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FINANCE AND POLITICS: A REVIEW
ESSAY BASED ON KENNETH DAM'S
ANALYSIS OF LEGAL TRADITIONS IN
THE LAW-GROWTH NEXUS

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**Finance and Politics:
A Review Essay Based on Kenneth Dam's Analysis of Legal Traditions in *The Law-Growth Nexus***

Mark J. Roe and Jordan I. Siegel*

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Abstract

Strong financial markets are widely thought to propel economic development, with many in finance seeing legal tradition as fundamental to protecting investors sufficiently for finance to flourish. Kenneth Dam, in the Law-Growth Nexus, finds that the legal tradition view inaccurately portrays how legal systems work, how laws developed historically, and how government power is allocated in the various legal traditions. Yet, after probing the legal origins' literature for inaccuracies, Dam does not deeply develop an alternative hypothesis to explain the world's differences in financial development. Nor does he challenge the origins core data, which could be origins' trump card. Hence, his analysis will not convince many economists, despite that his legal learning suggests conceptual and factual difficulties for the legal origins explanations. Yet, a dense political economy explanation is already out there and the origins-based data has unexplored weaknesses consistent with Dam's contentions. Knowing if the origins view is truly fundamental, flawed, or secondary is vital for financial development policymaking, because policymakers who believe it will pick policies that imitate what they think to be the core institutions of the preferred legal tradition. But if they have mistaken views, as Dam indicates they might, as to what the legal traditions' institutions really are and which types of laws really are effective, or what is really most important to financial development, they will make policy mistakes — potentially serious ones.

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Finance and Politics: A Review Essay on Legal Traditions

Mark J. Roe and Jordan I. Siegel

INTRODUCTION

Kenneth Dam examines the interaction between law and economic development, using much of *The Law-Growth Nexus* to evaluate an idea prominent in academic finance of the past decade, namely that a nation's legal origins largely determine its capacity for financial development. Dam, a law professor in the University of Chicago's law and economics mold and former Deputy Secretary of State during the Reagan administration, as well as a Deputy Secretary of the Treasury afterwards, is puzzled by the theory's currency among many financial economists and World Bank policymakers, because he sees the legal origins descriptions as afflicted with too many misunderstandings of how legal systems work today and of how they developed.

Because the legal origins idea has influential adherents, both in academe and in policymaking positions, Dam's focus is quite important. Because there's so much uncertainty about what policymaking prescription will work well, a simple idea like the influence of legal origin, if plausible, can be persuasive in prescribing policy. The problem though is that Dam concludes the legal origin idea is just wrong. If it is, the policy consequences of following it are not pretty.

There are several ways to evaluate an idea — one is to look at the details and contradictions an idea entails, contradictions that, if they accumulate and overwhelm, could lead the reader to reject the target idea. A second way is to offer a compelling counter-narrative. A third is to show that the data supporting the target idea are weak or, better, that, overall, the data better supports the compelling counter-narrative.

Dam uses the first way to analyze legal institutions, legal origins, and their relationships to finance and economic growth. And, hence, in our view, economists will find Dam's analysis unconvincing. He does not present the kind of alternative big picture explanation, data, or analysis that an economist would look for, although he gets us ready for one. Such a big picture alternative exists — a political economy

theory already has several pieces in the economic literature — and fault lines in the basic data may exist as well. We present both possibilities — the already-developing political economy explanations and the data fault lines — after we examine Dam’s core case on origins.

I. DAM’S CASE

What does Dam, a law professor, present that might interest economists?

The legal origins story rests on beliefs about how legal systems developed, principally in Europe, and how the institutional structures of some systems support, while others impede, markets, finance, and growth. Because, proponents say, the originating institutions spread around the world via colonization and imitation, the initial conditions of European legal origins largely determine the financial world that we see today. Financial markets depend on legal origins.

The first conduit from origin to outcome was seen as coming via a differential *capacity* to protect investors. For finance to thrive, legal institutions must protect investors. To protect investors well, the law must bar insiders from systematically tunneling value out from the firm and into insiders’ pockets. Common law systems, it was said, largely use fiduciary duties — open-ended obligations of fair dealing from insiders to outsiders — and savvy common law judges reduce the insiders’ efforts to divert value into their own pockets down to something tolerable. Civil law systems use codes (read: rigid codes) that set up rules that the wily insiders can manipulate to their advantage, while the (rigid) civil law judge is handcuffed, able only to apply the rules as written.

The second origins conduit is through regulation. Civil law systems just do too much of it. Statist, heavy, and excessive regulation is intrinsic to civil law systems. They do not know how to govern otherwise. Common law systems, though, do not regulate as much, so their economies flourish.

The third origins channel is more subtle. Common law systems *prefer* decentralized, market-oriented, transparency-enhancing outcomes, so they get them. Civil law systems *prefer* statist solutions to economic and social problems, solutions that squelch markets. Legal origins tell us what the systems *prefer* — markets or government.

Kenneth Dam doesn't mince words, saying this is pretty much all wrong: "although much has been written ... that developing countries that inherited a common law system have a development advantage over those that inherited a civil law system, ... there is little merit to that idea." (Dam, p. 24.) On the first channel: Fiduciary duties aren't the central structure of market regulation in common law countries, says Dam; codes are. Common law countries use corporate law codes, securities law codes, and bankruptcy law codes. On the second channel: Common law systems regulate a whole lot, as well; historically, they may well have regulated more than civil law nations. And if countries regulate too much, or badly, or with the wrong goals, much more explains bad regulation than legal tradition, because legal traditions largely developed without markets in mind. And, lastly, although he is less specific here, there's nothing *intrinsic* to the mechanics of common law that's property-respecting, decentralized, and market-oriented. Some of history's largest state interventions have occurred in common law countries; prior to twentieth century communism, history's *biggest* governmental land grabs occurred in common law, not civil law, countries. One must look elsewhere than legal traditions to understand why some countries protect property well and others do not. With these counter-arguments in mind, he thinks he's defeated the legal origins perspective.

