on adaptive judges, wide judicial discretion, light regulation, and private contracting — facilitates financial markets. A corollary, often unstated, is that these tendencies to codify or not, to use a wide-ranging judicial style or not, to regulate intensely or not, and to prefer markets or not do not change easily once a legal system is in place. Some characteristics might change at the edges, the theory might concede, but not enough to make a big financial difference. These characteristics of the two major legal systems — seen to persist to this day in the legal origins theory — are strong enough to explain financial differences around the world. Equally importantly, the theory views later influences on governmental structure — such as modern revolutions, civil wars, new constitutions, and deep social reactions to economic and wartime devastation — as paling in consequence to the structural predisposition wired into legal origin.

Qualitative analysis, I argue, is at odds with the legal origins theory. It's not that fiduciary duties are unimportant, but that even common law systems use regulators to protect minority stockholders. There are institutional substitutes. And, although American judges in the nineteenth century restrained legislatures on economic matters, the modern era is one not of judicial restraints on economic regulation, but is instead one of legislative primacy. We live in an age of statutes, as has been said. Common law nations' legislatures regulate; civil law nations' legislatures regulate. How legislatures choose to regulate reflects legislative policy decisions, voter preferences, and surely interest group power far more than it results from faded historical channels of legal origins that date back to Rome's Empire, the Middle Ages, and Napoleon's Code.

Although many modern financial outcomes seem to correlate with legal origin, we know correlation is not causation. For one thing, the causative links offered thus far in legal origins theory are weak. For another, legal origin in the wealthy West also correlates with other historical characteristics, such as how Western nations experienced the early twentieth century's wars and disruptions. That modern history had powerful political economy consequences that deeply affected markets, financial and otherwise. To buttress this alternative explanation, I use the proponents' method of quantifying national differences to show that twentieth-century history and politics explain financial differences as well as legal origin does and qualitatively link more strongly to outcomes than do origins. In nations where legal origin originated, policy variables — the domain of legislatures and regulators — strongly predict basic financial institutional facts. Those policy differences seem more attuned to differences in postwar politics than to distant differences in legal origin. For example, a risk-averse polity or one preoccupied with left-right conflict would not rebuild strong financial markets with alacrity. And remember that for the first decades after World War II, fighting communism was central to the domestic political agenda in much of Western Europe and East Asia. This anti-communist

agenda alone strongly affected Western European and East Asian nations' policies toward capital markets through the 1980s. In fact, the differential impact of the World Wars and civil wars of the ugly early twentieth century generally packs as much explanatory power as legal origins in predicting the depth of late-twentieth-century financial markets in the wealthy West.

* * * *

I describe in Part I the theories that link legal origin to financial results and bring to bear the legal academy's views of the classical differences between civil and common law. First, common law systems simply regulate less, it's said; they prefer market solutions and private contracting to centralized, statist regulation. Second, the common law judge better protects outside financiers, especially minority stockholders, with common law–based fiduciary duties. The civil law judge is in contrast hamstrung by a rigid code. Third, because legal origin long preceded modern financial outcomes, markets could not have determined origin. Because common law nations protect investors better than civil law nations, origin seems in the theory to cause deep financial markets. But the correlation here seems more coincidental than causal. The qualitative links between origins and investor protection seem weak, and without those links a linchpin in the theory is removed, suggesting that a strong causal connection between civil law and weak financial markets just may not exist. Many in the legal academy see the classical differences between civil and common law as not very important in modern economies, whose policy needs induce nations everywhere to regulate and codify. Moreover, while common law's open-ended fiduciary duties have ex post strengths, civil law structures can, and do, use open-ended, ex post inquires as well; they're just not labeled as fiduciary duties. Common law systems just use them more. And much stockholder protection in common law nations comes from ex ante regulation (think of the American Securities and Exchange Commission and the massive codification of the securities rules through which the SEC works), which is not at the core of common law's institutional advantage. Again, the idea isn't that law is unimportant but that once the first-order condition of political support for capital markets is reached, either origin can create the legal institutions that financial markets need.

In Part II, I describe the twentieth-century shift in institutions around the world. Regulation is everywhere; the legislature is supreme. The common law judge's import in economic policymaking has faded relative to that of the regulator. It's not just that we in the United States use both securities regulators and fiduciary duties but that we regulate financial markets *more* intensely than our civil law cousins do — as measured by regulatory budgets, personnel, and so on. And we often build up market-protecting devices via regulation — the American securities code is dense, specific, and detailed. The function sought — protecting outside investors — thus can be achieved through multiple means, making the question not primarily one of legal tools but of political will. The small legal structural differences that persist could readily be overcome by a determined polity.

In Part III, I examine data. While legal origin predicts securities market strength, a simple emblematic legislative policy does so just as well. While one should be skeptical of many nation-by-nation regressions because there aren't enough

relevant countries to run a sophisticated statistical analysis, I nevertheless first examine the same set of twenty-seven nations whose financial differences proponents have said are driven by legal origin (and I then examine a larger set of countries). I show that the financial contrasts can be just as well explained by the relative destruction of the richer economies in the first half of the twentieth century. Some nations were destroyed; some survived. A few prospered. Those that suffered the most had weaker financial markets than the others in the ensuing decades, even after they had otherwise recovered economically from the earlier destruction. This correlation could be the basis for more compelling theories than distant legal origin, theories tied to modern political economy.

In Part IV, I examine alternative theories emanating from modern politics. The political economy approach looks at how political institutions interact with preferences to create policy outcomes. In the wealthy West, some legislatures haven't wanted vibrant securities markets because their polities just would not support pro-market policies. Post–World War II political issues — left-right labor politics, trade barriers, the median voter in nations whose capital stock had been destroyed — are more promising roads than legal origin for research seeking to explain financial outcomes. For example, nations fighting communism internally and externally — and recall that this was the central agenda in Western Europe and East Asia in the decades after World War II — had reason to protect labor markets tightly and to ignore their capital markets. They did so, often regardless of whether the government in power had a locally left-of-center or right-of-center ideology. A political economy approach is both simple — because politics is more vital than legal origin — and complex — because tracing which political theory works best overall will not be easy.

I then conclude, summarizing the four new issues I here bring to the table. First, a sustained analysis of the law-based literature on legal origin shows both common and civil law nations' increasingly using regulatory tools during the twentieth century. Second, the availability of the classical tools associated with each legal origin is less important than whether a nation wants to build up capital markets. Third, political theories explain the differences in willingness to build up capital markets, with the political theories tying to variation in how nations experienced the first half of the twentieth century. And finally, the development agencies' reliance on common law's core tools may thus be misguided.

I. CONSIDERING LEGAL ORIGINS

That an important intellectual movement attributes much to legal origin is not in doubt. Even the titles of articles assert legal origins' centrality: *Why Does Legal Origin Matter?*[5] Or just: *Legal Origins*.[6] But could origin — which to many legal

[5] Thorsten Beck et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653 (2003). This is one of the important articles associated with the World Bank.

[6] Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q.J. ECON. 1193 (2002).

academics seems just to be a technical aspect of judicial style — determine the strength of securities markets?

With so many authors contributing to this literature, it's hard — and potentially unfair — to summarize it. Early movers' views have evolved, emphasizing different institutional features than they did originally. Not all players sign onto every idea others espouse. But the idea that legal origin hardwires a national system in ways that are hard to overcome is out there and influential. Here I summarize its major elements.[7]

A. The Classic Differences

First, what have legal scholars seen to be the classic, core differences between legal origins?

The civil law codifies. The Emperor Justinian had Roman law compiled and, when the compilation was completed in the year 533, barred future decisionmakers from referring to the work of judges and from citing authorities other than his Code. All law was reflected in his Corpus Juris Civilis, all else extraneous.8 Napoleon, seeking to control the judges in post-revolutionary France as the revolutionaries had sought in 1791 — by requiring judges, if the legislative text was ambiguous or silent, to ask the legislature its meaning — promulgated his famous Code.9 The common law, on the other hand, grows as judges decide cases and precedents evolve, without the judges' referring to a central code. A code centralizes authority; common law judges disperse it.

Civil law and common law judges read the text of the governing code differently, it is said. Civil law judges read its plain meaning; if the text is incomplete, it is said, a classic civil law judge does not fill in gaps where a common law judge would.10 Hence, the civil law judge deters insider corporate schemes ineptly, while the wily common law judge adapts and stops insider thievery. Common law judges follow precedent, thereby building a cohesive system of law from the ground up. Civil

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[7] As said in an excellent recapitulation: "[D]ifferences in legal tradition *cause* differences in property rights." Ross Levine, *Law, Endowments, and Property Rights* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 11502, 2005), *available at* http://www.nber.org/papers/w11502.pdf. "La Porta, Lopez-de-Silanes, Shleifer, and Vishny . . . argue that . . . legal origin . . . *explains cross-country differences in financial development*." Menzie D. Chinn & Hiro Ito, *What Matters for Financial Development? Capital Controls, Institutions, and Interactions* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 11370, 2005) (emphasis added), *available at* http:// www.nber.org/papers/w11370.pdf; *see also* Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Regulation of Labor*, 119 Q.J. ECON. 1339, 1340 (2004) (asserting that more than a country's current politics, "the historical origin of a country's laws shapes its regulation of labor and other markets").

[8] JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION 6–7 (2d ed. 1985).

[9] *See* JOHN P. DAWSON, THE ORACLES OF THE LAW 263 (1968); MARY ANN GLENDON ET AL., COMPARATIVE LEGAL TRADITIONS 67 n.1, 375–76, 378–79, 387 (2d ed. 1994) ("[T]he French royal courts[']. . . resistance . . . to all change . . . made them prime targets for revolutionary wrath . . . ."); Beck et al., *supra* note 5, at 655, 657–58, 660. Napoleon's Code was also designed for nation-building, uniting disparate legal systems throughout France.

[10] *But cf.* ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 16–17, 23–25, 29–30 (1997) (virtues of textualism).

law judges, in contrast, do not follow prior opinions, often do not write down their reasoning, and do not tightly tie their decisions to the facts of the case.

The civil law tends toward deductive thinking — "to making plans, to regulating things in advance, . . . to drawing up rules and systematizing them."[11] In contrast, "[t]he Englishman improvises, never making a decision until he has to. . . . Only experience counts . . . and so he is not given to abstract rules of law."[12]

The civil law plans, the common law reacts.

B. Legal Origins and Financial Progress

According to the legal origins theory, these contrasts between civil and common law systems induce differences in financial law, which lead to differences in financial outcomes.

The first link between legal origins and financial markets is said to be how the legal system protects small investors. "[C]ommon law countries protect shareholders better than do civil law countries and especially better than French civil law countries."[13] If small investors fear that insiders could rob them, they will not invest in the insiders' firms. If outsiders do not buy, then a deep stock market does not develop, and the big owners — founding families and their successors — are locked in.[14] Common law systems protect minority stockholders well via judge-made fiduciary duties,[15] while civil law systems, the theory goes, are too rigid to protect minority stockholders. As Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (LLSV) wrote:

> [There's a] 'judicial' explanation of why common law protects investors better than civil law . . . . Legal rules in the common law system are usually made by judges, based on precedents and inspired by general principles such as fiduciary duty or fairness. Judges are expected to rule on new situations by applying these general principles even when

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[11] KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 70 (Tony Weir trans., 3d ed. 1998) (1977).

[12] *Id.*

[13] Simeon Djankov, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The New Comparative Economics*, 31 J. COMP. ECON. 595, 610 (2003).

[14] The most precise model linking law to ownership diffusion does not tie the two via legal origin. *See* Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* 23–30 (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), *available at* http:// ssrn.com/abstract=203110.

[15] *See, e.g.*, Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. PAPERS & PROC. 22, 23–24, 26 (2000). Additionally, see Glaeser & Shleifer, *supra* note 6, arguing:

> [Bright line rules] notoriously fail to catch undesirable conduct [concerning] the expropriation of investors by corporate insiders . . . . [Bright line rules] do not work well in this area because a broad range of creative behavior designed to expropriate investors 'falls between the cracks' in the rules . . . . [C]ommon law regimes . . . do better than civil law in . . . investor protection . . . .

Id. at 1222.

> specific conduct has not yet been described or prohibited in the statutes.[16]

And "these rules [protecting investors] vary systematically by legal origin."[17]

The second major explanation for financial differences between civil and common law economies is that civil law systems overregulate, killing securities markets before they can develop. "[T]he state has a relatively greater role in regulating business in civil law countries than in common law ones."[18] Common law systems are more decentralized and less regulatory. They facilitate the private, marketplace transactions that allow securities markets to thrive.[19]

If either channel is determinative — financial protection via common law fiduciary duties or an intrinsically overregulatory character of the civil law — then, a sympathetic commentator concludes, the implications of the legal origins work (and the commentator's own) are that France and Italy "[*should i*]*nstall a common law, adversarial legal system and scrap their civil law systems*."[20] Although strong medicine, it's a natural conclusion here and not all that radical in the legal origins literature. Key players do say that legal origin explains why some nations protect property, grow, and get rich.[21]

So, could those differences in legal origin matter much for financial differences today in the wealthy West? Not likely, I argue in the following sections. The core differences could easily be exaggerated. The answers lie somewhere else.

1. Protecting minority stockholders via fiduciary duties. At common law, fiduciary duties run from controlling insiders to outside shareholders. Shareholders buy stock more comfortably when they know that a judge will protect them later from insider overreaching. Although hardly anyone thinks that legal protection is unimportant, the legal origins theory tries to go deeper: the common law — via its

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[16] Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 9 (2000).

[17] Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997). This is a foundational article in the law and finance literature. A deepening of the fiduciary duty argument — focusing on procedures to reduce self-dealing — can be found in Simeon Djankov et al., *The Law and Economics of Self-Dealing* (Nat'l Bureau of Econ. Research, Working Paper No. 11883, 2005), *available at* http://ssrn.com/abstract=864645.

[18] La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 16, at 12; Rafael La Porta et al., *The Quality of Government*, 15 J.L. ECON. & ORG. 222, 224 (1999).

[19] Interesting recent legal origins papers propose a third channel — that common law nations intrinsically favor markets, transparency, and contract. *See, e.g.*, Djankov et al., *supra* note 17; Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006) [hereinafter La Porta et al., *What Works?*]. Leaders in the legal origin debate may — as they turn to the overall preference for market-friendliness — find themselves emphasizing political factors and forgetting about legal origins, particularly as some civil law nations move away from their post–World War II unease with markets.

[20] Dennis C. Mueller, *The Economics and Politics of Corporate Governance in the European Union* 28 (European Corporate Governance Inst., Law Working Paper No. 37/2005, 2005) (emphasis added), *available at* http://ssrn.com/abstract=730366. But, the author adds, mid-range reforms could help. *Id.*

[21] *See* Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Law, Endowments, and Finance*, 70 J. FIN. ECON. 137, 138 (2003). Although not every legal origin proponent signs onto every idea held by every other legal origin proponent, the items quoted and summarized here are representative, not outliers.

use of fiduciary duties — is structurally better suited to protect distant shareholders than civil law.

The fiduciary duty channel for the legal origin theory has its weaknesses. For one thing, the United States doesn't just use fiduciary duties to do the job, but also uses securities regulation. And civil law nations could, were they so disposed, develop the institutions to protect minority stockholders. Moreover, some scholars see the protections coming from the American common law judge as anemic[22]: one of the best known American corporate law articles, by William Cary, former chair of the SEC, was a rolling assault on judges' unwillingness to protect distant minority stockholders.[23] Take an example from the 1960s and 1970s: Going-private transactions had insiders setting the price at which they bought out the public shareholders. Many such transactions were seen as scandalous, yet our courts let them go forward even though this problem — of controlling shareholders exploiting outside shareholders — is the type that can undermine a stock market. The SEC criticized the courts and there were calls for new legislation — and commentators think that it was those threats, and not the common law evolving on its own, that induced the courts to toughen up on insiders.[24] Another example: Earlier in the twentieth century, common law fiduciary duties were seen as weak enough to demand new federal regulation. Insider trading, for example, was legal in most states at common law.[25]

Thus, although common law fiduciary duties can be central in protecting shareholders, and often are in the United States, they're not always as strong as they can be cracked up to be.[26] Still, one has the impression that the United States uses fiduciary duties more than civil law nations (and maybe more than other common law nations). The critics could be seen as saying that American fiduciary duties should be even stronger — or that alone they do not protect investors enough.

Indeed, common law, fiduciary-based protections get much help from regulators like the SEC, from the stock exchange, and from the legislature. Yes, the American common law judge is, despite the critics, very important in corporate law,

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[22] *See* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992) (arguing that states have weak incentives to produce good law dealing with "self-dealing transactions, taking of corporate opportunities, . . . insider trading," and "regulation of going-private and parent-subsidiary freeze-outs" — the very insider machinations that can quash a stock market).

[23] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 670, 672, 681–84 (1974). The contrary view is in Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977), and ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 19–21 (1993).

[24] *See, e.g.*, RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1254–56, 1256 n.40 (2d ed. 1995).

[25] *See, e.g.*, Goodwin v. Agassiz, 186 N.E. 659, 660–62 (Mass. 1933) (holding that without privity between insider directors and individual stockholders, an insider was not liable for trading on inside information, a result that left buyers in the stock market with reduced recourse — or none at all); WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 577–78 (2003). The bright-line rules of section 16(b), 15 U.S.C. § 78p(b) (2000), sufficed until the 1960s, when the SEC expanded insider trading liability.

[26] *See* Bebchuk, *supra* note 22, at 1441.

but the judge is not alone in protecting American stockholders. And even if the common law judge were central — and not just very important — we'd need to know that regulators could not do the job as well before concluding that common law judging had an inherent structural advantage over the civil law in building financial markets. Indeed, in Britain, the other major common law jurisdiction, the judge seems not to have protected minority stockholders well.[27]

And much that's important to shareholder protection isn't driven by fiduciary duties. Fiduciary duties do not protect distant stockholders from managerial mistake or from managers' neglect of shareholders' interests. Because the business judgment rule stifles such lawsuits (properly, I might add), American stockholders must rely on *other* institutions to protect them from managerial error. Thus, if unconstrained managers would be systematically less shareholder-oriented in some firms, or in some nations, than in others, then dominant shareholders could not easily sell out their stock to distant stockholders because stockholder value would sharply decline.[28]

Thus, if the common law–civil law distinction rested on basic fiduciary duties, it would be weak: Yes, fiduciary duties have been important to common law. But modern American corporate law is not solely fiduciary oriented, but also made largely by the SEC, a regulator. And the goal sought — protecting distant stockholders — can be achieved via multiple means, all within the reach of either legal origin. It would be a mistake to read the qualitative evidence as telling us to prescribe mainly judge-based, fiduciary duty tools to propel financial and economic development.

2. Overregulating financial markets. John Coffee reinvigorated the legal origins theory, arguing that civil law overregulates securities markets. Stock exchanges, if left alone, could protect stockholders. But statist, centralized civil law nations would not leave them alone, stymieing stock markets from emerging and quashing private efforts to protect minority stockholders. A low-regulation environment in the United States allowed the stock exchange to arise and to protect minority stockholders, and then exchange practices morphed into good securities law.[29]

Finance scholarship took up Coffee's overregulation theory[30] and expanded it to posit a deep preference in common law nations for markets and private

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[27] *See* Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 469–70 (2001) (importance of British stock exchange); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 41–42 (2001) (importance of British legislation).

[28] I develop this idea in Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002), and in MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 159–96 (2003).

[29] *See* Coffee, *supra* note 27, at 9. Paul Mahoney argues that although legal origin does not affect corporate law, weak property protection in civil law nations stunts their economic growth. *See* Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might be Right*, 30 J. LEGAL STUD. 503, 523 (2001).

[30] *See, e.g.*, Glaeser & Shleifer, *supra* note 6, at 1194 ("French civil law countries exhibit heavier regulation [and] less secure property rights . . . than do the common law countries."); La Porta et al., *The Quality of Government*, *supra* note 18, at 231–32 ("[C]ivil legal tradition . . . build[s] institutions to further the power of the State . . . .").

contracting.[31] The overregulation hypothesis comes in three varieties: first, common law judiciaries confine the overregulatory tendencies of their legislatures; second, civil law systems overregulate securities markets; and third, the civil law intrinsically induces overregulation of the economy, while the common law lets markets flourish.

With this third channel, origins theory ties into a system's propensity to adopt market-preferring, transparency-enhancing disclosure rules.[32] Pro- or anti-market regulation is important, but attributing it to origin suffers from two limitations: First, we are now talking more about nations' preferences for outputs — for (or against) markets, transparency, and private contracting — than about a legal system's institutional qualities. Stronger explanations for rival national preferences exist, as we see in Parts III and IV. Second, both legal origins in modern times could go either way. America passed the Sarbanes-Oxley Act of 2002,[33] which was quite directive,[34] while Germany was setting up market-preferring, transparency-enhancing "comply or explain" rules, which did not impose regulatory straightjackets.[35] A "comply or explain" rule instead requires a firm not following the rule to explain why it chose not to.

As we see later, civil law nations' heavy role in their economies is a twentieth-century phenomenon, not a longstanding one. And, where it counts most here — for financial markets — by most measures common law nations regulate their securities markets, via codes and regulators, more heavily than do civil law systems. We pick up the overregulation thread again in Part II, but first let's see how strong those classical differences between legal origins are today.

C. The Differences Erode

The preceding section shows that classical differences probably did not determine financial differences in the first place. Next we see that those classical differences do not sharply persist today for financial law.

To be sure, what I call classical differences — civil law's propensity to codify and its judiciary's unwillingness to invent ways to remedy wrongdoing — are in dispute. Civil law analysts see assertions of such differences as reflecting the prejudices of common law commentators, not the reality of their nations' judicial

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[31] *See, e.g.*, La Porta et al., *What Works?*, *supra* note 19, at 14, 28 (common law "emphasis on market discipline and private litigation").

[32] *See id.* at 27–28. This channel is distinct from Coffee's overregulatory channel.

[33] Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

[34] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529, 1594–1603 (2005) (severely criticizing the Act for being so directive).

[35] *See* Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Pulizität [Act in Furtherance of Transparency and Publicity of Corporate and Accounting Law], July 19, 2002, BGBl. I at 2681, art. 1, § 161; BERICHT DER REGIERUNGSKOMMISSION CORPORATE GOVERNANCE [Report of the German Government Panel on Corporate Governance] Rz. 8–10 (Theodor Baums ed., 2001) (recommending "comply or explain" rules). The effectiveness of these rules has yet to be seen. *See generally* E. Wymeersch, *The Enforcement of Corporate Governance Codes*, 6 J. CORP. L. STUD. 113, 113 (2006) (describing them as the "best means of developing adaptive but nevertheless effective corporate governance practices").

institutions.[36] But in this section I take the classical differences — or prejudices — at face value and argue, first, that these differences were never powerful enough to determine deep divergences in financial markets (because both systems' core tools can achieve the goal of investor protection) and, second, that enough of these classical contrasts have eroded that whatever subtle differences persist cannot explain disparities in modern financial markets.

First off, today both civil and common law regulate and codify. Consider Frederick Schauer's evaluation:

> [E]ven in common law countries, the civil law model seems so much in the ascendancy, and the common law model seems so much in decline. . . . [Classic common law] open-ended lawmaking and rulemaking is now . . . rare, with detailed statutes and detailed regulations far more the norm now than in the past.[37]

And how relevant are the classic differences to finance? These differences affected judicial action, not securities regulation — which is where much of the action is for American financial markets.[38] Indeed, more than thirty-five years ago, one general retrospective summarized the thinking then on legal origins: "there is no longer much difference between [the civil and the common law]"[39] because the differences eroded in the twentieth century "by reason of the parallel [institutional] developments [in all nations] . . . to satisfy the same societal needs."[40]

Thus, first off, the modern state's regulatory needs exceed the regulatory level that either the civil or common law tradition induced in prior centuries. Modern socioeconomic similarities among the richer nations presumably pressed all affected nations toward new and roughly similar regulatory institutions.

Second, civil law jurisprudence has adopted common law modes. Civil law countries no longer try to codify comprehensively.[41] "The French Code of Commerce is now but an empty shell. . . . [I]t could not provide an adequate conceptual framework for the new institutions which arose from the industrial revolution of the 19th century."[42]

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[36] *See, e.g.*, Carl Baudenbacher, *Some Remarks on the Method of Civil Law*, 34 TEX. INT'L L.J. 333, 357–60 (1999). *But see* Richard B. Cappalli, *At the Point of Decision: The Common Law's Advantage over the Civil Law*, 12 TEMP. INT'L & COMP. L.J. 87, 87–91 (1998).

[37] Frederick Schauer, *The Failure of the Common Law*, 36 ARIZ. ST. L.J. 765, 772 (2004).

[38] Recent legal origin literature recognizes this, but hasn't yet recognized in print how it can undermine the basic legal origins theory. *See, e.g.*, La Porta et al., *What Works?*, *supra* note 19, at 15, 27–28.

[39] Joseph Dainow, *The Civil Law and the Common Law: Some Points of Comparison*, 15 AM. J. COMP. L. 419, 434 (1967).

[40] *Id.* at 420; *see also* Basil S. Markesinis, *Learning from Europe and Learning in Europe*, *in* THE GRADUAL CONVERGENCE 1, 30–32 (Basil S. Markesinis ed., 1994); John Henry Merryman, *On the Convergence (and Divergence) of the Civil Law and the Common Law*, 17 STAN. J. INT'L L. 357, 359 (1981) (finding more convergence than divergence). Dainow fights the common conclusion that the two have lost many of their old differences, but he focuses on lawmaking involving topics other than economic regulation. *See* Dainow, *supra* note 39, at 434.

[41] *See* MERRYMAN, *supra* note 8, at 155.

[42] Denis Tallon, *Reforming the Codes in a Civil Law Country*, 15 J. SOC'Y PUB. TCHRS. L. 33, 35 (1980).

True, civil law judges perhaps once refrained from implying duties, from looking at facts in a common law way, and from using precedent in a common law way, but these classic differences today are less stark than they once might have been.[43] Modern civil law judges look at the *functions* of the legislation and interpret rules in light of function. They develop a shadow common law in key areas; although they tie their lawmaking to the legislative text, that text can have duty-type, open-ended standards, such as that of good faith.[44] A "striking example is Article 1382 of the French civil code, which simply says that anyone causing damage to another by their fault must compensate for the damage."[45] From that open-ended legislative standard a law of torts emerged.[46]

German corporate litigation further illustrates the modern civil law system's interpretive capacity. When a German corporation transferred assets to a subsidiary in a way shareholders disliked, a shareholder sued. The text of the German corporate code did not require that shareholders approve the transaction. A legal origins analyst might have predicted that the civil law judge, lacking legislative guidance, would not act, leaving the German shareholder unprotected.

That's not what happened. The German court held that the transfer hurt shareholders such that the shareholder assembly had to approve it. The German court thus widened the zone of protection beyond the legislature's words.[47] The doctrine persisted, morphed, and adjusted. The ensuing debate and judicial moves to define the scope of the doctrine look to me like the typical aftermath of a major Delaware corporate law court decision. True, whether German courts do this often enough and well enough still needs to be evaluated. But they can and do use tools that resemble common law fiduciary duties.

Third, and ironically here, the common law judge often feels hamstrung by the legislative corporate rule — the very weakness attributed to the civil law judge.[48] As

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[43] *See* Katja Funken, "The Best of Both Worlds": The Trend Towards Convergence of the Civil Law and the Common System 14–16 (July 2003), *available at* http://ssrn.com/abstract=476461. Again, some civil law theorists say the differences never were so stark.

[44] *See* Baudenbacher, *supra* note 36, at 347; Katharina Pistor, *Legal Ground Rules in Coordinated and Liberal Market Economies* 19 (European Corporate Governance Inst., Law Working Paper No. 30/2005, 2005), *available at* http://ssrn.com/abstract=695763 ("[I]n Germany . . . the good faith principle . . . has been widely used . . . and has allowed courts to develop extensive 'case law' beyond the specific strictures of the civil code.").

[45] H. PATRICK GLENN, LEGAL TRADITIONS OF THE WORLD 137 (2d ed. 2004); *see also* BASIL S. MARKESINIS, FOREIGN LAW AND COMPARATIVE METHODOLOGY 90 (1997) ("[I]t is not the general clause [of the code] but the case law of the courts which produces the rules.").

[46] For this insight into a civil law judiciary's capacity to work with open-ended legislation to build judge-made law, see Beck et al., *supra* note 5, at 658–59.

[47] *See* Marc Löbbe, *Corporate Groups: Competences of the Shareholders' Meeting and Minority Protection — the German Federal Court of Justice's Recent* Gelatine *and* Macrotron *Cases Redefine the* Holzmüller *Doctrine*, 5 GERMAN L.J. 1057, 1057 (2004). For another instance of expansive lawmaking in the civil law judiciary, see Baudenbacher, *supra* note 36, at 339–40, who notes how French courts create and expand product liability tort remedies. *But cf.* Glaeser & Shleifer, *supra* note 6, at 1212 ("In civil law countries . . . judges are not even supposed to interpret the codes very much . . . .").

[48] *See, e.g.*, Hariton v. Arco Elecs., Inc., 182 A.2d 22, 25–26 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963) (Delaware court refusing to go beyond the terms of a statute to recognize a de facto merger).

William Bratton concluded: "With [Delaware's doctrine of independent legal significance], the state court effectively announces that no body of substantive principles informs certain applications of the legislature's corporate code, inviting transaction planners to exploit the literal word at will."[49] Textualist theories of common law jurisprudence, such as those associated with Justice Scalia, are similar: common law judges should be hamstrung by legislative words.[50]

Fourth, common law systems have codified much of their financial law and thereby have become more regulatory. Once it could be said that if the "common law stands for anything, it is absence of codes, and likewise civil law stands for codification."[51] But American reformers began codifying in 1892, with the Uniform Law Commission. "[T]he efforts of the [Uniform Laws] Conference have substantially promoted legal unification in the American states, *especially in the area of commercial law* . . . ."[52] Since the 1950s, the United States has had a Uniform Commercial Code. Since 1923, the American Law Institute has been recapitulating, in code-like form, American law. "[The ALI's] Restatements are rather like the Civil Law codes in their systematic structure of abstractly formulated rules . . . ."[53] And common law codes are often *more* detailed than civil law codes, leaving *less* discretion for the common law judge.[54]

Moreover, codification here wasn't inimical to markets. Business interests often *wanted* it, as they thought the common law confusing, giving the legal profession too much power to extract rents in business transactions.[55] The legal profession, not business interests, resisted codification. Indeed, a strong tradition of legal theorists concludes that ex ante precise codification yields better predictability for business than ex post judicial general decisionmaking. Jeremy Bentham is the classic critic of the common law on this score: "In his view, the fundamental evil was the common law that had evolved over hundreds of years. . . . It was unclear, uncertain, and full of fictions and tautologies; the judiciary was slow and unjust."[56] Bentham recommended codification.

Indeed, imagine an inquiry into why secured credit and securitization are so strong in the United States. One would bump into article 9 of the Uniform Commercial Code — a code so richly drafted that it leaves little interpretive

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[49] William W. Bratton, *Gaming Delaware*, 40 WILLAMETTE L. REV. 853, 854 (2004); *see also* D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 827 (2004). *But cf.* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

[50] *See* SCALIA, *supra* note 10, at 16–17, 23–25, 29–30.

[51] R.C. VAN CAENEGEM, JUDGES, LEGISLATORS AND PROFESSORS: CHAPTERS IN EUROPEAN LEGAL HISTORY 39 (1987); *see also* F.H. LAWSON, A COMMON LAWYER LOOKS AT THE CIVIL LAW 47 (1953).

[52] ZWEIGERT & KÖTZ, *supra* note 11, at 252 (emphasis added).

[53] *Id*. The Restatements are not themselves law. The uniform codes become law when enacted.

[54] *See id.* at 267–68 (discussing English codes).

[55] *See* Donald J. Smythe, Transaction Costs, Contagion Effects, and the Diffusion of the Uniform Sales Act, 1906–47, at 5 (July 2005), *available at* http://ssrn.com/abstract=799324.

[56] Gunther A. Weiss, *The Enchantment of Codification in the Common-Law World*, 25 YALE J. INT'L L. 435, 476 (2000).

discretion for the judge. One might then hypothesize that it's the American capacity to codify in detail that facilitates secured credit and securitization. One might hypothesize that regulatory codification plays a similar role for American securities law.

Although early codifications systematized common law decisions, "the new statutes [have] frequently [been] meant to be the primary source of law. Courts, limited to honest interpretations of these statutes *and committed to legislative supremacy*, . . . [gave] them the authority they claimed for themselves."[57] It may be an exaggeration to say that the real difference between the Napoleonic Code and American codification is that the former just predated the latter — but we're all codifiers now.

Indeed, much American corporate law *is* codified in the 1933 and 1934 Securities Acts,[58] their major legislative amendments such as the Williams[59] and Sarbanes-Oxley Acts, and the SEC's regulatory implementation. Many American corporate lawyers do not decipher fiduciary duty cases, but instead apply the detailed rules of the SEC's Regulation S-K.[60]

Remaining big differences between civil and common law lie in the civil law's penchant for formalism, in the nature of the trial, and in the availability of a jury[61] — differences unlikely to affect finance deeply. Commercial interests in the United States at times opt *for* formal rules, preferring their relative certainty.[62] Although the civil law often does not use the jury common in the United States, our primary corporate law court — that in Delaware — operates *without* a jury, with this seen as one of its advantages.[63]

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Legislatures in common law countries today regulate. They tell administrative agencies to write the rules to implement the legislature's general instructions, thereby reducing the relative import of the courts. What counts today is not method but content — that is, policy. And, to the extent policy does not flow from the pens of regulators promoting the public welfare, it's politics.

D. Can Legal Origin Anchor Law as the Primary Cause?

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[57] GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 5 (1982) (emphasis added). Judge Calabresi critiques judicial deference.

[58] 15 U.S.C. §§ 77a–77aa, 15 U.S.C. §§ 78a–78mm (2000).

[59] 15 U.S.C. § 78m(d)–(e), § 78n(d)–(f) (2000 & Supp. III 2003).

[60] 17 C.F.R. §§ 229.10–.702 (2006).

[61] *See* ZWEIGERT & KÖTZ, *supra* note 11, at 272–74.

[62] *See, e.g.*, Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1769–70 (1996).

[63] *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 708 (2002). English civil courts also typically operate without a jury. *See* NEIL ANDREWS, ENGLISH CIVIL PROCEDURE 775 (2003) ("The jury has been excluded from the great majority of civil cases . . . [due] notably [to] the need for consistency and predictability.").

Important to the legal origins inquiry is how origin could buttress the centrality of corporate law in creating financial markets. That is, even if we regularly saw "good" corporate law in countries with deep stock markets and "bad" corporate law in countries without them, we wouldn't know which caused what. Do financial markets mostly arise for economic reasons and then players in those markets insist on protective law?