The origins literature didn't discover that investor protection is vital to finance, given its obviousness and long-standing understanding in law and in economics. Nor do the origins advocates suggest that they've *discovered* investor protection. La Porta et al. (2008: 285) assert more than the obvious and the long-stated: they are saying that investor protection *depends* vitally on legal origin. Legal style determines financial substance.

Much is at stake in getting this right: If origins are seen to be important, then policymakers will imitate the tools associated with the winning origin and shun those associated with the loser. But if the origins story is wrongly believed, policymakers may adopt policies that go awry, while ignoring other, more important policy tasks, as we'll see below.

What counter-examples to the origins story does Dam present? We can't list them all — this is a book review essay, not the book — but we can give you their flavor with a few:

Straight common law mechanisms (like fiduciary duties) can't be central, says Dam, because so much corporate and commercial law comes in codes, *especially* in common law countries. American securities laws do not primarily operate through judge-made fiduciary duties but through both a legislative code and a massive regulatory code. This basic fact, well known to business lawyers but not immediately part of the academic financial analysis, “raises serious questions about the leading interpretation of their results to the effect that the common law method of judge-made laws is superior to legislative enactments in building stronger financial sectors and hence in enhancing economic growth.” (P. 33.) And while there was once a common law style of legislating, by which the legislative code would regularize law that was first made via judicial interpretation, that era has long passed, although this fact is not captured in the origins literature. If there's a social, business, or economic problem of weight, the legislature will likely legislate or the regulator will regulate. Neither waits for the judge.

Consider, for example, the Sarbanes-Oxley Act. The Enron and WorldCom failures induced lawmakers to act. Congress didn't wait for common law accretive decisions that it then codified. It acted via legislation and instructions to the SEC to regulate, not via common law lawmaking.¹

Moreover, the history in the origins literature is too often inaccurate, says Dam: Latin American countries were *already* independent when Spain adopted a French-civil-law oriented code.² What the colonies got from Spain and Portugal was the Roman-oriented system that the French civil code sought to replace. Technically, they weren't French civil law countries in their formative years. (P. 42).

¹ Dam's criticism of the origins' purported debt channels is yet more severe. Since the United States gets one of the lowest credit ratings, Dam is ready to dismiss the origins' coding effort on that alone. And, as bankruptcy lawyers know, American and British bankruptcy laws are so different — with the United Kingdom historically liquidation-oriented and the United States historically reorganization-oriented — that the concept of legal origin for debtor-creditor law has little traction. Pp. 204, 210-211. If that were not enough, Zimbabwe does as well as Britain (and better than the United States) in protecting creditors according to the origins scoring, while Ecuador and Egypt in the French family do much better than France itself. These results can't let one take the origins investigation seriously, Dam says (pp. 206-207). Combine that with logical fallacies: poor countries do well sometimes in the law indices say the origins authors, because they need some means for financing, but, says Dam, the index is supposed to predict where debt financing is deep and broad, not where it is weak (Dam, p. 208). Space does not allow us to recount the full range of Dam's dismissiveness nor fully convey his tone in discussing the accuracy problems that he concludes afflict too much of the origins' work.

But the technical point is itself not a winner for Dam, as origins' advocates would reply that it's Roman law that's the problem, with French civil law its most egregious manifestation. Yet Dam's point isn't just technical. Not only did the Latin American nations amalgamate elements not just of Spanish, but also of modern Italian, classical Roman, and German law, but they also adopted important measures of *American* law. (Pp. 45, 48.) Much of Latin America's securities law is American securities law. The origins' classification parameters become too messy for his taste, leading him to stand one step away from concluding that many countries decide on their own what kind of law they want, whose law they'll imitate, and what goals they'll pursue. Particularly when it's important to them, countries pick and choose. The origins project depends on basic law having been imposed from the outside, but too much law was *voluntarily* imported or consciously rejected. If internal circumstances determined the law that would be imported for a key number of nations, then one should be studying the *internal* circumstances of the relevant nations, *not* their formalist origin classification. The *fundamental coding of origin* is off.

In the same spirit, if one looks at structural, statist tendencies embedded in nations' legal structures, *Britain*, the quintessential common law nation, looks *more* like continental civil law nations and *less* like the United States (Pp. 48-49, 108-110). Unlike the United States, "Britain has *never* recognized judicial review of statutory enactment." (P. 48.) Its "Parliament is [fully] sovereign (just as the French Assembly is sovereign)" (p. 48), unlike the American Congress, whose laws the U.S. Supreme Court reviews for constitutionality. No limits from judicial review or checks and balances in the United Kingdom: the English executive (via the prime minister) and its Parliament are fused in the same institution *whose actions the English judiciary cannot reverse*. Not even a written constitution to confine parliamentary authority can be found; tradition and opinion are all there is to confine the Parliament, as it's the Parliament itself that interprets those constitutional traditions (p. 49). Judicial review of the constitutionality of legislative actions is primarily an *American* phenomenon, *not* a common law one, a type of error — taking an American quality and concluding that it's a universal common law one — that

² La Porta et al. (1998: 1126) are aware of the late transmission to Latin America. They, however, interpret it as quasi-involuntary, because the former colonies' crucial consideration in importing law was their commonality of language with the mother

Dam sees as permeating the recent legal origins view. If one codes origin according to statist formal structure, he suggests, Britain ought to be coded as part of a legal family with continental nations, not with the United States.³

Dam has more ammunition on the statist front. If legal origin were a primary propellant of statism, then one would expect measures of differences in statism to persist through time. Yet, consider a standard measure of state presence: the size of a nation's government as a proportion of its economy, G/GDP. The *current* common-civil law range in Table 1 buttresses the legal origin story nicely: civil law countries have a heavier governmental presence in their economies than common law ones. But look back to the ratios a century ago: civil law countries did *not* then have that same burdening presence. Indeed, common law countries' governments weighed somewhat heavier in their economies than did civil law countries. The statist difference in origins, as measured, is a post-war, late twentieth century phenomenon, not a nineteenth or early twentieth century one. The numbers correspond to descriptions of the core civil law countries as market-oriented and laissez-faire during the earlier era. Keynes (1927: 39-49).