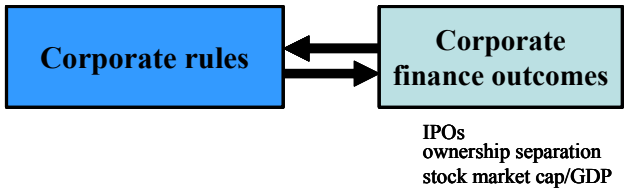

Figure 1. Law largely determines finance outcomes

Legal origins theorists argue that good on-the-ground corporate law and good financial outcomes are both found in common law nations and the opposite in civil law nations. Because origins long preceded modern markets, markets could *not* have caused legal origin, as Figure 1 illustrates. Origin causes good (or bad) financial law, the theory runs, and then that financial law makes markets flourish (or not), as Figure 2 shows.

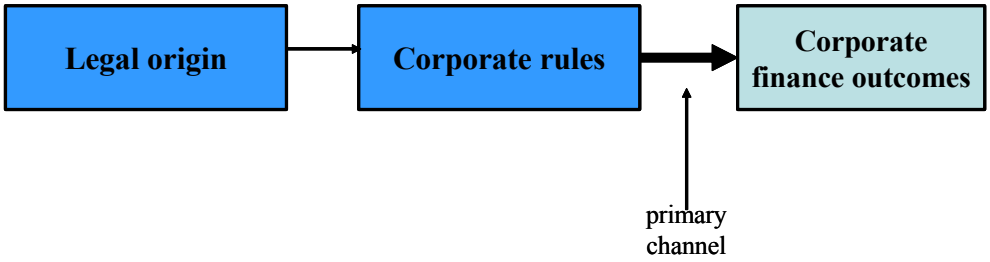

Figure 2. The law and finance approach
(Because origin and types of rules correlate, causation is largely from rules to finance, not vice versa.)

Law largely determines finance outcomes. Because origin and types of rules correlate, causation is largely from rules to finance, not vice versa.

If the sequence in Figure 2 breaks down, the case strengthens for other explanations of why and how law and financial markets interact. Law, economic task, and politics might well be determined simultaneously. And, if that sequence breaks down far enough, as I argue it must, then a persisting line of academic explanation for strong financial markets could be incorrect and a persisting line of development efforts misguided.

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That's the legal origins theory and some of its explanatory weaknesses. In the rest of the Article I further argue against it, show that twentieth-century history can

explain the data as well as or better than medieval legal origins, and conclude that the big-picture inquiry should now put aside legal origins and focus on how economic function interacts with policymakers' political motivations and constraints.

The basic political economy story is simple: First, the classic differences between legal origins are easily exaggerated. What counts is whether the system can protect investors; either set of tools can be deployed to do the job. Second, modern securities law revolves around a regulatory agency operating through a comprehensive regulatory code — not an intrinsic common law institutional advantage. What counts is not the tool but the polity's willingness to tolerate financial markets. Third, all modern states regulate the economy much more than either legal origin would induce. Legislatures legislate and regulators regulate in both systems. What counts is *what* the legislature legislates: whether it protects or denigrates property rights and capital markets. The legislature and its regulatory creations are central today in defining economic rights, but it's the *judiciary* that defines legal origins differences.

The legal origins literature has pushed us to think more deeply about how institutions and markets relate. But it may be modern political economy issues and not origins that drive institutional differences in the wealthy West. Differences between civil and common law are mostly ones of judicial style, but legal origin has become bundled in too many people's minds with substantive regulations, with regulators' ideological tendencies, and even with voters' preferences — which are mostly modern political economy variables with which origins ought not to be bundled.

The effects of the early twentieth century's cataclysms were probably more powerful than classical features of judicial style and legal origin. Even among nations where securities markets had once been strong, where devastation and instability were relatively greater from 1914 to 1945, securities markets were shallower at the end of the twentieth century. The core civil law countries were wrecked more severely than the core common law countries, as the latter were separated by oceans and channels from the twentieth century's bloodiest battlefields. The consequences were not small. Common law nations' institutions survived more or less intact; the core civil law nations' institutions were wrecked and then rebuilt in the post–World War II political environment, one in which they did not strongly prefer financial markets. Some nations denigrated stock markets, protected labor markets, and had the state allocate capital; others did not. These differences set the modern foundations for differing financial structures in the wealthy West — not legal origin.

II. STATE POWER AND LEGAL ORIGIN IN THE TWENTIETH CENTURY

I focused in Part I on the weakness of the fiduciary duty argument, the growing importance of codification in both legal systems, and the general rise of regulatory agencies. I focus in this Part on the historical trends in civil and common law countries of state presence in their economies.

First, although there are differences in the weight of the state among the world's wealthiest nations, these differences historically did not break sharply along origins lines. Second, variation around the world today in regulatory budgets for finance does not fit a neat legal origins dichotomy: it's the common law nations that spend more on financial regulation.

One view that's come up — that the common law confines state power — should be put aside. Some origins advocates see common law institutions restraining governmental power and protecting property: "[T]he common law historically stood on the side of private property owners against the state. *Rather than becoming a tool of the state*, the Common law has acted as a powerful counterbalance that has promoted private property rights."[64] The better view, as I see it, is that the common law *is*, or can be, such a "tool of the state." Property owners long dominated the state in Britain[65] (and perhaps the United States), inducing it to protect property via common law judges; if the judges had not protected property owners, the owners would have found other institutions to protect themselves, inducing their Parliament to enact a code if need be.

It's true that a long time ago American courts barred state legislatures from demeaning preexisting property rights in what's often called the *Lochner* era, named after the Supreme Court's 1905 decision of the same name.[66] And Congress's own capacity back then to make economic law was more limited than today. The Constitution does not grant full economic sovereignty over the United States to Congress, whose formal power comes from clauses like the Commerce Clause,[67] which gives it power to regulate interstate commerce. That power was originally seen as narrower in scope than it became later in the twentieth century. Here and there at the end of the nineteenth century, Congress used its commerce authority to regulate the railroads or to pass antitrust laws for firms in interstate commerce. But until the early twentieth century, the interstices were not all that porous.[68] (Strictly speaking, common law is not even the impetus here. The Supreme Court was sitting not as a common law court but as a constitutional one. Nor is judicial restraint on legislative economic power inherent in the common law. British courts did not analogously confine Parliamentary authority.[69] In Britain "there are no special,

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[64] Beck et al., *supra* note 5, at 658 (emphasis added).

[65] *See* BARRINGTON MOORE, JR., SOCIAL ORIGINS OF DICTATORSHIP AND DEMOC-RACY 19 (1966).

[66] Lochner v. New York, 198 U.S. 45 (1905); *see also* 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 1344, 1350 (3d ed. 2000); WILLIAM M. WIECEK, THE LOST WORLD OF CLASSICAL LEGAL THOUGHT 152–54 (1998).

[67] U.S. CONST. art. I, § 8, cl. 3.

[68] *See* WILLIAM H. RIKER, THE DEVELOPMENT OF AMERICAN FEDERALISM, at x (1987) ("[A] 'dual federalism' . . . prevent[ed] both state and federal regulation of industry."). Some legal origins analysts understand well the limited role common law courts play in controlling congressional legislation. *See, e.g.*, Rafael La Porta et al., *Judicial Checks and Balances*, 112 J. POL. ECON. 445, 447 (2004) ("[T]he U.S. Supreme Court has long accepted the government's power to tax and regulate . . . ."). The next step is to grapple with the political forces that affect legislatures.

[69] *See* JEFFREY GOLDSWORTHY, THE SOVEREIGNTY OF PARLIAMENT 10, 235 (1999); Kenneth W. Dam, *The Judiciary and Economic Development* 31 (Univ. of Chi., John M. Olin Law & Econ. Working Paper No. 287, 2006), *available at* http://ssrn.com/abstract=892030.

'fundamental' laws that cannot be abolished or changed by Parliament."[70] Some even see democratic lawmaking in the United States as the key to property protection, with judicial review secondary.[71])

Moreover, the logic linking property and finance in this channel of the legal origins theory is not so clear cut. Property rights protect the investor against the state's encroachments. A nation could strongly protect property from state incursion but poorly protect outside investors from insider machinations — and vice versa.

The common law judge — or at least its constitutional law avatar — is still a powerful figure in American lawmaking. But we should not mistake the judge's centrality in some spheres for an importance in spheres in which the judge has become a lesser figure. The American judge draws boundaries for lawmakers on social policy issues, such as abortion, affirmative action, and gay rights, not rights to property protection.[72] The modern regulatory state, although subject to judicial interpretations of what authority the legislature gave the regulator, is defined more by the *legislature* — not a common law institution — than by the judiciary.

A. The Rise of the Regulatory State in the Twentieth Century

State presence in common law systems today exceeds its historical presence in civil law nations. Historians often mark World War I as a turning point: old governmental structures collapsed just after the War, statist institutions emerged, people demanded more from their governments, and the welfare state grew. Nations transformed themselves into administrative states that act primarily through statutes, directives, and regulation.

The United States began moving away from judge-made law, and even away from legislatively made but judicially enforced law, well over a century ago when Congress set up the Interstate Commerce Commission and chose to have regulators, not judges, make law.[73] The New Deal was built on these regulatory beginnings, when the *Lochner*-era skepticism towards administrative regulation and positive government ended.[74] Courts' "uncoordinated, decentralized structure made them ill

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[70] VAN CAENEGEM, *supra* note 51, at 20.

[71] *See, e.g.*, WILLIAM A. FISCHEL, REGULATORY TAKINGS 139–40 (1995); Daniel H. Cole, *Political Institutions, Judicial Review, and Private Property: A Comparative Institutional Analysis*, 15 SUP. CT. ECON. REV. (forthcoming 2007) (manuscript at 51, on file with the Harvard Law School Library).

[72] One newspaper's list of milestones in Chief Justice Rehnquist's thirty-three year term was dominated not by economic issues but rather by those of federalism, jurisdiction, the separation of church and state, civil rights, abortion, the death penalty, and flag burning. *See Significant Cases in a 33-Year Term*, N.Y. TIMES, Sept. 5, 2005, at A19. When the Court recently ruled on property-taking powers, it deferred to legislative power. *See* Kelo v. City of New London, 125 S. Ct. 2655, 2663 (2005). Several states shortly thereafter seemed poised to restrict local governments' power to take local property for economic development. *See* Christopher Cooper, *Court's Eminent-Domain Edict Is a Flashpoint on State Ballots*, WALL ST. J., Aug. 7, 2006, at A4. The polity, not the judges, restricts takings.

[73] *See* Morris P. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?*, 39 PUB. CHOICE 33, 35–40 (1982).

[74] *See* W. Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937).

suited to undertaking" modern social and economic reform.[75] "[T]hey could not even begin proceedings on their own [and] were rarely experts in the matter at hand. As a result, the New Deal period saw a large-scale movement away from the courts [toward regulators and the legislature] as a system of social ordering."[76] "[W]e have gone from a legal system dominated by the common law, divined by courts, to one in which statutes, enacted by legislatures, have become the primary source of law."[77]

As a leading political scientist said two decades ago: "Congress invariably [now] chooses to regulate economic . . . life by creating agencies . . . . Congress [usually] delegates power to regulatory agencies *instead of passing laws and allowing the courts to oversee their enforcement*."[78] Primary economic matters — such as the structure of financial markets — are not left for the common law judge to resolve.

Modern political science often extols the virtues of administrative over judge-made law: if economic regulation depended primarily on the judiciary, we'd face delay, inconsistency, and sporadic action, since courts must wait for a controversy to come before them.[79] Common law institutions aren't up to dealing with many modern economic problems. This view — that we're all regulators now — is deep, persistent,[80] and, in my view, inconsistent with legal origins theory.

B. The Power of the State

Data show the regulatory state rising in *both* civil and common law nations, with the divergence in state role between the two a modern phenomenon.

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[75] CASS R. SUNSTEIN, THE PARTIAL CONSTITUTION 61 (1993).

[76] *Id.*

[77] *Id.* at 1.

[78] Fiorina, *supra* note 73, at 33, 35 (emphasis omitted).

[79] *Id.* at 43; *see also* MELVIN ARON EISENBERG, THE NATURE OF THE COMMON LAW 4 (1988) (showing that courts are passive, equipped to decide only discrete controversies).

[80] *See, e.g.*, ROBERT E. CUSHMAN, THE INDEPENDENT REGULATORY COMMISSIONS 5–7 (1941); GABRIEL KOLKO, RAILROADS AND REGULATION 1–6, 231–39 (1965) (noting that Progressives and the railroad industry alike wanted railroad regulation in light of their unhappiness with common law institutions); JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 24 (1938). Proponents of a regulatory capture tradition suspect that such regulation often results from the deleterious influence of interest groups. *See, e.g.*, Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 350–51 (1974); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 4–6, 17–18 (1971).

Table 1. Growth of government, 1870-1996 (expenditures as a percentage of GDP)[81]

	Legal origin	Late 19th Century about 1870	Pre WW I 1913	Post WWI 1920	Pre WWII	1996
Austria	Civil	10.5	17.0	14.7	20.6	51.6
Belgium	Civil	n.a.	13.8	22.1	21.8	52.9
France	Civil	12.6	17.0	27.6	29.0	55.0
Germany	Civil	10.0	14.8	25.0	34.1	49.1
Italy	Civil	13.7	17.1	30.1	31.1	52.7
Japan	Civil	8.8	8.3	14.8	25.4	35.9
Netherlands	Civil	9.1	9.0	13.5	19.0	49.3
Norway	Civil	5.9	9.3	16.0	11.8	49.2
Spain	Civil	n.a.	11.0	8.3	13.2	43.7
Sweden	Civil	5.7	10.4	10.9	16.5	64.2
Switzerland	Civil	16.5	14.0	17.0	24.1	39.4
Australia	Common	18.3	16.5	19.3	14.8	35.9
Canada	Common	n.a.	n.a.	16.7	25.0	44.7
Ireland	Common	n.a.	n.a.	18.8	25.5	42.0
New Zealand	Common	n.a.	n.a.	24.6	25.3	34.7
United Kingdom	Common	9.4	12.7	26.2	30.0	43.0
United States	Common	7.3	7.5	12.1	19.7	32.4
Average		10.7	12.7	18.7	22.8	45.6
	Average Common/Civil	12/10	12/13	20/18	23/22	38/49

1. A timeline of state power in the twentieth century. Government spending was low in *both* civil and common law nations at the end of the nineteenth century and higher in *both* at the end of the twentieth. Government spending in every civil law nation in 1870 and 1913 was well below spending in the common law nations in the late twentieth century. Common law governments spent about the same as civil law nations — or more — before World War I.

True, government spending imperfectly indicates state power: the state can bar an activity without spending much. We cannot perfectly measure state power, but the numbers suggest that civil law does not compel high state presence in the economy. Before World War I, civil law governments had modest roles in their economies[82] and were often politically conservative. Their budgetary domination of their economies is a late-twentieth-century phenomenon, not a centuries-old one.

Table 2. Government subsidies and transfers, 1870-95 (as a percentage of GDP)[83]

	Legal origin	About	1937	1960	1970	1980	1995

[81] Based on VITO TANZI & LUDGER SCHUKNECT, PUBLIC SPENDING IN THE 20TH CENTURY: A GLOBAL PERSPECTIVE 6-7 (2000). Clipping off the two highest in 1870—Australia and Switzerland—maintains the rough equivalence between civil and common law spending then, with the average-common/average-civil ratio going to 8.4/10.1.

[82] *See* HAROLD JAMES, EUROPE REBORN 48 (2003) ("[Before World War I] there was a substantial level of [economic] integration, with large flows of goods, capital and labor that were largely unaffected by national control and regulation . . . . Property rights were secure and widely understood as a basis of civilization.").

[83] Id. at 31.

		1870					
Austria	Civil	n.a.	n.a.	17.0	16.6	22.4	24.5
Belgium	Civil	0.2	n.a.	12.7	20.7	30.0	28.8
France	Civil	1.1	7.2	11.4	21.0	24.6	29.9
Germany	Civil	0.5	7.0	13.5	12.7	16.8	19.4
Italy	Civil	n.a.	n.a.	14.1	17.9	26.0	29.3
Japan	Civil	1.1	1.4	5.5	6.1	12.0	13.5
Netherlands	Civil	0.3	n.a.	11.5	29.0	38.5	35.9
Norway	Civil	1.1	4.3	12.1	24.4	27.0	27.0
Spain	Civil	n.a.	2.5	1.0	6.7	12.9	25.7
Sweden	Civil	0.7	n.a.	9.3	16.2	30.4	35.7
Switzerland	Civil	n.a.	n.a.	6.8	7.5	12.8	16.8
Australia	Common	n.a.	n.a.	6.6	10.5	16.7	19.0
Canada	Common	0.5	1.6	9.0	12.4	13.2	14.9
Ireland	Common	n.a.	n.a.	n.a.	18.8	26.9	24.8
New Zealand	Common	0.2	n.a.	n.a.	11.5	20.8	12.9
United Kingdom	Common	2.2	10.3	9.2	15.3	20.2	23.6
United States	Common	0.3	2.1	6.2	9.8	12.2	13.1
Average		.7	4.6	9.7	15.1	21.4	23.2
	Average Common/Civil	.8/.7	4.7/4.5	7.8/10.5	13/16	18/23	18/26

2. Timelines of government budgets, government transfers, and financial markets. Nor do civil law nations historically show a higher propensity than common law nations to redistribute income, wealth, or property. Table 2 shows no big difference between the size of government subsidies and transfers in common and civil law nations at the end of the nineteenth century. Two trends emerge from Table 2: First, subsidies and transfers increased *throughout* the developed world over the past century. Second, civil law nations did not redistribute noticeably more than common law nations until the latter part of the twentieth century — and often distributed less. The numbers for the end of the nineteenth century are consistent with many civil law nations being conservative, property-oriented regimes.

Moreover, stock and other financial markets were stronger in civil law nations before World War I than after World War II, as Table 3, drawn from Raghuram Rajan and Luigi Zingales's data, shows. The fraction in each cell in Table 3 is the total value of the nation's stock market as a percentage of its gross domestic product. Back in 1913, several core civil law nations' stock markets — those of Belgium, France, Germany, and Sweden — were stronger than America's. Between 1913 and 1970, stock market capitalization declined in most wealthy civil law nations while it increased in most wealthy common law nations. By 1970, the trend in the civil law nations reversed, and every nation's stock market capitalization rose; by 1999, civil and common law nations again began to look similar.

The data in Tables 1, 2, and 3 suggest that something happened in the twentieth century that pushed civil and common law nations — once seemingly on a similar financial path — to diverge sharply after World War II, with that divergence fading at the end of the century.

Table 3. Stock markets from 1913 to 1999[84]
(stock market capitalization as a percentage of GDP)

Country	Legal Origin	1913	1960	1970	1999
Belgium	Civil	.99	.32	.23	.82
Denmark	Civil	.36	.14	.17	.67
France	Civil	.78	.28	.16	1.17
Germany	Civil	.44	.35	.16	.67
Italy	Civil	.17	.42	.14	.68
Japan	Civil	.49	.36	.23	.95
Sweden	Civil	.47	.24	.14	1.77
Switzerland	Civil	.58	n.a.	.50	3.23
Australia	Common	.50	.94	.76	1.13
Canada	Common	.74	1.59	1.75	1.22
United Kingdom	Common	1.09	1.06	1.63	2.25
United States	Common	.39	.61	.66	1.52
	Average Common/Civil	**.68/.54**	**1.05/.30**	**1.20/.22**	**1.53/1.25**

3. Regulating financial and labor markets. Strands of the legal origins theory say that it's the density and intensity of regulation in civil law systems that's important. Civil law systems lay on too much rigid securities regulation and thereby demean securities markets.[85] They do the same with labor regulation, thereby making labor markets rigid.[86] It was just a matter of time before their robust 1913 stock markets collapsed under the weight of overregulation.

But the data do not show this for securities regulation. Many of the same nations that hardly regulate securities markets regulate labor markets intensely, creating the well-known labor rigidities in Continental Europe.[87] The policy tool — regulation — is there, but it is used to protect incumbent labor, not shareholders. The policies differ; the tool does not.

Table 4. Labor and securities disclosure regulation negatively correlate in the OECD

Disclosure regulation	Labor		Disclosure regulation	Labor

[84] *See* Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003), at 15, tbl. 3. Their data does not account for float—i.e., the portion of stock not owned by the controlling insiders (float could be high or low, with the same stock market capitalization)—but float typically has correlated the ratio of stock market capitalization to GDP. This kind of historical data is often uncertain. Recalculating the 1913 numbers with a data source economic historians prefer suggests that Table 3 understates the size of America's stock market and overstates Britain's. See Richard Sylla, *Schumpeter Redux: A Review of Raghuram G. Rajan and Lugi Zingales's* Saving Capitalism from the Capitalists, 44 J. ECON. LIT. 391, 401 (2006); RAYMOND W. GOLDSMITH, COMPARATIVE NATIONAL BALANCE SHEETS: A STUDY OF TWENTY COUNTRIES, 1688-1978, at 233, 301 (1985). Such adjustments though wouldn't change the rough similarity of stock market capitalization in 1913 of common law and civil law nations. Id. at 199, 210, 217, 226, 250, 256, 290.

[85] *See* Coffee, *supra* note 27, at 9–10.

[86] *See* Botero et al., *supra* note 7, at 1339, 1375–80.

[87] *See* Gilles Saint-Paul, *The Political Economy of Employment Protection*, 110 J. POL. ECON. 672, 696–99 (2002); Horst Siebert, *Labor Market Rigidities: At the Root of Unemployment in Europe*, 11 J. ECON. PERSP. 37, 39 (1997).

Country	intensity	regulation	Country	intensity	regulation
United States	6	.48	Norway	3.5	1.33
Canada	5.5	.46	Sweden	3.5	1.28
United Kingdom	5	.47	Mexico	3.5	1.17
France	4.5	1.41	Denmark	3.5	.99
South Korea	4.5	.99	Spain	3	1.33
Japan	4.5	.79	Netherlands	3	1.19
Australia	4.5	.72	Finland	3	1.06
Italy	4	1.28	Turkey	3	.88
Switzerland	4	.87	Portugal	2.5	1.46
Ireland	4	.81	Germany	2.5	1.31
New Zealand	4	.41	Belgium	2.5	.94
			Greece	2	1.00
			Austria	1.5	.86
Averages in high	**4.6**	**.79**	**Averages in low**	**2.8**	**1.14**
			Overall average	3.6	.98

Several polities protect the marginal blue-collar worker more than the marginal stockholder. Consider Table 4, which lists measures of securities market regulation and labor market regulation in the wealthier nations belonging to the Organization for Economic Cooperation and Development. Labor market regulation is intense in some nations, weak in others. But intense labor market regulation does not go along with intense securities market regulation. They correlate negatively.[88]

That contrast — civil law regulating labor markets intensely and capital markets lightly — meshes awkwardly with a theory that civil law overuses regulatory tools. It is also hard to make a case that civil law is intrinsically pro-labor and anti-capital, given that civil law nations' nineteenth-century politics were anti-labor.[89] France outlawed labor unions from 1791 to 1884 and barred strikes until 1864.[90]

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[88] The correlation coefficient is -0.52 and the t-statistic is -2.89, highly significant statistically ($p<.01$). For LLSV's twenty-seven developed nations (which are mostly OECD nations anyway), the correlation coefficient is -0.58 and the t-statistic is -3.51, even more statistically significant ($p=0.002$). Data for additional nations outside of the OECD is also available. For the forty-nine total nations for which data is available, the t-statistic is -2.80 and the significance level is $p<.01$.

[89] For France, see DAVID S. NEWHALL, CLEMENCEAU 254–61 (1991), which describes how Clemenceau used the French military to crush a miners' strike in 1906, and Jean Sagnes, *Voies européennes du syndicalisme*, *in* HISTOIRE DU SYNDICALISME DANS LE MONDE: DES ORIGINES À NOS JOURS 21, 42 (Jean Sagnes ed., 1994). For Germany, see A DICTIONARY OF NINETEENTH-CENTURY WORLD HISTORY 33 (John Belchem & Richard Price eds., 1994), which states that "[the 1878 German] Anti-socialist Law stemmed from Bismarck's determination to crush the newly formed socialist party . . . . The law banned socialist political parties and meetings, and forbade the publication of newspapers expressing socialist views . . . . Many socialists were imprisoned or chose exile." *See also* Klaus Tenfelde, *Germany*, *in* 1 THE FORMATION OF LABOUR MOVEMENTS 1870–1914 — AN INTERNATIONAL PERSPECTIVE 243, 244 (Marcel van der Linden & Jürgen Rojahn eds., 1990) ("[T]he new Prussian-German state made every effort to at least pacify the labor movement, at best to suppress it. . . . Repressive measures were directed equally against strike activities and organizational efforts. In this regard, the Socialist Law merely represented the climax of the repressive policy conducted by the state against the labor movement.").

[90] *See* Sagnes, *supra* note 89, at 42–43. Consider:

> [T]here was a remarkable similarity in the substance of [French, American, and British labor] law, though the processes by which it was established reflect the differences between the countries' respective legal systems. The Loi Chapelier, a product of the French Revolution, and the provisions of the Napoleonic Penal Code forbidding combinations are remarkably similar in substance to British and American doctrines of common law conspiracy.

Germany banned or restrained labor unions during most of the nineteenth century, most famously in its (anti-) Socialist Law in force between 1878 and 1890.[91]

One might argue that the negative correlation between labor market and capital market regulation here *does* fit a legal origin story: Common law systems use disclosure-forcing regulation for securities markets but are laissez-faire for their labor markets. Civil law systems regulate their labor markets but do not use their rule-making capacity to force disclosure in their securities markets. The problem with this view isn't the fit between the opposite outputs but attributing that fit to legal origin. For both securities market regulation (American-style) and labor regulation (European-style), a regulator has to write and enforce rules. Both use regulatory means to get to these differing outputs. Policy preferences differ, but policy differences are better explained by ongoing political economy considerations than by medieval legal origins.

*4. Instruments and powe*r. More generally here, we should not confuse legal tools with the power to use those tools. Napoleon's Code reined in judges to do the state's work. But his Code was just a tool; what mattered was that a powerful French state stood behind it. The Code was the *instrument* of power, not power itself. If Napoleon had not been able to control courts via a code, he could have set up administrators and, if faced with recalcitrant, classic common law–style judges, stripped them of their power entirely.

Similarly, were the vaunted British courts really the driving force in protecting property, or were they rather an epiphenomenon? The latter, it seems: Power had passed by 1688 from the King to the Whigs and their merchant constituents. They had killed one King, dethroned another, and chosen his replacement. They wanted their property protected and did so via the common law judges. But if the judges had been recalcitrant, the Whigs could have written, enacted, and codified new rights of property, in effect translating Locke into a code.

And in the twentieth century, what counted beyond basic economic conditions for a nation's financial market was not which medieval instruments lawmakers had at their disposal. Rather it was *where* power lay. Were capital owners ascendant or weak? Did the state cater to labor interests? Were dominant shareholders inside large firms able to dominate the polity as well? Did policymakers see capital as conducive to national well-being? What did those with power want to do? Either set of legal tools would work, if the polity wanted to use those tools to favor markets.

C. Which System Regulates Securities Markets More?

The intensity of securities market regulation varies widely.

1. Regulatory budgets. Howell Jackson has built an important new database of the intensity of financial markets regulation, measuring intensity by budgets and

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Frederic Meyers, *France*, *in* INTERNATIONAL HANDBOOK OF INDUSTRIAL RELATIONS 169, 170 (Albert A. Blum ed., 1981).

[91] *See* Philip Taft, *Germany*, *in* COMPARATIVE LABOR MOVEMENTS 243, 245–47, 253–54 (Walter Galenson ed., 1952).

personnel. The database shows common law nations regularly spending more on regulating securities markets than do civil law systems.[92] Figure 3 illustrates.

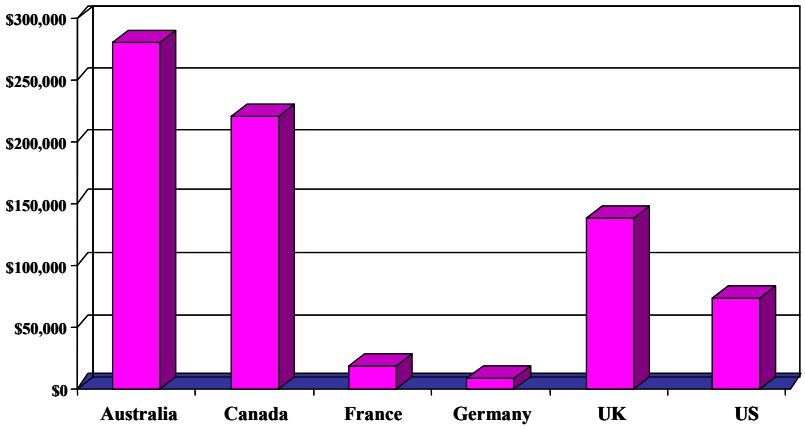

Figure 3. Spending on securities regulation, per billion dollars of stock market capitalization[93]

Civil law nations spend less regulating securities markets than the United States does. I list in Table 5 the high-regulatory-budget nations in the left column and the low-budget regulators in the right column. Common law countries dominate the high-spending column and civil law nations dominate the low-spending column. Qualitative results are similar. Civil law nations have weaker insider trading sanctions.[94] Yet Table 4 shows the same nations' propensity for strong labor law. Some nations simply value securities markets and devote money and people to make them work, typically via regulation.[95]

True, Table 5 shows that spending correlates with origin. But conceptually, common law ought not to force high regulatory spending, nor should civil law nations be less willing to spend and regulate. The usual preconceptions would predict the opposite. Yet the American polity accepts securities market regulation, especially when it is cast as protecting small shareholders from insider machinations. The wider distribution of securities could help to explain that willingness to spend.

Table 5. High common law budgets for financial regulation

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[92] Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 19–20 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper No. 521, 2005), *available at* http://ssrn.com/abstract=839250.

[93] Id. at 19. One might adjust market capitalization to GDP for the float, not total capitalization. But nations with many controlling shareholders might need *more* enforcement resources, not less.

[94] *See* Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 159 (2005).

[95] Rich countries that spend more on securities regulations and have more people enforcing them have bigger financial markets, more initial public offerings, and more firms. *See* Howell E. Jackson & Mark J. Roe, Public Enforcement and Financial Markets: Preliminary Evidence 2 (Oct. 23, 2006) (unpublished manuscript, on file with the Harvard Law School Library). That correlation doesn't eliminate the possibility of reverse causation — that is, a country gets a good stock market for some extraneous reason and then the stock-owning polity demands protection.

Country	Budget (per billion of GDP)	Legal Origin	Country	Budget (per billion of GDP)	Legal Origin
Luxemburg	$1,043,972	Civil law	Finland	$88,199	Civil law
Hong Kong	665,800	Common law	Denmark	92,925	Civil law
Singapore	483,016	Common law	Austria	86,853	Civil law
United States	425,827	Common law	Portugal	84,615	Civil law
Australia	413,265	Common law	Sweden	83,373	Civil law
Ireland	316,872	Common law	Switzerland	83,301	Civil law
Israel	278,641	Common law	Norway	83,258	Civil law
United Kingdom	276,788	Common law	France	74,533	Civil law
South Korea	268,509	Civil law	New Zealand	73,026	Common law
Canada	148,908	Common law	Greece	52,023	Civil law
Netherlands	144,031	Civil law	Italy	50,648	Civil law
Belgium	142,715	Civil law	Spain	53,057	Civil law
Argentina	141,473	Civil law	Germany	45,441	Civil law
			Japan	32,825	Civil law
	Avg. budget	High:		Avg. budget	Low:
High regulators	$339,273	8 common law	Low regulators	$70,291	1 common law

2. The SEC. The SEC protects American stockholders distant from their firms from insider machinations. It regulates. It operates via detailed codification in the Code of Federal Regulations.

True, some securities regulation comes via the courts. Much of the American jurisprudence of securities fraud is judge-made. But even there, the judges make the rules only after a regulator — the SEC usually, the Department of Justice occasionally — acts. And, true, the SEC often has a common law style. It consults the regulated, as it must under the Administrative Procedure Act.[96] It gives the accused a chance to be heard via a Wells submission. But these are regulatory nuances. And even when the securities laws operate through private suits, James Cox, Randall Thomas, and Dana Kiku have importantly shown that an SEC enforcement action is often the foundation for a successful private lawsuit.[97]

Consider how the United States reacted to the recent Enron and WorldCom scandals, which called into question both the quality of American corporate governance and the capacity of American law to protect distant stockholders from insiders' scheming. The polity demanded and got reform. But headlines didn't demand action from common law judges.[98] Rather, the legislature legislated and told the regulators to regulate. The Sarbanes-Oxley Act of 2002 gave the SEC new

[96] 5 U.S.C. §§ 551–559, §§ 701–706 (2000 & Supp. IV 2004).

[97] James D. Cox, Randall S. Thomas & Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 777 (2003). Bidirectional causation again cannot be ruled out: the SEC may act because it fears being embarrassed if it does nothing and private suits then show wrongdoing.

[98] *See, e.g.*, *Triumph of the Pygmy State*, ECONOMIST, Oct. 25, 2003, at 55–56; *cf.* Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99 (2003) (showing that states acted slowly). It's not so much that state courts stood still — they did act — but that legislatures and regulators acted first and strongest. And a fear of federalization could have prompted what judicial toughness emerged. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 601–06, 643 (2003); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 682 (2003).

authority and charged it to better protect investors — via codification and directive regulation.[99] Legislators buttressed *regulatory* and not common law institutions.[100]

III. REEXAMINING THE DATA: DO POLITICAL ECONOMY DIFFERENCES BETTER EXPLAIN FINANCIAL DIFFERENCES?

Thus, the qualitative evidence supports neither the fiduciary duty theory nor history as providing compelling legal origin channels driving nations to have sharply differing financial systems. But even though proponents may not yet have found a convincing channel from legal origin to financial markets, legal origin and securities market strength correlate. Proponents might argue that the right channel just needs to be found, not that the theory ought to be abandoned. But in this Part, I explain the variation in finance in the wealthy West without using legal origin. The richer common law nations experienced the twentieth century differently from the richer civil law nations: the former were relatively spared from the most severe early-twentieth-century destruction, and the latter were not. Postwar policies differed, quite possibly because of the nations' contrasting prior historical experiences, and these differences in postwar policies can explain late-twentieth-century financial contrasts in the wealthy West as strongly as legal origins in terms of regressions, and better in terms of qualitative linkages.

The central thesis in Part III is that modern political economy channels explain modern financial markets more strongly than medieval legal origin. And each plausible postwar political economy channel maps onto an abstraction from modern political theory — left-right conflict, the median voter theorem, or the power of political incumbency.

A. Reexamining Legal Origins as Predicting Ownership Separation in the Wealthy West

1. Corporate law, legal origin, and legislative policy. In a well-known finding, La Porta, Lopez-de-Silanes, and Shleifer showed that legal origin correlates with both the degree of ownership separation in a nation's large firms and the quality of its corporate law.[101] (Ownership separation — the extent to which a country's

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[99] Plaintiffs bringing post-scandal private lawsuits found the securities laws more congenial for suing than common law fiduciary duties. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861, 864 (2003).

[100] Securities regulation isn't absent from recent important legal origins work. *See* Edward Glaeser, Simon Johnson & Andrei Shleifer, *Coase Versus the Coasians*, 116 Q.J. ECON. 853 (2001); La Porta et al., *What Works?*, *supra* note 19. These authors see SEC regulation as an outgrowth of the common law, but it is better seen as supplanting or supplementing common law lawmaking. And it does need regulators — government administrative officials — to make it work.