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

This table is drawn from Vito Tanzi & Ludger Schuknecht (2000: 6-7). It shows government expenditures as a percentage of GDP since the late 19th century. The table shows that the growth of government is a second-half of the 20th century phenomenon and that the divergence of civil law from common law's G/GDP numbers is a post-World War II phenomenon.

	Legal origin	Late 19th century, circa 1870	Pre-WWI 1913	Post-WWI 1920	Pre WWII	1960	1996
Austria	Civil	10.5	17	14.7	20.6	75.7	51.6
Belgium	Civil	n.a.	13.8	22.1	21.8	30.3	52.9
France	Civil	12.6	17	27.6	29	34.6	55
Germany	Civil	10	14.8	25	34.1	32.4	49.1
Italy	Civil	13.7	17.1	30.1	31.1	30.1	52.7
Japan	Civil	8.8	8.3	14.8	25.4	17.5	35.9
Netherlands	Civil	9.1	9	13.5	19	33.7	49.3
Norway	Civil	5.9	9.3	16	11.8	29.9	49.2
Spain	Civil	n.a.	11	8.3	13.2	18.8	43.7
Switzerland	Civil	16.5	14	17	24.1	17.2	39.4
Australia	Common	18.3	16.5	19.3	14.8	21.2	35.9
Canada	Common	n.a.	n.a.	16.7	25	28.6	44.7
Ireland	Common	n.a.	n.a.	18.8	25.5	28	42
New Zealand	Common	n.a.	n.a.	24.6	25.3	26.9	34.7
United Kingdom	Common	9.4	12.7	26.2	30	32.2	43
United States	Common	7.3	7.5	12.1	19.7	27	32.4
Average		10.7	12.7	18.7	22.8	27.9	45.6
	Average Common/ Civil	11/11	12/13	19/19	23/23	27/32	35/48

country and the overall compatibility of the imported institutions with the former colonies' own institutions.

³ Dam also questions the accuracy of the legal origins coding of legal rules, correcting errors while fearing that there are too many conceptual and coding mistakes to induce reliability. Pp. 226-227. The coding errors may systematically bias the results against the quality of civil law. Id. The origins research, he says, is done "without any particularized legal analysis, as to whether or not any given country has that rule in actual practice." P. 228.

Dam also denigrates the concept that legal traditions were passed around the world via the colonial process, because too many colonies just weren't positioned to absorb whatever institutions the mother country sought to transfer. Berkowitz, Pistor, and Richard (2003) have presented this argument and underlying data. Dam is convinced: the colonization argument isn't strong enough because the receivers may well not have been receptive. Australia, Canada, New Zealand, and the United States, originally populated mostly with colonizers not natives, were receptive, as perhaps was Quebec. Most other countries were not, including most common and civil law countries in Africa and many in Latin America.

The legal origin perspective assumes that the colonizer transferred its institutions to the colonies. So origins proponents see the common law jury as a key anti-statist institution that England transferred around the world to its colonies, decentralizing power (Glaeser and Shleifer (2002)). And, they say, "the transplantation of the two legal systems ... may account for some crucial differences in social and economic outcomes in countries [to which the mother country institutions were transferred]." Id.: 1194.

But *did* Britain seek to uniformly transplant such institutions to its colonies?

Legal historians tell us that it did not. As Dam says (p. 227), widespread use of the jury in civil (i.e., noncriminal) trials is mostly an *American* institution, *not* a common law one. For Britain, to transfer the jury widely would have clashed with its colonial policy: Its nineteenth century experience with the jury in Ireland was an unhappy one, as convictions of Irish citizens in crimes involving Englishmen were hard to obtain from Irish juries. Britain was running an empire, not spreading its institutions wherever it could. Roe (2007). Young (1988: 35) states: "By the time of the British imperial occupation of African territory, the dangers to colonial hegemony in indiscriminate transfer of British practices was well recognized. Thus, *there was no question of application of the jury system* in criminal law, which had so undermined the effectiveness of the law as a vehicle for colonial control in Ireland and the North American colonies."

And, the last reason given for common law superiority is that common law countries just prefer market-oriented, contract-based solutions to problems (La Porta et al. 2006). One gets markets because

one likes them and we know who likes them based on who has them. Culture could indeed be important, but Dam indicates (pp. 60-69) legal tradition would not be the best place to look for key cultural characteristics. So he looks elsewhere. Even if there's something deeply embedded in some countries to prefer, and others to be repelled by, transparent, market solutions, there are too many other inputs into such preferences for origins to be central: considerations such as who wins and who loses from market solutions; recent national experience with markets; or the recent prevalence (or not) of forced statist structures.⁴

Overall, Dam's case is that the origins' history is wrong; the legal traditions are not different enough to be primary determinants of financial differences.

* * *

But will Dam convince finance academics who are already sympathetic to the legal origins argument?

We don't think so. Dam has contradicted the viability of each channel thus far asserted for why common law systems better protect investors. But believers in origins will seek another channel. Critics like Dam may be frustrated that each institutional explanation brought forward is wrong, or too weak to drive basic financial results, but those with strong priors have two powerful objections to Dam's methodology and will remain unconvinced.

First, there's the data, which Dam doesn't challenge directly. (And here Dam doesn't give the origins' proponents their due: They took the methodology of cross-country regression prevalent in other disciplines and applied it to study legal institutions, particularly institutions that they thought emanated from legal origin. It's potentially a powerful analytic engine.) But, second, even in the realm of verbal argument, Dam does not deeply develop an alternative explanation to legal origin for financial outcomes around the world. If the correlations persist and are not shown to proxy for a more important

⁴ These last considerations in the textual paragraph aren't Dam's main focus, but he does raise such issues (p. 69). A related formulation, developed after Dam's book was published, is that the institutional preferences and know-how were transferred as part of the human capital of the colonists. (La Porta et al 2008). Conceptually possible, but the theory would have to confront criticisms similar to those of the jury transfer from Dam. The colonists as a human capital transmission mechanism could explain, say, the United States and Canada. But it cannot readily explain the results for Japan (classified as a German civil law nation) or most of Africa or Asia (not populated by the colonists); yet the theory seeks universality.

characteristic, and if Dam doesn't bring forward an alternative channel, then legal origins believers will conclude that, notwithstanding Dam's legal learning, some other channel, yet to be discovered, runs from origins to outcomes.