[101] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 494, 506 (1999); La Porta et al., *Law and Finance*, *supra* note 1, at 1113–52. Recent

large firms have dispersed owners and no controlling shareholder — roughly shows the willingness of outsiders to turn over their investments to corporate insiders.[102] I focus on separation here in the text for concreteness, and in the data Appendix I show similar results for other usual measures of financial development.)

Table 6 shows some of that data. The legal origin theory has much going for it here: both its original fiduciary duty angle and the overregulation of securities markets story are in play. And the countries where the degree of ownership separation is an issue — rich nations with large firms — are the countries where legal origins originated, where the distinctive civil and common law systems are most highly reticulated.

Table 6. Control of mid-sized publicly traded firms around the world

Nations with high stockholder rights			Nations with weak stockholder rights		
Country	**Ownership Separation**	**Legal Origin**	**Country**	**Ownership Separation**	**Legal Origin**
United States	0.9	Common law	Switzerland	0.5	Civil law
Ireland	0.63	Common law	Denmark	0.3	Civil law
Canada	0.6	Common law	South Korea	0.3	Civil law
U.K.	0.6	Common law	Belgium	0.2	Civil law
New Zealand	0.57	Common law	Finland	0.2	Civil law
Singapore	0.4	Common law	Germany	0.1	Civil law
Australia	0.3	Common law	Israel	0.1	Common law
Japan	0.3	Civil law	Netherlands	0.1	Civil law
Norway	0.2	Civil law	Sweden	0.1	Civil law
Argentina	0	Civil law	Austria	0	Civil law
Hong Kong	0	Common law	France	0	Civil law
Spain	0	Civil law	Greece	0	Civil law
			Italy	0	Civil law
			Mexico	0	Civil law
			Portugal	0	Civil law
Avg. ownership dispersion in nations with *high* stockholder rights	0.38	8 common law	Avg. dispersion in nations with *low* stockholder rights	0.13	1 common law
			Overall average dispersion	0.2370	

But it's not just legal origin that correlates with financial strength. The intensity of *labor* regulation predicts corporate ownership separation *better* than legal

work focuses on common law nations' securities laws that facilitate private lawsuits. *See* La Porta et al., *What Works?*, *supra* note 19, at 22 (saying that perhaps "we have [now] found the 'true' channel through which legal origin matters").

[102] La Porta et al., *Corporate Ownership Around the World*, *supra* note 101, measure ownership separation for a nation based on whether its mid-sized public firms usually have a large stockholder. They measure stockholder rights — high in the countries on the left side of Table 6, low in those on the right — by counting corporate law measures that give stockholders specific remedies against insiders.

Separation is not the ultimate measure of financial depth: strong insiders may stay inside the firm to keep an eye on managers, for example. Debt can substitute for outside equity. Separation is only one rough indicator. Other usual indicators are stock market capitalization, the size of debt markets, the number of initial public offerings, and the number of firms. Each of these presents similar conceptual problems, but in the aggregate they tell us something about the strength of a nation's financial market.

origin, providing the basis for a political economy explanation for financial market strength. With a modern policy variable predicting ownership separation well, we have reason to think that some nations, as a matter of policy and politics, support labor markets and ignore stock markets, presumably because labor interests dominate or influence their governments whereas finance-oriented property interests do not. Since nations that regulate stock markets weakly regulate labor markets strongly, we have reason to think that that policy package — strong labor, weak finance — is central in affecting finance. Table 4 shows a negative correlation between labor and stock market regulation. Table 7 shows labor power nicely predicting ownership separation.

Table 7. A policy variable: Labor protection

(high labor power; low ownership separation)

Country	Total Labor Power (employment and collective bargaining laws)	Ownership separation	Country	Total Labor Power (employment and collective bargaining laws)	Ownership separation
Portugal	1.46	0	Belgium	.94	0.2
France	1.41	0	Argentina	.92	0
Norway	1.33	0.2	Switzerland	.87	0.5
Spain	1.33	0	Austria	.86	0
Germany	1.31	0.1	Ireland	.81	0.63
Sweden	1.28	0.1	Japan	.79	0.3
Italy	1.28	0	Australia	.72	0.3
Netherlands	1.19	0.1	Singapore	.65	0.4
Mexico	1.17	0	Hong Kong	.63	0
Finland	1.06	0.2	Israel	.60	0.1
Greece	1.00	0	United States	.48	0.9
Denmark	.99	0.3	United Kingdom	.47	0.6
South Korea	.99	0.3	Canada	.46	0.6
			New Zealand	.41	0.57
High labor power nations' averages	**1.22**	**.10**	**Low labor power nations' averages**	**.69**	**.36**
			Overall averages	.91	.23

Table 9 in the data Appendix, *infra* p. 49, technically compares the explanatory power of securities regulation and labor policy for ownership separation. Yes, stronger securities disclosure predicts more ownership separation well, as column (1) shows. But labor policy, in column (2), better predicts ownership separation.[103] When the two are run together, as in column (3), labor policy is the stronger predictor. Legal origin is even less important in predicting ownership once we account for whether a nation's legislative policy favors capital markets or prefers to protect incumbent workers, as columns (4) and (5) show. Although modern labor policy in theory could flow from distant legal origin,[104] it more likely flows from postwar policy, as we see here and in Part V.

The regressions hardly prove that modern legislative policy is more important than legal origin to finance. It's not just that correlation is not causation, but that since all three institutions — legal origin, labor policy, and securities policy — correlate, we don't know for sure which one is doing most of the work. In theory, something in legal origin could induce people to prefer stockholders to workers in common law nations and induce the converse in civil law nations. But if so, (a) both sets of nations use roughly similar tools (regulators), and (b) they did not have such preference packages at the end of the nineteenth century, when core civil law nations were antagonistic to labor movements. Moreover, once the origins theory is based not on institutions but on national preferences — claiming that one origin prefers markets and the other does not — we have much stronger, recent history to explain contrasting national preferences.

2. The World Wars. These late-twentieth-century policy differences may stem from differing national experiences during the first half of the twentieth century. Financial markets were developing nicely in civil law nations until 1913, and state presence did not differ much among the core countries of either origin. But the core civil law nations suffered internecine ruin from 1914 to 1945, with most overrun and militarily occupied. Such convulsive events destroy institutions, wreck societal foundations, and heighten voters' insecurity. By contrast, a channel of water or an ocean separated the core common law nations from the cauldron of the early twentieth century, sheltering their markets from similar disruption.

As a consequence, voters' attitudes toward risk differed among nations in the wealthy West after World War II. Strong securities markets propel change, and a stunned populace may have abhorred more risk in their economic lives. And, due to the differing degrees of wartime destruction and interwar inflation, capital holdings of the average citizen differed. If the financial savings of a nation's middle class were devastated first by interwar hyperinflation and depression and then by wartime destruction of the underlying physical assets, then it is possible that, for decades after 1945, typical voters in such a nation would have cared little about protecting financial capital both because they had little of it and because their well-being was tied more to their human capital.

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[103] The content of the labor power index is described *supra* note 89.

[104] *See* Botero et al., *supra* note 7, at 1340, 1365, 1370 (asserting that legal origin more than politics "shapes [a nation's] regulation of labor").

To see if the World Wars' relative wreckage and not legal origin is plausibly our core cause in the wealthy West, I took the ratio of GDP in 1945 to that in 1913 as measuring a nation's twentieth-century wartime devastation. This ratio roughly predicts ownership diffusion forty years after the end of World War II, as Figure 4 shows intuitively and Table 11 in the data Appendix shows technically. And it does so controlling for GDP in the 1990s: even if a nation rebuilt and became richer, the Wars' devastation correlates with weak modern securities markets. The mid-century destruction unleashed social and political forces that created strong or weak securities markets in the subsequent decades. I suspect it's no accident that Switzerland — a civil law nation — has securities markets and ownership separation numbers that more closely resemble those in America and Britain than those in France or Germany: Switzerland is one of the few core civil law nations *not* destroyed during the twentieth century.[105]

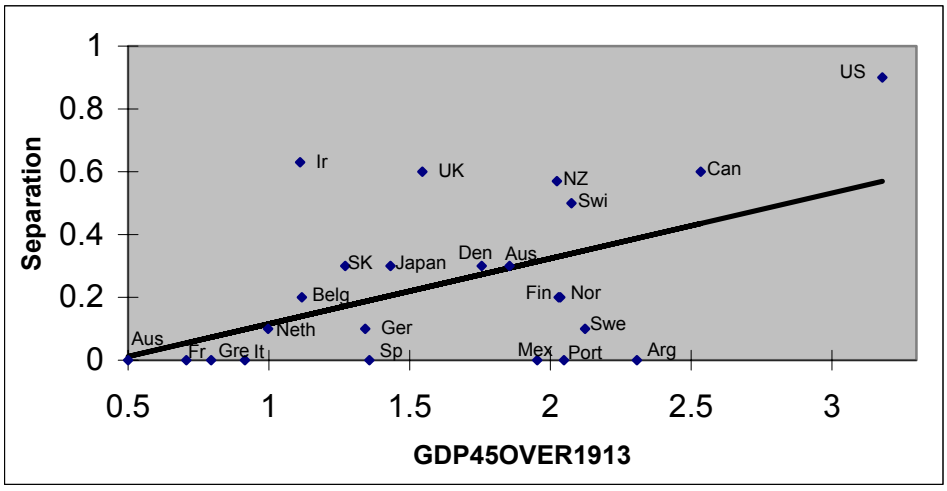

Figure 4. Mid-20th century economic collapse predicts weak ownership separation

So financial markets in major civil law nations were developing nicely until 1913, as summarized in Table 3. Early-twentieth-century ruin strongly predicts late-twentieth-century financial markets' strength. It may explain both post–World War II strong labor policy in the devastated nations and the weaknesses of securities markets in the same nations.

3. Invasions and military occupation: The twentieth century's centers of institutional destruction. GDP change is not the only way to measure a nation's

[105] Britain, the United States, Canada, and Australia all escaped invasion during the twentieth century. If we were invaded, Anglophiles might argue, our legal origin would have enabled us postwar to rebuild more quickly, establish markets immediately, and reconstruct our financial system in due course. I argue a parallel point elsewhere but attribute a good part of American resiliency during the Depression to the country's political stability and the wide distribution of middle-class property, not legal origin. *See* ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, *supra* note 28, at 116–24; Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

twentieth-century devastation. Some nations suffered invasion, military occupation, and revolution, all of which presumably degraded their institutions more than economic reversal alone. We see in Table 8 that whether a nation was occupied or suffered a civil war in the twentieth century also predicts weak securities markets in the 1990s. Of the nations where more than half of the mid-sized public firms have been widely held, *all* were stable in the twentieth century; *none* suffered a military occupation, civil war, or violent revolution. The nations that had lower ownership separation in 1995 suffered the most instability earlier. Moreover, "Total Destruction," which combines into a single variable the two measures of destruction — economic and military — even more strongly predicts the strength of late-twentieth-century securities markets, as I show in Table 12 in the data Appendix. Economic and military devastation consistently predict weak end-of-the-twentieth-century financial markets in the wealthy West as well as, or better than, legal origin.

Table 8. Modern national history and financial markets in the wealthy West

Country	Ownership Separation	Military Occupation?	Country	Ownership separation	Military Occupation?
United States	0.90	Stable	Netherlands	0.10	Occupied
Ireland	0.63	Stable[106]	Germany	0.10	Occupied
Canada	0.60	Stable	Sweden	0.10	Stable
U.K.	0.60	Stable	Israel	0.10	Stable
New Zealand	0.57	Stable	Hong Kong	0.00	Occupied
Switzerland	0.50	Stable	Spain	0.00	Civil war
Singapore	0.40	Occupied	France	0.00	Occupied
Australia	0.30	Stable	Mexico	0.00	Stable
Japan	0.30	Occupied	Greece	0.00	Occupied
Denmark	0.30	Occupied	Italy	0.00	Occupied
South Korea	0.30	Occupied	Argentina	0.00	Unstable
Norway	0.20	Occupied	Austria	0.00	Occupied
Belgium	0.20	Occupied	Portugal	0.00	Coup d'état
Finland	0.20	Occupied			
Higher ownership dispersion	0.49	7 of 14 stable	*Lower* ownership dispersion	0.03	3 of 13 stable

Postwar trendlines also point to war as more important than legal origin. If origin were the core cause, then its posited effects on financial outcomes should persist through time. If the World Wars were more important, then their effects should have begun to fade during the succeeding decades, as Table 3 shows they did, a trendline that fits less well with legal origin than with postwar political consequences.

4. Fighting Communism after the World Wars; ignoring capital markets. The basic postwar political facts in Continental Europe are clear: polities placated voting

[106] Whether a nation suffered military occupation or civil war comes from THE STATESMAN'S YEARBOOK: THE POLITICS, CULTURES AND ECONOMIES OF THE WORLD (Barry Turner ed., 2005). Ireland could have been classified as unstable during its early 20th century independence era, although much unrest was in Ulster, which did not become part of Ireland. (Ireland could also be seen as militarily occupied until 1922.) Mexico faced a civil war that ended in the 1920s; it could also have been classified as unstable. Israel and Argentina are hard to classify. In the regressions we classified Israel as stable and Argentina (due to the coups of the Peronist era) as unstable. Dropping these four nations from the regressions does not materially change the results. All nations with ownership separation of .50 or greater were stable.

workers, with political leaders often turning not to markets but to governments to mobilize capital.[107] And in Western Europe and East Asia, the typical postwar polity was fighting communism. A nation fighting communism externally and internally — the Communist Party got more than a quarter of the vote in the first postwar French election and was that strong in Italy for decades[108] — would adopt policies differing from those of nations that felt more secure. Even locally right politicians favored policies conciliatory to those to whom the Communist Party could appeal.[109] From about 1948 to 1989, the communist threat was central to international and much domestic politics. As Raymond Aron, the conservative French public intellectual, put it: "Every action, in the middle of the twentieth century, presupposes and involves the adoption of an attitude with regard to the Soviet enterprise."[110] As Tony Judt's recent retrospective states:

> The attraction of Communism was real. Although the Communist parties of Italy, France and Belgium . . . remained in governing coalitions [only] until May 1947, through their trade union affiliates and popular demonstrations they were able to mobilize popular anger and capitalize on the failures of their own governments. The electoral successes of local Communists, combined with the aura of the invincible Red Army, made an Italian (or French, or Czech) 'road to Socialism' seem plausible and seductive. By 1947 907,000 men and women had joined the French Communist Party. In Italy the figure was two and a quarter million, far more than in Poland or even Yugoslavia.[111]

* * * *

Thus, after World War II, the world's richest nations had reasons to pursue differing policies vis-à-vis labor and capital markets. Differences in how nations experienced twentieth-century war, occupation, and local communist influence do seem strong bases for producing sharply differing postwar policies toward labor and capital markets.

B. Politics-Based Theories for the Developed World

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[107] *See* ANDREW SHONFIELD, MODERN CAPITALISM: THE CHANGING BALANCE OF PUBLIC AND PRIVATE POWER 84–85 (1969).

[108] *See* TONY JUDT, POSTWAR: A HISTORY OF EUROPE SINCE 1945, at 79, 207 (2005).

[109] Locally right-wing European governments sometimes favored labor. *See* Botero et al., *supra* note 7, at 1348–49, 1353–56, 1362–63. Fighting communism can explain why. In any event, one ought not array governments, as Botero et al. do, on a locally left-right spectrum, but rather on an absolute scale. Germany's Helmut Kohl and France's Charles de Gaulle were locally right but more to the left economically than conservatives in the United States and Britain. They placated local left interests.

[110] JUDT, *supra* note 108, at 197 (quoting RAYMOND ARON, THE OPIUM OF THE INTEL-LECTUALS 55 (1955)) (internal quotation marks omitted). Raymond Aron, although a lifelong anti-Communist, acknowledged "that Marxism was the dominant idea of the age: the secular religion of its epoch." *Id.* at 401.

[111] *Id.* at 88.

Political economy–based theories seem stronger than the legal origins theory. In this section, I briefly outline them. Although each differs from the others, they share a core — namely, that politics affects whether policymakers want to, and can, build financial markets.

While it makes sense intuitively that politics is more important than origin, specifying the exact channel through which politics links political preferences and institutions to financial markets is not easy. That is the task for future work, but promising starts have been made.

The first political economy channel has military occupation weakening institutions overall. When it came time to rebuild, the polity rebuilt human institutions in early decades, waiting until later to rebuild stock markets. The second channel ties destruction to postwar domestic politics. Stunned voters were averse to risk, labor was powerful, and savings were meager. Those background political conditions were not market-friendly. The third channel is postwar international politics. The program in many nations was fighting communism, inducing most Western European and East Asian governments to befriend international communism's most likely domestic allies. A fourth channel is that destroyed nations do not immediately need large pools of capital from financial markets.[112] Banks are adept at allocating capital to known technologies, while securities markets are more adept at allocating capital to new and untried technologies.[113] After World War II, reconstruction was largely a known task for which banks were well suited, perhaps better suited than volatile equity markets, and which fit with a polity that preferred steady and low-risk reconstruction.

1. Left-right labor politics. I've argued elsewhere that European social democracies did not provide the institutions that securities markets need because their concerns lay elsewhere. Stockholders in firms subject to heavy labor pressures (from inside the firm or from pro-labor government actors) were often unwilling to turn their firms over to professional managers for fear that the managers would not be loyal enough to distant stockholders. Labor made strong claims on firms' cash flows, and concentrated owners could resist some of those claims.[114]

The potential importance of left-right labor differences to capital markets and corporate ownership can be seen by looking at recent disputes at Daimler-Benz, Germany's largest manufacturing firm. Wolfgang Bernhard, who had been "the hard-charging No. 2 executive at the company's Chrysler division," was slated to run the company's Mercedes division.[115] But Bernhard's promotion was "scuttled at the

[112] Founders built new firms in the 1950s in the wake of wartime destruction. Some firms succeeded, stayed in family hands for another generation or two, and then started to diffuse their ownership. Nations not destroyed in the World Wars presumably saw more of their firms' founders disperse their ownership earlier.

[113] *See, e.g.*, Franklin Allen, *Stock Markets and Resource Allocation*, *in* CAPITAL MARKETS AND FINANCIAL INTERMEDIATION 81, 104–05 (Colin Mayer & Xavier Vives eds., 1993); Colin Mayer, *Financial Systems and Corporate Governance: A Review of the International Evidence*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 144, 161 (1998).

[114] *See* ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, *supra* note 28, at 35; Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 600–03 (2000).

[115] Mark Landler, *Dispute Disrupts Daimler in Germany*, N.Y. TIMES, July 16, 2004, at W1.

last minute . . . ostensibly to mollify workers at Mercedes. [The workers were said to have been] offended by Mr. Bernhard's suggestion that Mercedes was in need of a radical overhaul."[116]

Labor participates in management in Germany. Where labor's influence is strong, concentrated ownership should persist as a countervailing power and, hence, equity markets should develop less strongly. Moreover, some polities demean the tools that align managers in diffusely owned firms with shareholders, such as incentive compensation, shareholder-value norms, hostile takeovers, and financial transparency.[117] Close owners do better for shareholders than diffuse owners because close owners can cabin managerial agency costs better than distant, small shareholders. Such agency costs could readily be high in firms in which powerful labor interests press managers to ignore shareholder value. Several studies show how wages rise when owners do not tightly control managers.[118]

More directly, in some polities, managers who expand their firms and hire more employees cannot easily retreat later if the expansion proves unprofitable. Local labor rigidities preclude easy downsizing. But managers who are not tied to shareholders — such as managers who face little shareholder oversight in diffusely owned firms — would worry less about the consequences to themselves of expanding unprofitably than would owner-managers. The owner-managers' money is at risk, unlike the diffusely owned firms' managers' money. The diffusely owned firms' managers presumably prefer the power and prestige of bigger firms and wish to avoid the stress of labor confrontation; they do not defend stockholders' interests as strongly as does the owner-manager. Hence, the original owners find it harder to diffuse ownership because the firm is worth less in the hands of diffuse owners than in the hands of concentrated owners.

Consider Figure 5, which shows the fit between a nation's devastation from the World Wars and later labor prominence. The sources of this left-right labor-based divide for decades after World War II could be several. The organization of production could have been labor intensive. Voters stunned by the Wars could have been risk averse and lacked their own financial savings and capital to protect. The governing parties — even those on the right — could have deferred to local labor to blunt a communist appeal. That left-right divide was there after World War II and was stronger for several decades in some nations than in others. And where it was strong, capital markets were weak.

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[116] *Id.*

[117] Transparency is complex: labor might want transparency of profits, but close capital owners might not. Distant capital owners are ambivalent: they need transparency to check on insiders but fear it would strengthen labor's claims on firms' cash flows.

[118] *See* Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999); Antoinette Schoar, *Effects of Corporate Diversification on Productivity*, 57 J. FIN. 2379, 2381, 2399–2401 (2002) (data showing diversified firms pay higher wages); Henrik Cronqvist et al., Do Entrenched Managers Pay Their Workers More? (Nov. 28, 2005), *available at* http://ssrn.com/abstract=845844. Countries with more hostile labor relations have more concentrated ownership. *See* Holger M. Mueller & Thomas Philippon, Family Firms, Paternalism, and Labor Relations (Nov. 2006) (unpublished manuscript, on file with the Harvard Law School Library).

Figure 5. Twentieth century devastation predicts post-war labor power[119]

2. Incumbent capital owners. Incumbents dislike new competitors. The already successful owners often do not want strong financial markets to develop because better financial markets would strengthen new competitors. Since the incumbents already have capital — or access to it — they prefer weak investor protection, so as to crimp new entrants' capacity to raise capital. Hence, incumbents oppose financial development.[120]

And wealthy incumbent capital owners have the resources to stifle competition by contributing to politicians who pass rules that stymie upstarts from going into business. Since the new entrants don't have wealth (yet), they cannot fuel political campaigns as easily as can the incumbents.[121] Incumbents also have a corporate reason to oppose financial improvement. Once incumbents have structures that

[119] Destruction combines the GDP ratio used in Figure 3, minus one if the nation was occupied as in Table 8. The U.S. is re-centered at zero, to be the nation suffering the least destruction. I here use only the 27 nations in Table 8 and first used in this segment of the legal origins literature. (Two nations drop out because of a lack of GDP data.) For the most part, they are the rich, OECD nations.

[120] Rajan & Zingales, *supra* note 84, at 19. Similar ideas are found in Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463, 1490 & n.47 (2001); Enrico C. Perotti & Paolo F. Volpin, *Lobbying on Entry* 1–2 (EFA 2004 Maastricht Meetings Paper No. 2277, 2006), *available at* http://ssrn.com/abstract=558588 (arguing that incumbent entrepreneurs out-lobby new entrants).

[121] *See* RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 182 (2003).

benefit them, they dislike strong financial markets, which could destroy those benefits.[122]

3. Trade openness. However, Rajan and Zingales argue, when a nation is open to trade, the incumbents' calculations — and their political power — change. The incumbents face tougher product market competition and need new financing themselves. Hence, they are less willing and less able to oppose better capital markets.[123] When European political leaders lowered trade barriers in the decades after World War II — as they sought to unify the Continent economically to avoid future wars — incumbents had less reason to oppose stronger capital markets, which grew.

4. Median voter. Central to modern political science is the median voter theorem: Voters are arrayed on a left-right spectrum and distributed over a center-humped normal curve. Politicians seek out the median voter, who determines the election and a nation's politics.[124] Enrico Perotti and Ernst-Ludwig von Thadden recently put forth a median voter hypothesis for financial market strength: In some richer democracies, the median voter owns less financial capital or has more labor-based human capital to protect than the median voter in other nations. Such voters do not vote to develop capital markets — which by fostering industrial and financial change could quickly erode the median voter's own human capital.[125]

Torben Iversen and David Soskice set up the baseline idea here: "[I]ndividuals who have made risky investments in skills will demand insurance against the possible future loss of income from those investments."[126] The polity in nations where such individuals are the median voters should dampen the rapid industrial change that strong financial markets propel. Posit a country that has banks that prefer low-risk enterprises and employees whose income and wealth come from wages, not savings and capital. Especially if the employees have firm-specific skills that capital markets imperil, these employees would prefer low-risk corporate ownership structures to vibrant equity markets, which can corrode incumbent industries. Incumbent financiers — the banks in particular — and incumbent employees combine to stifle securities markets.[127]

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[122] *See* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 157–60 (1999).

[123] *See* Rajan & Zingales, *supra* note 84, at 36, 42–43.

[124] *See* DUNCAN BLACK, THE THEORY OF COMMITTEES AND ELECTIONS 16, 18 (1958); ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 117–18 (1957). The theorem depends on voters facing few cross-cutting preferences so that most voters can be arrayed on a single spectrum.

[125] *See* Enrico C. Perotti & Ernst-Ludwig von Thadden, *The Political Economy of Corporate Control and Labor Rents*, 114 J. POL. ECON. 145, 169 (2006).

[126] Torben Iversen & David Soskice, *An Asset Theory of Social Policy Preferences*, 95 AM. POL. SCI. REV. 875, 875 (2001) (emphasis omitted). "[I]nvestment in skills that are specific to a particular firm, industry, or occupation exposes their owners to risks for which they will seek nonmarket protection. Skills that are portable, by contrast, do not require extensive nonmarket protection . . . ." *Id.*

[127] True, neither the European, Asian, nor American median voter owned much common stock, making a *pure* stock-ownership-based median voter theory weak. Rather, Americans who own financial and other property made up a larger fraction of the electorate than in Europe. That smaller fraction in European countries made it easier for politicians to denigrate capital-favoring rules and institutions. (Reverse and bidirectional

Perotti and von Thadden argue that, hence, an economically and financially enfeebled middle class in the countries previously ravaged by inflation, such as Austria, Belgium, Germany, France, and Italy, responded to the Great Depression by seeking stabilizing governance structures and greater social insurance. The result was greater restriction of markets and the emergence of other features of corporatist economies.[128]

5. Core similarities. Other political economy channels can be relevant: Marco Pagano and Paolo Volpin argue that some parliamentary systems produce a corporatist-type deal between owners of closely held firms and labor that yields weak financial rules.[129] Dennis Mueller argues that dispersed single-member district polities are harder for centralized interest groups like unions to influence than centralized, party-based parliamentary polities.[130] Peter Gourevitch and James Shinn contrast corporatist polities and liberal market economies: the former have weak and the latter have strong securities markets.[131]

Although these political economy explanations differ — and political theorists have a stake in which ones better describe modern democratic polities — all have two features in common. At their core, they are all theories of democratic policymaking, not legal origin. Each ties to the World Wars and the interwar era as laying the foundation for the political economy contrasts of the late twentieth century in the wealthy West.

Thus, trade policy is primary in one theory. But for a nation to have open trade, its polity must permit it. In democratic polities, business leaders cannot build trade barriers if the rest of the polity opposes them. They need allies among the voters, and a left-right or a corporatist political framework tells us something about whether they can find such allies. Incumbent owners need incumbent workers for the votes that shield established sectors from trade and competition.

Similarly, a median voter theory depends on the average voter valuing human capital more than financial capital, so that voters who would constitute the left in more conservative nations dominate the middle. And a left-right theory needs to explain — when the left, even if powerful, is not where the median voter is — why the median voter coalesces with the left and how that then affects firms and stock markets.

To bring the connectedness of the political economy explanations full circle, if a nation has an exogenous reason to promote free trade — historical proclivities,

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causality are again possible. If stockholders are protected, then the average person is more willing to hold stock.)

[128] *See* Perotti & von Thadden, *supra* note 125, at 168.

[129] *See* Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005, 1027 (2005).

[130] *See* Mueller, *supra* note 20, at 16–22.

[131] *See* PETER ALEXIS GOUREVITCH & JAMES J. SHINN, POLITICAL POWER AND COR-PORATE CONTROL 22 (2005); Peter A. Hall & David Soskice, *Introduction* to VARIETIES OF CAPITALISM 1, 8–9 (Peter A. Hall & David Soskice eds., 2001).

international alliances[132] — then free trade can shatter the power of incumbent labor and corporatist interests.[133] Reducing trade barriers may tear down roadblocks to stock markets. The converse is also so; if trade is closed and product competition weak, the nation's polity can protect incumbent labor more easily than polities more open to trade could. Labor can have a greater say in the firm, competitive markets aren't powerful enough to counter labor's goals, and hence strong owners persist as a counterweight. The political channels reinforce one another and may move as a package.[134]

The political theories are not at their core inconsistent with one another, but they are inconsistent with any strong form of the legal origin story. Moreover, they do not describe policies and politics that are immutable: a century earlier, many of these nations had contrary policies and relatively deeper stock markets. Each theory fits with a modern polity conditioned by a half-century of war and devastation.

6. Britain and Switzerland. The British and Swiss experiences illustrate the thesis here. True, Britain at first seems at odds with it at a superficial level because it had left-oriented politics after World War II and relatively deep financial markets. But those markets developed *earlier*, when Britain was conservative, and persisted in spite of Britain's politics in the 1970s. And Switzerland fits awkwardly with a legal origins perspective because it's a civil law country with financial markets that have been continuously solid through the twentieth century. I briefly examine both.

Britain suffered greatly during the early twentieth century, and its post–World War II politics for a time leaned quite to the left. Labour governments ran Britain in seventeen of the first fifty years after the end of the war, mostly from the mid-1960s to the late 1970s,[135] and they did not do so in the market-friendly mode of Tony Blair.

But properly analyzed, Britain exemplifies the thesis here, first of all because it did *not* experience its leftward tilt and develop its financial markets simultaneously. Rather, Britain built its stock market and the related sustaining institutions when it was conservative; ownership began separating from control early in the twentieth century, but Britain's leftward tilt occurred *later* when its financial markets had already been built.[136] During this left-leaning period, its financial markets took a

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[132] *See* Jeffrey N. Gordon, *The International Relations Wedge in the Corporate Convergence Debate*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 161 (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

[133] *See* Neal E. Boudette, *As Jobs Head East in Europe, Power Shifts Away from Unions*, WALL ST. J., Mar. 11, 2004, at A1.

[134] ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, *supra* note 28; Roe, *Rents and Their Corporate Consequences*, *supra* note 120.

[135] THE STATESMAN'S YEAR-BOOK 1299 (Brian Hunter ed., 134th ed. 1997).

[136] *See* Julian Franks, Colin Mayer & Stefano Rossi, *Ownership: Evolution and Regulation* 21–28 (European Corporate Governance Inst., Finance Working Paper No. 09/2003, 2005), *available at* http://ssrn.com/abstract=354381. Earlier data saw the 1980s as the transition period. *See, e.g.*, Brian R. Cheffins, *Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience*, 46 BUS. HIST. 256, 275 (2004).

beating but survived. Britain might not have built strong stock market institutions during Labour's postwar heyday, *but by then they already existed*.[137]

Second, British postwar politics show the limits of the legal origin theory: when British politics changed, legal origin didn't stop Britain from being more regulatory than it had been or than it later became in the Thatcher years. Third, however much Britain suffered during the War, institutional continuity was greater there than on the Continent. The City — their Wall Street — persisted; the Bank of England and the Treasury were staffed with influential players who wanted strong British capital markets. The London Stock Exchange closed on September 1, 1939, and reopened for the War's duration one week later.[138] Middle-class savings were not obliterated in an interwar hyperinflation, so Britain had savers and investors — middle-class voters — after the War. Fourth, Labour did *not* seek to displace Britain's *already* well-developed financial markets with state-driven capital allocation. On the Continent, in contrast, new institutions had to be built and most governing parties *wanted* the state to control capital allocation. It was easier for Britain to maintain an already extant private capital market than for Continental Europe to build a new one atop wartime rubble. Fifth, the British City was itself a powerful interest group that could resist change, even in the face of an unsympathetic polity.[139] Although the postwar political milieu could have impeded pro-capital, pro-finance institutions and interest groups from first arising, these institutions and interests were already in place.[140]

Switzerland, a civil law nation, has had strong financial markets throughout the twentieth century. Although the World Wars surely affected its economy — the country is landlocked and was surrounded by warring nations for much of the early twentieth century — it suffered neither a military occupation nor a violent revolution during this period.

Turn back to Table 3 on page 23. In 1913, Switzerland's stock market capitalization resembled that of France, Germany, and the other civil law nations. But its stock market capitalization did not collapse mid-century, as happened elsewhere in Europe. By 1999, Swiss stock market capitalization as a fraction of its GNP *exceeded* that of Britain and the United States.[141] Its density of true public firms resembles more that of Britain than that of the rest of Continental Europe: as

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[137] Labour's heyday was during the 1970s, when British stock market capitalization declined about 75%. *See* Rajan & Zingales, *supra* note 84, at 15. Even British financial markets might not have withstood another decade of pressure.

[138] *See* RANALD C. MICHIE, THE LONDON STOCK EXCHANGE 288–90 (1999).

[139] "In the [Labour-dominated] 1960s, the City had greater bargaining leverage than the Government." Sue Bowden & Andrew Gamble, *Corporate Governance and Public Policy: 'New' Initiatives by 'Old' Labour to Reform Stakeholder Behaviour in the UK, 1965–1969*, 5 J. INDUS. HIST. 35, 40 (2002).

[140] This interpretation of the British experience puts a twist on Mancur Olson's idea that wars destroy interest groups, thereby freeing the government and the economy from these groups' destructive grip. In my version, war destroyed the interest groups that protected finance and capital on the Continent, but only weakened them in Britain. *See* MANCUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES 77–87 (1982).

[141] *See* Table 3, *supra* p. 23. Switzerland's status as a refuge for capital — with that capital perhaps disproportionately finding its way into Swiss financial markets — must also be part of the story.

Table 6 on p. 29 shows, Switzerland's 1995 index of ownership separation (50%) is closer to Britain's (60%) than to France's (0%) or Germany's (10%). Switzerland's labor policy was slightly less intense than the average, and its securities market regulation was slightly more intense, as shown in Table 4 on p. 23. The Swiss state had an above-average role in the economy before World War I, as Table 1 on p. 21 shows, but a below-average role after World War II.

Switzerland's financial markets are unlike those in other civil law nations. Unlike most of them, Switzerland was not occupied in the twentieth century.[142]

* * * *

Political theories explain the relative depth of financial markets in the wealthy West as well as, and at times better than, legal origins theories. Figure 6 illustrates a politics and finance view of where the foundations for finance lie. Wartime destruction had a continuing effect on politics in the wealthy West for decades after World War II and fits well with the new political theories. Financial differences between occupied and nonoccupied nations, and between civil and common law nations, faded in the wealthy West as 1945 grew more distant. Since the Wars' effects on politics *should* fade over time, this fading fits well with political theories. But since legal origin persists, fading fits poorly with the legal origins theory.

[142] The other major Continental European country that was not occupied was Sweden. Although Swedish corporate ownership — our main metric here — is concentrated, Sweden has had one of the stronger financial markets in Europe, with stock ownership widespread through the populace and most large firms relying on external capital, even though most have a dominant owner. By most measures, Swedish and Swiss financial markets have been two of the strongest in Continental Europe since World War II. *See* Jonas Agnblad, Erik Berglöf, Peter Högfeldt & Helena Svancar, *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control*, *in* THE CONTROL OF CORPORATE EUROPE 228, 228 (Fabrizio Barca & Marco Becht eds., 2001); Peter Högfeldt, *The History and Politics of Corporate Ownership in Sweden* 25, 32–34, 54–58 (Nat'l Bureau of Econ. Research, Working Paper No. 10641, 2004), *available at* http://www.nber.org/papers/w10641.pdf .