II. THE CASE FOR A POLITICAL ECONOMY CHANNEL

You can't beat a horse without a horse. Dam shows that the origins horse is slow. But where's the horse to beat it?

One idea Dam could have brought forward is that finance derives from the other elements of economic development. It's a long-held view, most famously associated with Joan Robinson, that where industry leads, finance follows. In modern form, the view might go like this: Develop a nation's basic educational system, its health system, and its public economic infrastructure, and then finance will follow. If the country can get a property-owning middle class, it will have the foundation for market-based economic development. Economic actors will find informal ways to do business. Then the legal system will come along.

Dam doesn't develop these alternatives to origin, although he briefly turns to geography and culture. Geography makes some countries poor and culture makes some hostile to financial markets, he says, noting Jeffrey Sachs's (2003), Acemoglu et al.'s (2001), and Stulz & Williamson's (2003) work in the area. He neither pushes this argument far nor develops one of the more interesting outgrowths of this literature, namely that geography or culture induced (or retarded) the development of government and other institutions during the colonial era and these institutions continue to affect economic and financial development. Although he discusses closely-related work, such as Acemoglu et al.'s and Rajan & Zingales's (2003), he doesn't mention Engerman & Sokoloff's (2002) basic related work.

Dam had a more powerful and faster horse to ride — and here we move beyond the book itself to the relevant ideas and work out there in the literature. The potential political economy explanations for financial backwardness already out there are so powerful that it's surprising that they do not already dominate formalistic ones (like origins) in finance and haven't been well-developed by the many talented

financial economists working the field. That's the horse for Dam to ride, but he doesn't take it out from the stall:

Left open are such questions as whether the legal culture of a country reflects the general political culture of a country, including ideology and nationalism. ... For example, Roe has emphasized social democratic politics [in western Europe] as a determinant of legal rules. Rajan and Zingales have emphasized interest group politics in which incumbent financial firms resist financial development because it breeds competition for them. (Dam, p. 69)

“[T]hese political issues,” says Dam, “are not addressed in this book.” (Dam, p. 60).

But once Dam has roughed up origins by showing its historical and conceptual inaccuracies, shouldn't he say what really explains why some nations protect investors and others don't?

A. The Over-Arching Political Economy Story

The intuition behind the political economy story percolating in the academic finance literature is simple. Investor protection is a policy choice. To explain a policy choice, we look to political interests, political institutions, and political preferences. Tell us whether the influential decisionmakers win or lose from financial development and, say the political economists, we'll tell you whether a nation will get strong or weak investor protection.

At that level, it's hard to see why the political economy idea has had a rough going in some sectors of academic finance. Its weak acceptance thus far may be due to its purveyors having different explanations for what the primary interest group or driving political preference is. Its weak acceptance could also be due to their not focusing on the generality — preferences and interests interacting inside political institutions — instead of local variations of preferences and outcomes. Its weak acceptance could also have been due to this subject area in finance being for a time more susceptible to the usual path dependency of the academic refereeing process.

B. The Political Economy of Finance in the Developed Democracies

We can combine the several preference-based, interest-group explanations already out there into a single abstraction: When we don't see finance developing, look for the polity's dominant interest. That interest varies over time and over nations, but, where finance is weak, one should expect that the

dominant interest wants financial markets weak. So, as Rajan and Zingales (2003) show, elite incumbent industrial interests with local market power do not want financial development, because finance can propel competitors and erode the incumbents' industrial position. The incumbents, with strong market positions, can finance themselves well enough, and seek to stifle upstarts by cutting off their blood supply: access to new finance. Perotti and von Thadden (2006) look less to elites than to democratic preferences. Their prototypical country is a European one whose middle class had its savings devastated in the interwar inflation. Their dominant interest is the median voter in, say, the 1960s, one lacking financial assets but with strong human capital, a voter who has little reason to support investor protection and some reason to oppose it: Financial markets are corrosive and bring about change. Such a median voter has reason to fear financial markets, which are likely to erode the current way of doing business and degrade the median voter's human capital.

Gourevitch and Shinn (2005) see different production technologies as entailing differing levels of cooperation and, hence, as calling forth differing political settlements and differing ownership structures. Pagano and Volpin (2005) argue that shifting coalitions among managers, employees, and shareholders in differing legislative structures (such as party-list, proportional vs. first-past-the-post local elections) explain the degree to which a policy will provide outside shareholders protection. Their dominant interest is a shifting coalition among the three.

Roe (2003, 2006) looks at European social democracy and corporatism as affecting corporate governance thusly: If product market competition is weak in a nation, incumbent owners and incumbent labor have rents to split. If owners do not keep their ownership interests focused, they won't capture those rents. They have little reason to support institutions that would strengthen financial markets, because they do not want them for themselves since they keep a focused ownership interest in the firm, so that when the supra-competitive spoils are divided, they get a good share of the pie. Moreover, for Europe and East Asia, post-world War II left-right conflict and the effort to co-opt internal left-oriented groups and political parties explain key financial outcomes there in the post-war decades. Capital-oriented interests

were weakened after the war — their underlying assets were largely destroyed. With fewer assets, they had less influence in the polity and, hence, on the rules and institutions that came forward after World War II. Labor was not similarly constrained — they had little capital to begin with, but they did have votes — they were the dominant interest in the immediate post-war continental Europe. Hence, the rules and institutions that came forward favored their interests. In the ensuing post-war decades in Europe, labor power made strong claims on firms' cash flows, he argues, powerful claims that gave concentrated owners an advantage over dispersed owners in forming a countervailing coalition to keep more value in shareholder hands. Democratic nations with strong left power after World War II had governments less likely to support capital markets institutions, such as well-funded regulators or business courts, that would protect outside stockholders and bondholders. Nations that pursued strong labor protection (as evidenced by strong employment protection laws) had weaker financial markets.

C. The Political Economy of Finance in Developing Nations

For the developing world, there are two intertwined political theories already at work, each of which Dam could have employed. The first is that colonial legacy determined historical property rights and, eventually, financial and economic development. Acemoglu, Johnson, and Robinson (2001) and Engerman and Sokoloff (2002) provide powerful, parallel argumentation and data for this proposition. Their concept relates to Rajan and Zingales's (2003) view on the stifling potential of incumbents, who seek to squelch financial development if it will bolster new competitors who would threaten the incumbent interests. In the endowments view, colonies that developed via extractive industries or plantation agriculture run by a small, elite group of colonizers using a large, indigenous labor force tended to have weak property rights. In contrast, colonies settled by immigrants from the mother country developed stronger property rights, stronger educational traditions, and persistently stronger financial and economic development. Differing colonial legacies induced differing institutional structures and the differing structures either facilitated or impeded economic and financial development and persisted sufficiently intact until the present day to have important continuing effects. Engerman and Sokoloff (2002: 44-46, 63-83) focus on initial colonial conditions that fostered equality or inequality. In their view,

geographic conditions best suited to produce labor-intensive cash crops induced “institutions that provided [citizens] narrow access [to opportunities, making such nations] less capable of realizing the potential of the new technologies, markets, and other economic opportunities that developed over the nineteenth century.” Where the colonial geography was conducive to less labor intensity and better suited to smaller family-owned plots, equality was greater and the colonizers and colonists built more open, opportunity-enhancing institutions. Although they concede that contrasting agricultural conditions (and their effects) persist today, Engerman and Sokoloff emphasize the enduring importance of the institutions that arose during the colonial era.

Roe and Siegel (2008) advance a complementary idea — that financial markets cannot develop easily in severely unstable political environments. Inspired by Engerman and Sokoloff’s (2002) work, they find that political instability robustly explains differing levels of financial development, even after controlling for legal origin, trade openness, and the level of economic development, and does so in both country-fixed-effects and instrumental variable regressions, and across multiple measures of instability and financial development. Investors’ basic property rights cannot be secure, because investors cannot be sure what the polity will look like over the life of their investments. Moreover, a political economy literature plants instability’s roots inequality-perpetuating institutions and ethnic fractionalization. E.g., Alesina and Perotti (1996); cf. Ayyagari et al. (2008). The first factor, economic inequality, fits tightly with explaining why investor protection doesn’t develop in unstable environments: For the unstable polity to protect investors, it would have to protect the most favored elements in that polity. Yet that unstable polity is riven by contention over the division of wealth and income — of whether the favored can get to keep their wealth. They use proxies for inequality-perpetuating institutions and social fractionalization of the type brought forward by Engerman and Sokoloff (2002) and validated by Easterly (2007) as further evidence for the old idea that inequality induces instability. If a nation is unable to break the negative causal chain of inequality-to-instability-to-weak-financial-development, then whatever formal legal rules are transplanted — the core of the legal origin perspective — are unlikely to make a difference.

* * *

If any of these political economy views is even only partly correct, the success in some circles of the origins literature may well have induced policymakers to take their eye off of what counts for financial development and economic growth. The technical institutions of investor protection may well be no more important, and perhaps less important, than the political economy considerations of whether the polity *wants* to protect investors. Get the political economy configuration in place and the investor-protection institutions will follow — any origin has the tools to do so. If the political economy isn't in place, then good investor-protection institutions, even if built, will degrade. Legal origins theorists have not, thus far, responded head-on to the political economy challenge. Rather, they have focused on rebutting the possibility that origins proxy for a political economy explanation. E.g., La Porta et al. (2008: 310-313). Although this is important and contested, the core political economy idea is more than that: it's that even if something was going on with legal origin, differing political economy facts, many of which vary both from nation to nation, and over time more powerfully explain differing policy choices such as investor protection.

This is the political economy counter-narrative, the horse that Dam needs. Dam would have helped his case had he synthesized — or, better, extended — the political economy work that has already been done.

III. DOES THE DATA BACK DAM UP?

Legal origins proponents have two responses here to the political economy explanation. One is to fall back and re-group, the other is to counter-attack.

The fallback position concedes the relevance of political economy channels that are independent of origins, but holds onto origins as a, or the, primary determinant. Observers who are not participants may see origins as counting, but nowhere as much as other societal forces, such as political economy ones. But origins proponents belittle political economy explanations as primary and seek to defeat the idea that origins proxy for political economy considerations. La Porta et al. (2008). The political economy theories,

however, are saying something more fundamental: not only may political economy explanations in the end proxy for origins, but, regardless, they are better positioned to explain nations' differing policy choices — to protect or not to protect investors — than origins.

The origins proponents' counter-attack to doubts about origins' importance and to the political economy as an alternative and perhaps stronger explanation for outcomes is important to examine. La Porta et al. answer the myriad of objections such as Dam's to origins channels with a bottom-line rebuttal: "To us, the most important aspect of these results is how pervasive is the influence of legal origins." La Porta et al. (2008: 298). And they add: "The [persistent] correlations ... require an explanation." (Id.: 302.) Time and time again — in a section entitled "Explaining the Facts," they say, common law origin produces strong financial results; French civil law origin produces poor financial results.

Dam doesn't rebut this core objection to his kind of attack. He avoids it: "Although my focus on the legal origins literature is not on the authors' regressions ...," he says. (P. 35.) He presents some simple bottom-line counters: "In 1979 ... French per capita income was \$14,070, compared with \$13,165 in the United Kingdom" (P. 39.) If origin were critical to growth, he says, we shouldn't see the average French citizen richer than the average Brit. But it's too much to ask origins to explain everything; other factors determine average per capita wealth in any two nations. And, in any case, origins' analysts proposed the possibility that France overcame its own civil law rigidities while its former colonies and the other French civil law nations did not. Beck, Demirgüç-Kunt, and Levine (2003: 655). Hence, proponents could say to Dam that it's outcomes in the *other* nations — the receivers of legal tradition, generally the poorer half of the world — that count, battling Dam's simple data to a standstill. Does origin predict financial outcomes across many variables, for many countries, and over many years, particularly in the developing world? Since, they conclude, origin does so, the precise channel may still need to be specified, but it's there waiting to be uncovered, they confidently believe.