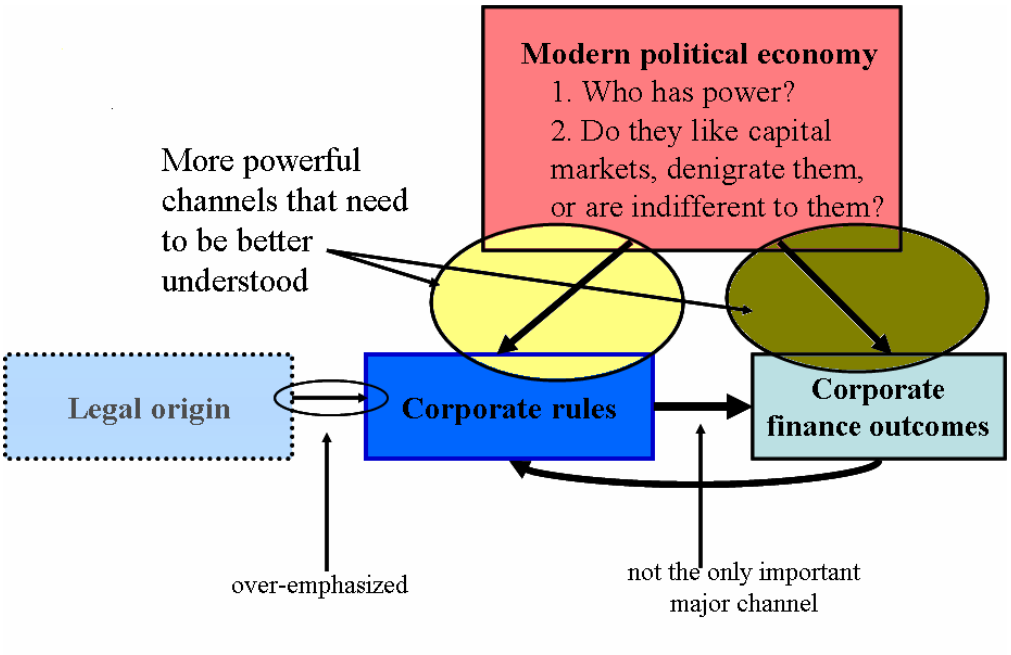

Figure 6. A politics and finance approach

C. REEXAMINING METHOD: INSTRUMENTAL VARIABLES AND ITERATIVE DEVELOPMENT

A typical legal inquiry examines cases, statutes, and their histories and induces a result. Legal comparativists have long looked at subtleties in language and focused on differences in form, which often yield similar functional ends, as Detlev Vagts has reminded us.[143] Financial economists have reduced comparisons to indices and used basic econometric techniques to scrutinize the institutional supports for financial markets.

Each method has strengths and weaknesses. Traditional comparativists get a nuanced contrast, which can yield a textured theory. But they lack strong means to test competing theories. Basic econometric techniques require straightforward theoretical contrasts to test, but an investigator can compare results and reject hypotheses or leave them standing. These techniques, however, may be worse at sorting out complex iterative processes, or those in which several societal features simultaneously affect one another.

Moreover, public choice may be crucial, but it may be that no single public choice channel will explain financial outcomes, with particular public choice

[143] Detlev Vagts, *Comparative Company Law — The New Wave*, *in* FESTSCHRIFT FÜR JEAN NICOLAS DRUEY 595, 595–96, 605 (Rainer Schweizer et al. eds., 2002); *see also* Paul Davies, Gerard Hertig & Klaus Hopt, *Beyond the Anatomy*, *in* THE ANATOMY OF CORPORATE LAW 216, 216–17 (Reinier Kraakman et al. eds., 2004).

channels varying from nation to nation. Without uniformity, the public choice explanation would disappear in the finance economists' regressions, but not in the real world. The methodological challenge for economists is to find public choice metrics that are regular enough to test.

A problem in linking law to finance was that the results did not tell us which way causation ran: perhaps good law induced strong finance, or perhaps deep, strong financial markets called forth good law. Perhaps an industrializing economy induced both. The econometric technique was to find a feature that correlated with good or bad corporate law but which modern markets couldn't have caused. Legal origin is such a feature, as Figure 2 on p. 16 illustrates. But the literature then jumped to conclude that legal origin primarily *caused* good financial markets.[144]

Neither method is attuned to what may be — and I believe is — an iterative process. Some outside event — the rise of large economies of scale in industry, for example — gets a stock market started. The nascent financial market demands a supporting legal structure, which further propels securities market development. The stronger financial markets then demand further legal improvements. If ownership is widespread, the owners have a political base to demand protective laws. And so on. Neither the standard methodology of the legal comparativists nor that of the financial economists captures this iterative, bidirectional causation well.

And a case could be made that this iterative, back-and-forth process describes how American stock markets developed: The American merger wave at the end of the nineteenth century induced a demand for financial capital that its fragmented financial institutions could not provide directly because they were too small.[145] Stock market rules provided rudimentary support in 1910, and populist politics kept American financial institutions smaller and less powerful than they otherwise would have been.[146] Later stock exchange rules supported the widening of the stock market in the 1920s, and that expansion — with the help of a stock market crash and a Depression — provided the political impetus for the securities laws of 1933 and 1934. The Glass-Steagall Act[147] then reconfirmed that populist weakening of strong

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[144] *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 101, at 505 (arguing that legal origin predicts which countries have better protection for minority shareholders); La Porta et al., *Law and Finance*, *supra* note 1, at 1126 ("[*O*]*ur focus on the legal origin becomes crucial*. . . . If we find that legal rules differ substantially across legal families and that financing and ownership patterns do as well, *we have a strong case that legal families*, as expressed in the legal rules, *actually cause outcomes*." (emphasis added)). Important ongoing analyses, some associated with the World Bank, use legal origin as an instrument. *See, e.g.*, Simeon Djankov, Caralee McLiesh & Rita Maria Ramalho, Regulation and Growth 4 (Mar. 17, 2006), *available at* http://ssrn.com/abstract=893321 ("Legal origin has the characteristics of a good instrument for business regulations. It . . . is linked to the complexity of business regulations."). In the first half of this Article, I show that legal origin in the end is a *poor* instrumental variable and, hence, cannot anchor causation as running primarily from law to financial outcomes.

[145] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 3 (1994); Cheffins, *supra* note 136, at 257–58; Mark J. Roe, Rents and Ownership Separation 15–16 (Sept. 27, 2001) (unpublished manuscript, on file with the Harvard Law School Library).

[146] *See* ROE, STRONG MANAGERS, WEAK OWNERS, *supra* note 145, at 30, 33–35, 60–61.

[147] 12 U.S.C. § 24 (2000).

finance.[148] The securities laws in turn were a foundation for further widening of the stock market after World War II.

And to make explicit the thesis here: Total economic collapse, war, revolution, or military occupation could have interrupted that iterative process — and did in some nations. But in the United States, no such cataclysm interrupted the process.

IV. POLICY IMPLICATIONS FOR THE DEVELOPING WORLD

Although the devastation-by-war theory better explains modern financial differences in the wealthy West than does the legal origins theory, it does not (and is not intended to) directly explain differences in the rich nations' former colonies. In looking to understand whether legal origins in richer nations with basic contract and property rights in place induce financial differences, we cannot very well expand the inquiry to poorer nations with weaker basic institutions. Indeed, the sample with which this legal origins literature begins, consisting of twenty-seven mostly OECD countries,[149] is about right for our inquiry into finance in the wealthy West. It's true that adding other Latin American, African, and Asian nations reduces the power of the wartime destruction–based regressions and that in some cases legal origin re-emerges as statistically powerful. But they *should* disappear: We are here using a variable attuned to Europe and the West's twentieth-century experience, not the developing world's. If we use a more universal variable for the wider group of nations — political stability — politics may well again trump origins.[150]

There's good reason to restrict the sample here to the rich, developed nations. It's these developed nations where we're comparing apples to apples: in nations where the institutional and economic structure is developed enough for financial markets to be important, what explains differences in financial outcomes? Moreover, wartime occupation measures whether institutions were weakened and whether the polity was risk averse by the mid-twentieth century. In econometric vocabulary, postwar political forces make a difference, but the difference is conditional on the nation's being one of the world's richer democracies.[151]

But military occupation is not the only way to weaken a nation's institutions and financial markets. Colonial legacy or twentieth-century political instabilities in Latin America and post-independence Africa, for example, could have yielded results

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[148] That's not to say that many financial laws did not have public policy motivations as well.

[149] *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 101, at 492.

[150] *See* Mark J. Roe & Jordan Siegel, Political Instability and Financial Development (Oct. 20, 2006) (unpublished manuscript, on file with the Harvard Law School Library).

[151] Formally, I regress financial outcomes on the military occupation variable, obtaining mixed results, and then add an interaction variable, membership in the OECD (the richer nations' club). The interaction variable measures whether occupation has an effect on the financial market variable *if* the nation is rich. It does, as Table 13, *infra* p. 52, shows. The explanation is intuitive: some nations had good institutions that were adversely affected by the two World Wars; other nations began with poor institutions. The significance of the interaction variable justifies splitting the samples. For a paper using a similar methodology to split an international sample, see Randall Morck et al., *The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?*, 58 J. FIN. ECON. 215 (2000).

there like those wartime devastation did in much of Europe and East Asia. And many poorer nations were occupied — via colonialism — well into the twentieth century, while many whose colonial status ended in the nineteenth century were saddled with political structures that bred instability.

That said, the West-based devastation theory helps us to assess the likely impact of legal origin on financial development and the efficacy of origins-based policies for the developing world. Since legal origins theory poorly explains financial differences in the nations where these systems originated, it's unlikely to strongly explain differences among nations to which legal systems were transplanted.[152] The analysis here of the richer nations thus buttresses alternative theories for the developing nations. In the twentieth century, political instability[153] and government policies — such as state-led capital allocation strategies common for several decades in countries as diverse as Brazil and India, by which government policy crowded out private finance — are likely to prove important in explaining how and why financial markets developed.

If the strong-form legal origins theory were correct, then a nation should get common law–style legal rules to propel development. But since the theory is more likely to be incorrect or secondary, then policymakers under the sway of the origins thinking may induce developing nations to forgo good alternatives. If one mode is easier to build and sustain, then nations may incur real costs. Common law institutions tend toward private remedies, but if public enforcement is important for financial markets (either because it's just as good or because it's been needed even in common law nations, as the centrality of the American SEC suggests), then developing nations and their advisors in the international agencies may make mistakes — possibly big ones.

There's more. If legal structures, whatever their origin, crack and collapse because of incompatible political and social foundations, then developmental agencies could do damage. They could focus on building, say, perfect contract-enforcing institutions that may collapse the first time those institutions confront the powers-that-be. Property-protecting common law courts and transparency-favoring regulators may do well *in a polity that wants to protect property*. Transplant those courts and regulators into a hostile political environment and the polity will displace that judicial and regulatory structure with one to its liking. For the common law–style structure to work, the existing societal arrangements would have to change. But changing them is not easy. Not only is it hard to develop enough social regularity

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[152] True, in weak institutional environments, origins could be more important than in strong institutional environments. *See* Beck et al., *supra* note 21, at 145 (asserting that law evolved in France but has stagnated in the former French colonies).

[153] *See* Roe & Siegel, *supra* note 150. Perhaps instability traces to colonial legacy, which left many nations with instabilities distantly similar to those that upset some wealthy Western nations in the twentieth century. Some colonizers wrecked indigenous institutions without building good new ones. *See* Daron Acemoglu, Simon Johnson & James A. Robinson, *Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution*, 117 Q.J. ECON. 1231, 1262–65 (2002); Stanley L. Engerman & Kenneth L. Sokoloff, *Colonialism, Inequality, and Long-Run Paths of Development* 10 (Nat'l Bureau of Econ. Research, Working Paper No. 11057, 2005), *available at* http://www.nber.org/papers/w11057.pdf; Dani Rodrik, Getting Institutions Right 2–3 (Apr. 2004) *available at* http://ksghome.harvard.edu/~drodrik/papers.html.

and stability so that private structures can flourish, but seeking to do so may be beyond the legitimate scope or the real capacity of the development agencies.[154] Building legal structures incompatible with the political framework or the capacity for social stability may waste scarce developmental resources.[155]

Moreover, even if common law's fiduciary duties were a sine qua non for developed stock markets — probably an untrue assertion, as we've seen — such duties may be ill-suited for developing nations. Simple rules should be easier to enforce — if there's no political interference — than complex fiduciary standards.[156] And the property-protecting efficacy of the common law depends, as I've argued here, on a sympathetic legislature. But if the legislature isn't sympathetic, it's not obvious whether common law judges or a clear code would do better. A judge who deviates from a clear code is more salient than one who scurrilously but surreptitiously misapplies a standard. A weak but independent judiciary could resist some pressure and somewhat enforce a clear code rule but collapse under even light political pressure if it had the discretion a standard entails. In the abstract, code-like rules could do better.[157]

In essence then, the implications for development policy could be that the differences between common law and civil law instruments (such as judge-made law, codes, and regulatory agencies) may not be very important. Since the background political environment is indispensable, then the development agencies might choose to spend their development dollars in, and give their institutional advice to, those nations that have the requisite political foundations for finance. Others might need humanitarian aid, but the agencies ought to be wary of thinking that they can change a polity by getting a few pro-financial-market rules and courts in place.

CONCLUSION: POLITICAL ECONOMY VS. LEGAL ORIGIN IN EXPLAINING DIFFERENCES IN CORPORATE FINANCE

I've here evaluated political economy and legal origins theories of where the foundation lies for modern securities markets in the wealthy West. Differences in legal origins probably were never strong enough to explain differences in financial

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[154] "Until 1996, politics was the variable that dared not speak its name at the [World] Bank. . . . The Bank's . . . charter[] enjoin[s] its officers to remain studiously apolitical." *A Regime Changes*, ECONOMIST, June 4, 2005, at 65, 66 (citing Ajay Chhibber's 1997 World Development Report as changing that tradition).

[155] Some thinking here has offsetting distortions: Common law institutions are seen to be beneficial and not too regulatory. Securities regulation is (mistakenly) seen as a core common law–style institution. So, the syllogism may be challenged in two spots: on the questions of whether civil law is intrinsically too regulatory and whether securities regulators and securities regulation are core common law institutions. But by making these two offsetting conceptual errors, the literature could still come to a useful prescriptive conclusion, namely that building a securities regulatory agency and regulating securities markets can, when done astutely, help to develop securities markets.

[156] *See* Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 WORLD BANK RES. OBSERVER, Feb. 1998, at 1, 5.

[157] That is, civil is to common law as rules are to standards. For an analogous discussion of rules and standards, see Louis Kaplow, *General Characteristics of Rules*, *in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 502, 508–09 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

development well. What general differences there once were have greatly eroded. Common law systems regulate and legislate, as do civil law nations. Moreover, the function sought — investor protection specifically and property rights generally — can be achieved through multiple means. Common law nations already have shifted many such functions to regulators like the SEC. Much of the work that could be done by the judge and fiduciary duties is now done by the legislature and regulators. Most importantly, even where judges do the job and do it well, they can only do so if the legislature tolerates them.

If legal origin is a weaker explanator than modern politics in the wealthy West, then the conditions are ripe for policy error: policymakers enamored of the origins theory may prescribe institutional strategies to developing and transition nations — such as denigrating public enforcement and overemphasizing private litigation — that might not work in their polities and might be less efficacious than alternative strategies.

And the legal origins data is not as strong as it has seemed. Yes, origin predicts ownership separation in the wealthiest nations. But, using the same influential data set of twenty-seven rich nations that the legal origins literature has used, I show that indicators from the early twentieth century of economic destruction and national occupation, as well as simple indicators of post–World War II legislative policy, are usually as strong or stronger than legal origins in predicting financial outcomes in the last half of the twentieth century. Some nations' legislatures and polities have supported capital markets and some have not. It's not so much the *type* of institutions — the tools — that have counted in the world's wealthier nations, but whether the nation has used them to support capital markets.

If it's preferences and interests interacting with political institutions that count, the sources for those preferences and interests are more likely to be found in modern history. The political and social forces unleashed during the cataclysms of the first half of the twentieth century — the World Wars' devastation and economic collapse — are more plausible sources of many post–World War II polities' aversion to robust financial markets than the distant subtleties of legal origin. The basic data are as consistent with World War–based and legislative policy–based explanations for differing financial markets as with a legal origins–based explanation. The fading in the last decade of key post–World War II financial effects in the wealthy West tells us that the differences in finance were probably local and temporal, arising not from persistent features embedded in legal origin but from differing postwar politics, policies, and economic tasks.