But what if origins' association with finance outcomes aren't so pervasive? What if different origins are *not* persistently associated with differing levels of financial development?

The most prominent data dissent comes in Rajan & Zingales (2003), who show that the origins data is not time consistent when comparing beginning of the twentieth century results with end of the twentieth century results. They call their perspective the great reversals, in that financial markets were well developed in their data before World War I in civil law nations, and declined thereafter. The trend they show also maps to the trend for G/GDP across the world, as seen in Table 1 above. Musacchio (2007: esp. pp. 49-50, tbl. 1), an economic historian, rigorously updates the historical sources and presents extensive data indicating that the two legal types started the twentieth century at the same level of financial development; divergence occurred afterward.

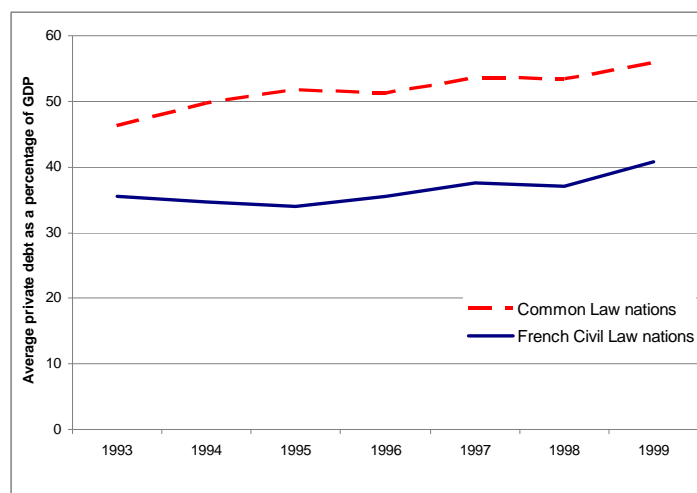
This time inconsistency is a problem for the legal origins thesis, as its proponents recognize. Hence, building on raw data Richard Sylla pointed to in his book review of Rajan and Zingales's work (Sylla (2006:39)), they've re-coded Rajan and Zingales's data and find that some early twentieth century civil law nations' financial market data is too high; some outlier observations (like Cuba) reflect a financial market that's derivative of America's; there's a mistake here and there. Total it up and Rajan and Zingales's (2003) rebuttal weakens, they say. But, as they acknowledge, they checked the civil law data to knock it down. Even so, they really haven't over-turned Rajan and Zingales's critique: they have shown that common law and civil law nations diverged during much of the twentieth century. That might require Rajan and Zingales to retroactively change their title from "The Great Reversals" to "The Great Divergence."

Let's take a quick look at the modern data in the legal origins story. The origins view is that common law is superior to other legal families in inducing strong financial development and French civil law is inferior. The difference results from differences in investor protection. As La Porta et al. (2000: 8) assert: "Common law countries have the strongest protection of outside investors — both shareholders and creditors — whereas French civil law countries have the weakest protection." Much of the data presented in the finance literature is from the 1990s, and that cross-sectional data does not support Dam. Consider a simple prediction: that common law origin countries have significantly higher levels of private

credit/GDP. Outside credit is foundational for financial development, as developing nations often grow debt markets first and stock markets later. The origins literature extensively investigates the breadth of outside credit around the world, especially in the world's less well off nations (La Porta et al. (1997: 1133-1137); Djankov et al. (2007: 302-312)).

Figure 1 shows the well-known World Bank World Development Indicators of nations' private credit markets, arrayed by origin. Just as the origins theory predicts, French civil law nations have, on average, *substantially shallower* financial depth than do common law nations. Overall, the results are very good for origins, but very bad for Dam's case.

Figure 1. World Bank's World Development Indicators of private credit, sorted by legal origin, 1993-1999.



This graph of the World Bank's World Development Indicators of private credit as a percentage of GDP shows persistently deeper credit markets in common law nations in the 1990s, as compared to French civil law nations. The upper line shows the mean WDI private debt as a percentage of GDP in common law nations; the lower line shows the mean private debt as a percentage of GDP for French civil law nations.

Consider next the breadth of private credit over a longer period in Figure 2: the World Bank's private debt/GDP data is available for most countries going back to the 1960s. The inferiority of French civil law to common law extends back from the late 1990s to 1992 — so far, good for origins. But going further back in time, the gap narrows and never reopens in the available data. Indeed, in 1984, the sign for French civil law reverses for a dozen years — more consistent with a random relationship than with a persistent one. Perhaps common law heritage provided little or no significant advantage in building better private debt markets in Africa, Asia, and Latin America for about three of the four recent decades for

which we have data. These are issues we would have wanted Dam to examine: Did something happen in the 1990s that made origin important in a way that it hadn't previously been? Or is the relationship more random, with one origin moving to superiority or inferiority over time?

Figure 2. World Bank's World Development Indicators of private credit/GDP data over four decades, 1965-2004, sorted by legal origin.

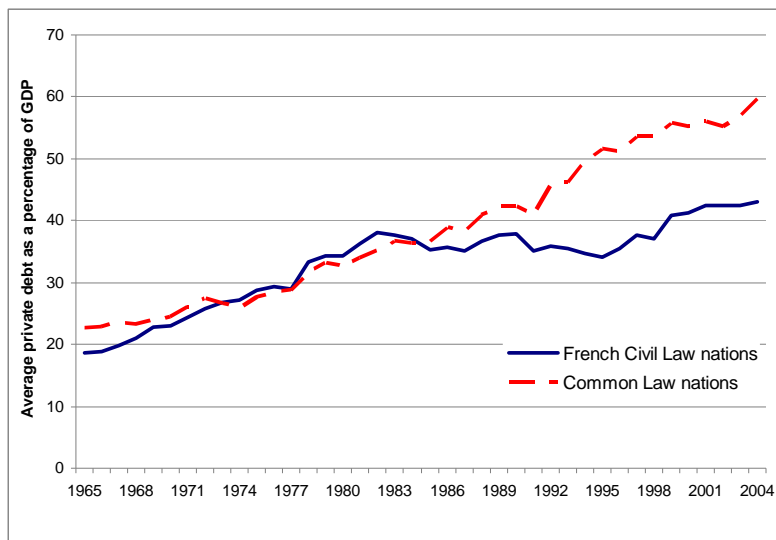


Figure 2 displays the World Bank's World Development Indicators of private debt as a percentage of GDP across four decades, sorted by two major legal origins. Log GDP per capita is held constant, as it is in Figure 1. The graph illustrates the deeper financial markets in common law nations, as compared to French civil law nations, in the mid-1990s. That greater depth is absent in prior decades.