Data Supplement

Table 9. Ownership separation, as predicted by securities law, labor power, and legal origin in OECD nations

Dependent variable: ownership separation in large firms in 1995, n=23					
	(1)	(2)	(3)	(4)	(5)
Securities regulation (disclosure)	**.16 (.03) p<.001*** **		**.09 (.03) p=.008*** **	**.07 (.03) p=.05** **	**.09 (.03) p=.015** **
Labor power		**-.64 (.07) p<.001*** **	**-.48 (.091) p<.001*** **	**-.36 (.14) p=.018** **	**-.43 (.07) p<.001*** **
Common law				.14 (.14) p=.35	
French civil law					-.08 (.05) p=.11
GDP/capita 1995	.011 (.003) p=.056	.011 (.006) p=.067	.008 (.004) p=.055	.009 (.004) p=.025**	.006 (.005) p=.23
R^2	.57	.73	.82	.84	.84

significant at .05 level * significant at .01 level robust standard errors in parentheses

Explanations for Table 9:

1. Column (1) shows that securities regulation disclosure predicts ownership separation well and is highly significant statistically. The second to last row, "GDP/capita 1995," controls for a nation's wealth. Column (2) shows that labor power predicts ownership separation just as nicely. The last row, R^2, shows it accounting (with national wealth) for about 73% of the variation in ownership separation. Columns (3)–(5) show that labor power is robust to securities regulation and legal origin in predicting ownership separation. It retains statistical significance. However, since disclosure, labor power, and legal origin all correlate (see Table 10), we cannot tell which factor most affects ownership separation in large public firms. The data though show a story much more contestable than the academic finance literature on legal origin has it but do not end the discussion.
2. The sample for Table 9 consists of the OECD nations for which there's data. The sample is nearly identical to the LLSV sample of twenty-seven nations that's proven influential in supporting the legal origin theory. *See* La Porta et al., *Corporate Ownership Around the World*, *supra* note 101, at 494. Substituting the LLSV twenty-seven-nation sample for the OECD one for the runs throughout this data Appendix yields substantially similar results. In fact, using the original LLSV sample (which includes four non-OECD nations) yields stronger results for a political economy theory, with securities disclosure losing significance against labor power in columns (3)–(5). (Results not published here, but available from the author.)

Table 10. Securities policy, legal origin, and labor policy correlate in OECD nations.

	Common law	French civil law	Securities disclosure	GDP 1945/1913	Occupied	Total 20th century destruction
French civil law	-0.45					
Securities disclosure	0.64	-0.39				
GDP in 1945/1913 GDP	0.40	-0.43	0.55			
Occupied	**-0.75**	**0.42**	**-0.54**	-0.45		
Total 20th century destruction	-0.65	0.50	-0.64	-0.89	0.80	
Total post-War labor power	-0.78	0.51	-0.52	-0.34	**0.67**	0.57

Explanations for Table 10:

1. The securities disclosure index counts up specific disclosures that a nation's securities law requires a firm to deliver to stock buyers. See *supra* note 89. The term "GDP 1945/1913" roughly measures how poorly countries did during the first part of the twentieth century by constructing a ratio of their gross domestic products. The United States grew during that period; its ratio of GDP in 1945 to that in 1913 is about three. In contrast, most Continental European nations did not grow and their ratios are just a little over one. "Occupied" measures whether the country was militarily occupied at some point in the twentieth century or suffered a civil war. The core common law countries were not occupied; most core civil countries were. "Total 20th century destruction" combines the last two variables.
2. The fractions tell us how strongly two factors correlate. A 1 would mean the factors move perfectly in tandem. If labor and securities had a correlation value of –1, for example, then when labor power was high, securities disclosure was low. Labor power and securities disclosure in fact correlate negatively (at –.45). I conjecture in the text (see *supra* pp. 23-26) that legislatures that promote one denigrate the other.
3. "Common law" and "Occupied" correlate highly negatively (at –.75); "French civil law" and "Occupied" correlate positively at .42. (Some civil law nations, such as Germany and the Scandinavian nations, are not French civil law nations.) The modern finance literature focusing on legal origin in the world's wealthiest nations may just be picking up whether the nation was occupied during the twentieth century, namely whether it lacked institutional stability. However, since the core explanatory possibilities — twentieth-century destruction, legal origin, and postwar legislative policy — all correlate, we cannot easily say one is statistically more important than another.

Table 11. The two world wars and the Great Depression

Dependent variable: ownership separation in 1995, n=23				
	(1)	(2)	(3)	(4)
GDP 1945 over 1913	**.21 (.08) p=.014****	**.19 (.07) p=.017****	**.09 (.05) p=.061****	.14 (.09) p=.17**
Common law			**.40 (.09) p<.001*****	
French civil law				**-.23 (.11) p=.042****
GDP/capita 1995		.014 (.008) p=.088	.013 (.006) p=.035	.006 (.008) p=.44
R^2	.30	.37	.76	.51

Table 12. Invasion, occupation and revolution in OECD nations during the 20th century

Dependent variable: ownership separation in 1995, n=23							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Occupation or revolution	**-.41 (.09) p<.001*** **	**-.39 (.09) p<.001*** **	-.13 (.13) p=.34	**-.32 (.10) p=.003*** **			
Total destruction in 20th century					**-.18 (.03) p<.001*** **	**-.08 (.04) p=.072* **	**-.14 (.05) p=.005*** **
Common Law			**.34 (.15) p=.03** **			**.34 (.10) p=.004*** **	
French Civil Law				**-.14 (.07) p=.051* **			**-.15 (.09) p=.09* **
GDP/capita 1995		.01 (.006) p=.12	.01 (.006) p=.05**	.006 (.007) p=.39	.011 (.007) P=.13	.012 (.005) p=.034	.008 (.007) p=.27
R^2	.59	.63	.74	.67	.58	.77	.63

* significant at .10 level ** significant at .05 level *** significant at .01 level

Explanations for Tables 11 and 12:

1. Columns (1) and (2) show that economic collapse (Table 11) and military instability (Table 12) nicely predict late-twentieth-century ownership dispersion. Columns (5), (6), and (7) run the same test, combining "Occupied" with "GDP1945/1913" to form "Total Destruction," on the theory that some nations, although occupied, suffered little economic damage, and other nations, even if not occupied, suffered great damage. Both factors, GDP change and occupation, get equal weight. The results are about the same, with "Total Destruction" a good predictor of late-twentieth-century financial markets, even after accounting for the wealth destroyed, which is controlled for in the second to last row via GDP per capita in 1995: equally rich nations in the 1990s have differing financial markets, with those destroyed in the early part of the twentieth century having weaker financial markets than those that fared less badly.
2. More work is done by the "Occupied" variable than by the GDP change variable. Unreported results for World War II alone (the ratio of 1945 to 1935 GDP) are similar. Again, running the same tests with LLSV's original twenty-seven nations yields similar results. Because "Common law" and "Occupied" correlate so highly (>.7), the results in column (3) — with "Occupied" dominating in the LLSV sample but "Common law" dominating in the OECD sample — are not meaningful. They're reported because of prior readers' curiosity. The data show a plausible case that something went on in the twentieth century that was more central to national governments and financial markets than legal origins and judicial style.

Table 13. Interaction of war and national wealth

Dependent variable: stock market capitalization/GDP in 1995, (1) OECD nations; (2)-(4) includes those poorer nations for which there's data					
	(1)	(2)	(3)	(4)	(5)
	n=30 (all OECD nations)	n=54 (add poorer nations for which there's data)			
Occupation or revolution	**-.32 (.11) p=.006*** **	**.02 (.14) p=.91**	.38 (.23) p=.11	..30 (.18) p=.10*	.35 (.21) p=.11
OECD			-.21 (.25) p=41	-.28 (.24) p=.24	-.27 (.27) p=.31
Interaction term: OECD*Occupied			**-.69 (.25) p=.009*** **	**-.44 (.25) p=.09***	**-.62 (.24) p=.012****
Common law				-.26 (.19) p=.17	
French civil law					-.12 (.14) p=.39
GDP/capita 1995	.04 (.01) p=.002***	.02 (.008) p=.021	.05 (.011) p<.001***	.05 (.01) p<.001***	.05 (.01) p<.001***
R^2	.58	.09	.38	.41	.39

* significant at .10 level ** significant at .05 level *** significant at .01 level

Explanations for Table 13:

1. I focus in this article on political and international disruptions in the wealthy West, arguing that they are more important than nuances of legal origin in explaining the relative strength of financial markets. That's reflected in column (1): occupation, revolution, or violent civil war negatively predict strong securities markets, even after controlling for national wealth.
2. In column (2), I add in poorer, non-OECD nations for which stock market size data exists, such as Colombia, Jordan, Kenya, Malaysia, and Nigeria. (I would have used ownership concentration, but the better data on ownership concentration is not available for the poorer, developing nations.) When I add the developing nations into the mix, the predictive power of occupation, revolution, and violent civil war disappears. The most plausible reason why this disappears is that war destroys institutions, but in nations where institutions are *already* degraded — as they are in many poorer nations — war does less relative institutional damage; that is, rich nations have much more institutional strength to lose in a war than do poor nations. Columns (3)–(6) test this possibility. I interact national wealth (via membership in the OECD) with the war variable by multiplying the two: if the nation is rich and was occupied or had a civil war, the variable takes on a value of 1. If the nations is poor or did not suffer from war or civil turmoil in the twentieth century, the variable takes on a value of 0. This interaction is statistically significant, consistent with the rich having much more to lose than the poor. It's also consistent with the possibility I argued in this paper that political disruption (and its potential effect on post-disruption policy and politics) is likely to have a stronger effect than smaller institutions, such as legal origin.
3. I add in the common law and civil law variables in columns (4) and (5). The interaction does weaken against common law (which itself does not reach statistical significance), but the significance of the interaction term persists, and it also persists approximately intact against civil law, which isn't significant in the last regression.

Table 14: Ownership Separation and Occupation

Dependent Variable		(1)	(2)	(3)	(4)	(5)	(6)
Separation #1 in 1995 (measured by the number of 20% shareholders in the twenty firms with a market capitalization just over $500 million)	Number of observations	N=23 (OECD nations)		n=27 (adds the 4 other nations for which there's data; i.e., the full original LLSV sample)			
	Occupation or revolution	-.39 (.09) P=.000***	-.32 (.1) p=.003***	-.38 (.08) p=.000***	-.33 (.09) p=.002***		
	French civil law		-.14 (.07) p=.05*		-.14 (.06) p=.04**		
	GDP/capita 1995	.01 (.01) p=.12	.01 (.01) p=.39	.01 (.01) p=.09*	.00 (.01) p=.46		
	R^2	.63	.67	.60	.64		
Separation #2 in 1995 (measured by size of holdings of three largest shareholders in each of ten largest firms)	Number of observations	n=24 (OECD nations)		n=44 (adds the poorer nations for which there's data)			
	Occupation or revolution	.09 (.05) p=.07*	.04 (.06) p=.51	.07 (.03) p=.04*	.06 (.03) p=.09*	.02 (.03) p=.54	.04 (.03) P=.14
	OECD					-.07 (.07) p=.29	-.06 (.06) P=.30
	Interact OECD * Occupied					.07 (.06) p=.22	.01 (.06) P=.86
	French civil law		.12 (.08) p=.12		.10 (.03) p=.003***		.11 (.04) p=.006***
	GDP/capita 1995	-.01 (.00) p=.01**	-.01 (.01) p=.23	-.01 (.00) p=.003***	.00 (.00) p=.02**	-.01 (.00) p=.09*	.00 (.00) P=.41
	R^2	.32	.43	.29	.43	..31	.44

Table 15: Block Premium, Labor Power, IPO density, Number of domestic firms, Private debt-GNP ratio

	(1)	(2)	(3)	(4)	(5)	(6)	
Dependent variable and number of observations	(wealthy, OECD nations only) Block premium: n=23 Labor power: n=28 IPOs per million citizens: n=22 Domestic firms per million citizens: n = 24 Private debt-GNP ratio: n=23		(adds the poorer nations for which there's data) n=38 n=52 n=40 n=48 n=41				A B C D E
Occupation or revolution	.06 (.05) .41 (.11)*** -1.29 (.54)** -16.9 (7.7)** .03 (.11)	.06 (.06) .36 (.10)*** -1.18 (.58)* -13.0 (7.7) .09 (.12)	.04 (.04) .16 (.09)* -.28 (.42) -1.34 (6.7) .04 (.09)	.04 (.04) .16 (.08)* -.14 (.42) -.29 (6.6) .06 (.08)	.03 (.07) -.18 (.11) .61 (.38) 10.6 (5.3)** .05 (.18)	.03 (.07) -.10 (.10 .48 (.33) 8.3 (5.9) .00 (.15)	A B C D E
OECD					.04 (.08) -.18 (.15) -.59 (.70) -16.5 (14.0) -.00 (.21)	.04 (.08) -.08 (.14) -.69 (.73) -18.5 (14.5) -.03 (.18)	A B C D E
Interact: OECD*Occupied					.04 (.09) .58 (.16)*** -1.91 (.66)*** -26.3 (10.2)** -.01 (.22)	.03 (.09) .44 (.14)*** -1.51 (.67)** -21.2 (11.0)* .11 (.20)	A B C D E
French civil law		.01 (.09) .18 (.07)** -.25 (.37) -10 (6.3) -.14 (.15)*		.06 (.07) .28 (.07)*** -1.23 (.39)*** -15 (5.3)*** -.17 (.09)**		.06 (.07) -.22 (.05)*** -.65 (.31)** -6.9 (4.5) -.19 (.10)**	A B C D E
GDP/capita 1995	-.01 (.00) *** -.02 (.01) .13 (.04)*** -.97 (.5)* .02 (.01)**	-.01 (.00)** .00 (.01) .12 (.04)*** .56 (.46) .02 (.01)*	-.01 (.00)** .00 (.00) .09 (.03)*** 1.4 (.35)*** .02 (.01)***	-.01 (.00) .01 (.00)** .06 (.02)** 1.1 (.30)*** .02 (.01)***	-.01 (.00)* -.00 (.00) .17 (.04)*** -3.0 (.77)*** .02 (.01)***	-.01 (.00) .00 (.00) .15 (.04)*** 2.7 (.78)*** .02 (.01)**	A B C D E
R^2	.32 .43 .46 .32 .21	.32 .51 .47 .37 .24	.15 .07 .22 .23 .31	.18 .31 .35 .30 .38	.18 .41 .51 .49 .31	.20 .54 .54 .51 .38	A B C D E

(standard errors in parentheses) * significant at .10 level ** significant at .05 level *** significant at .01 level

Explanations for Tables 14 and 15:

In Tables 14 and 15, I examine other national corporate finance outcomes for which there's data: a second measure of ownership separation, as well as block premium, labor power, the number of initial public offerings, the number of firms, and the total private debt to GNP ratio. Block premium measures whether concentrated owners do much better than small outsiders when big blocks are sold — it's a measure of how strongly the system protects outside shareholders. Labor power we've seen before. The initial public offerings variable indicates how many private firms sell some of their stock to the public in a given year, scaled by the population of the nation. The number of firms variable tells us how many corporations there are in the country. Total private debt tells us how much in debt has been issued in a country (divided by the size of nation's economy). All these are commonly-used measures of the strength of a nation's financial markets.

In these models, the "Occupied" variable is generally significant and usually robust to legal origin when run for the richer, OECD nations. But when we expand the sample to include poorer nations for which there's sufficient financial data, the story is mixed, with the "Occupied" variable sometimes significant and sometimes not. The interaction term, "OECD × Occupied," looks to see whether being occupied is important to the financial outcome if the nation is a rich member of the OECD. That interaction term is significant for a majority (six of ten) of the outcomes in Table 15. When significant, it's not always robust to legal origin, which itself isn't always significant.

Table 15 shows the interaction effect for ownership separation. The better measure of ownership separation, which I used in the earlier tables and discussion in the paper, is not available for a wide sample of nations. (That better measure corrects for the size of companies in a nation by measuring separation in a sample of the twenty firms that have just over $500 million in market capitalization.) Another measure, which looks at the ownership percentage of the three largest shareholders in the ten largest firms in a nation is less good but available for more nations. (It's less good because larger nations would have larger firms, and larger firms typically need to raise capital more widely.) For information purposes, Table 14 also shows results with the better measure of separation.

Again, because common law origin correlates highly and negatively with being occupied (at just under .8) in these regressions, running "Common law" against "Occupied" is not meaningful. "French civil law" correlates at about .42 with "Occupied." Because "Occupied" and "Common law" correlate so highly, we have here a plausible alternative explanation, although not one proven by the regressions.

In Table 15, I show the extent to which "Occupation" correlates with other national financial outcomes beyond ownership separation and stock market capitalization. In row A, I use block premium, which measures how much more an insider gets than an outsider when selling his or her big block of stock. "Occupied" does not predict block premium, as row A shows.

Row B shows that "Occupied" strongly predicts "Labor Power" for the wealthy, OECD nations. It loses significance in the larger sample that includes poorer nations, but the interaction term (measuring whether being militarily occupied is associated with enhanced postwar labor power in rich nations) is significant and robust to legal origin. The results in row B are important because, as I argue in the text, labor power may be a primary conduit for, and reflection of, post–World War II politics and policy in the wealthy West. Labor power itself predicts many postwar financial results.

Row C shows that "Occupied" predicts the number of initial public offerings per capita for the wealthy, OECD nations and is robust to legal origin (which itself is not significant). The interaction term is significant and robust to origin. Row D shows similar robust results for the number of domestic firms per capita: interaction between "Occupied" and OECD membership is significant and robust to origin. In a result that I do not reproduce here, "Occupied" predicts the extent to which firms use external capital. It's robust to legal origin in the wealthy, OECD nations sample, and the interaction term is significant in the larger sample but not robust to origin.

In row E, we see the extent to which "Occupied" predicts private debt in a nation. (Private debt over GNP measures the ratio of the sum of private sector bank debt and bonds to GNP.) While "Occupied" is not significant, the principal politics-based theories wouldn't predict it to be in the wealthy West: one would expect the occupied nations, with a polity stunned by war, to seek stability by using *more* debt, especially debt with governance rights, than the non-occupied nations. They do, as the positive sign of the interaction term indicates.

Overall, the salient factors of twentieth-century history — those that would contribute to institutional instability and deeply affect postwar polities — do about as well as legal origin in explaining differences in national financial outcomes statistically for the wealthy West. And, as I show in the text, they do much better qualitatively.

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