If common law nations fail to be consistently associated with better financial outcomes than French civil law nations in the decades before the 1990s, then other implications would arise. The political economy critics point out that civil law origin nations in the wealthy West map onto polities that were social democratic in the immediate post-war decades, when the median voter was unfriendly to capital markets. The origins proponents concede this identity but propose that origin trumps the European post-World War II political economy configuration in explaining financial market outcomes *because*, they say, common beats civil outside, in the developing, often nondemocratic, world. That inequality outside of Europe allows them, they say, to discriminate between the political economy and the legal tradition explanations for the wealthy West. But if common doesn't beat civil overall, as Figure 2 suggests it may not, and if it doesn't do any better among non-OECD developing nations in most years, that could pose

fundamental problems for the basic origins view. One wouldn't need an econometrics inquiry for Dam to examine the implications of the shifting relationship over time, which might have led him to conclude that Glaeser and Shleifer's (2002: 1194) conclusion that "[o]n just about any measure, common law countries are more financially developed than civil law countries" is overstated.⁵

Figure 3. World Bank's World Development Indicators of stock market capitalization in non-OECD nations, sorted by legal origin.



French civil law nations are arrayed on the left, common law nations on the right. Common law nations on average having a higher stock market capitalization/GDP than French civil law nations.

How about equity? At one level, it's less important for development policy, as debt markets typically build up first. But important questions exist here too. Recall that the core origins idea is that Britain systematically transferred superior institutions for finance and French civil law nations systematically received poor institutions for finance. Indeed, a picture of the basic data in Figure 3 (see La Porta et al. 1997, 1998) is consistent with that view of the world. French civil law nations are arrayed on the left, common law nations on the right. Common law nations on average have a higher stock market capitalization/GDP than French civil law nations. It confirms the legal origins story, that non-OECD common law nations seem to have superior equity markets.

⁵ The legal origins proponents do see origins' effects as more pronounced in the less developed nations. But the shifting relationship illustrated in Figure 2 is in place though for the non-OECD nations as well. The nation-by-nation data availability expands during the four decades of available data, but the relationship is the same when using a constant sample of the 60 or so nations for which private debt data is available for all years.

Now, put labels on some of the countries having a stock market capitalization greater than 100 percent of GDP in 1995 and do the same for other years for which the World Bank's development indicators are available here. Hong Kong, Malaysia, and Singapore are persistently influential observations. These three nations have obvious similarities among themselves and clear contrasts with the rest of the developing world's common law countries. Two are small city-sized financial centers that were successors to major British Empire trading entrepôts. The third was the hinterland to one of the trading centers.

Figure 4. World Bank's World Development Indicators of stock market capitalization in non-OECD nations in 1988, 1990, 1995, and 2000, sorted by origin.

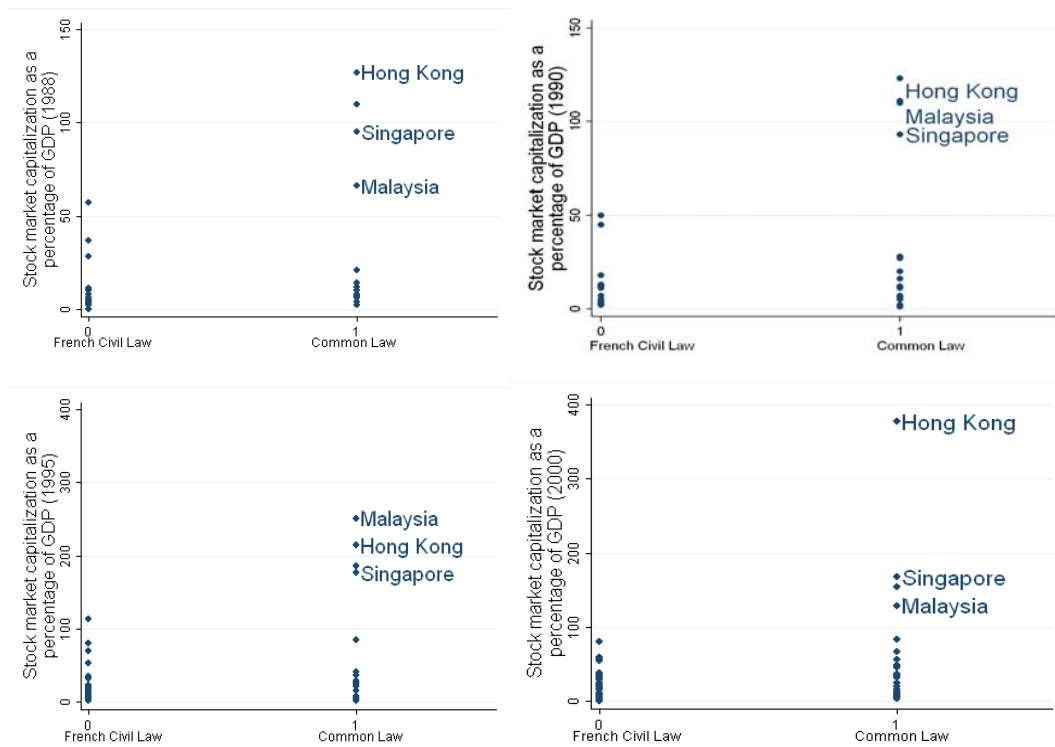


Figure 4 displays the World Bank's World Development Indicator for stock market capitalization as a percentage of GDP for the non-OECD nations in 1988, 1990, 1995, and 2000. (OECD membership is as of 1990; the first year of data availability is 1988, pictured in the upper left graphic.) French civil law nations are arrayed on the left of each graphic, common law nations on the right. Hong Kong, Malaysia, and Singapore have persistently high values, frequently with stock market capitalizations in excess of 100 percent of GDP. (The unmarked, fourth frequently influential observation is South Africa.)

What could it mean? The institutions needed to move stacks of bills of lading around a major trading port put Singapore and Hong Kong one short institutional step away from having the capacity to move around stacks of other securities. Dam could have taken his thesis a big step forward with the kind

of historical investigation he does elsewhere: did these three nations develop in a way sharply differing from other common law (and civil law) colonies, making them poised for financial strength in the late twentieth century? Is it possible that Britain left several important financial centers around the world that built on their positions as trading centers in the heyday of the British Empire, but that common law institutions, as they were actually transferred around the world, provided, say, African common law nations with little ongoing advantage over African civil law nations? Is it plausible that the British Empire developed lasting major trading ports while the French, German, Spanish, and Portuguese did not because the British bested them all in naval strength and in wartime? Is it possible that the English institutions were valuable primarily when embedded in a trading port, like Hong Kong and Singapore?

* * *

The pushback from Dam on origin is important for redirecting research in finance. The debt and equity figures here are broadly consistent with Dam's thesis that the institutional tissue connecting origins to outcomes is weaker than a prominent strand in the last decade's finance literature has thought. The figures don't end debate, but they point to the inquiry that's still needed here. If rigorous analysis of the data and Dam's historical analysis are consistent, the presumption deeply held in some finance circles — that something must be going on with legal origins *because* the data has common law persistently associated with strong financial outcomes and the civil law nations consistently associated with poor outcomes — could be revisited. And if revisited, potentially quite important policy consequences ensue.

IV. CONSEQUENCES

Ideas can make a difference. Even if the origins idea outruns the legal historian's understanding, it can deeply influence what people do to develop finance, here and now. The origins view militates for building technical, investor protection institutions modeled on institutions prevailing in common law countries. Those institutions should be largely private, in the origins view, with strong private rights to sue and little public enforcement of the type provided by, say, the Securities and Exchange Commission. For this view, see La Porta et al. (2006); World Bank (2006). The private micro-institutions of investor

protection are where the foundations for finance lie, in the origins view, and those are the institutions that need to be built in the developing world.

But if the origins view is wrong, then traditional common law institutions may lack an inherent advantage over civil law institutions in protecting outside investors. Hence, policymakers could be mistakenly copying the wrong institutions. Development agencies may tear down satisfactory institutions that just needed some fixing and instead fully replace them, to no beneficial effect. This has been happening: some policymakers at the World Bank and their academic backers have rejected public enforcement of securities laws to deepen developing stock markets (e.g., World Bank (2006)), preferring private enforcement, despite that the view is based more on the origins-based ideas than on the data, as Jackson and Roe (2009) show.

And what if the origins view is wrong and the political economy one right? If so, the technical institutions can only be effective if the economics and politics get the nation into the ballpark where financial markets are welcomed and functional. Technical fixes cannot and will not work if the polity is unsupportive of financial markets. And they will not work at all if the polity is hostile to financial markets. Many polities today are only wary, but many more were historically deeply hostile to finance. Today, a development agenda that focuses on the micro-institutions of finance and investor protection is more plausible than before. Moreover, even if the origins differences are real, the political economy view is that legal origin differences are minor in comparison to political economy differences.

CONCLUSION

Kenneth Dam has performed a service for economists in general and financial economists in particular by critically examining the legal origins thesis that has been important in finance thinking of the past decade. The specification of the origins' institutions is historically and currently incorrect, he says. The original judicial-based fiduciary duty argument is unlikely to be decisive, because even in common law countries the primary protective laws come via codes and regulations. The state-structure-oriented argument is not likely to be correct because state structure does not divide along common and civil law

lines. Even the classification into origins' types is contestable, says Dam, because so many countries imported their corporate and financial law, with many ostensibly civil law countries using American securities law.

Yet, while Dam denigrates the origins perspective, his argument and his correction of the history alone will convince few economists. He doesn't develop a deep alternative view and he does not examine the origins' data. But an alternate view is already out there — a political economy one: financial markets will not blossom unless those with authority in a society want them to. They will not flower, say the political economy theories, when elite industrial interests want to suppress competition (and can do so by thwarting financial channels to new entrants), when the median voter has no property to protect, and when labor makes strong claims on firms' cash flows. Moreover, there's reason to believe that much of the problem for developing nations in developing financial markets stems not just from *too much* government (from statist, civil law governments), but stems as much from *too little effective* government, as too many governments are too unstable to provide a steady foundation for markets to build themselves up.

Nor does Dam examine the origins data. That data, for many origins' believers, is their trump: even if they haven't figured out the right channel, if the correlations stay strong (they may think), it's just a matter of time until theory catches up with the data. But the basic data is much weaker than it's usually thought to be. Most challenges thus far to origins data have claimed it not to be robust to this or that characteristic, such as a cultural trait, an economic consideration like trade, a solitary political one like political stability, or more complex political economy considerations (like left-right alignment, populist preferences, or coalitional tendencies). Several, such as trade, colonial characteristics, left-right political orientation, interwar inflation, and developing country political instability have been shown to have quite compelling effects.

But Dam also has going for him the basic fact that the strongest data-based case for the superiority of common law and inferiority of French civil law is for the 1990s. When one looks backward from the 1990s to the development of debt markets, common law nations regularly lack substantial financial

superiority to the French civil law nations. Frequently the reverse is true. In fact, the reverse is true so often that it's as consistent with a random relationship as with any other. This is the place for Dam — or someone else — to begin to re-examine the basic empirics behind origins.

If the origins view is wrong, as Dam argues it is, there are consequences for financial development, and they may be profound. The micro-institutions of investor protection that development agencies have focused on may not be the right ones, or at least not the only ones that work. Regulation may be needed. Trashing it, instead of improving it, may set countries back in the efforts to improve their financial markets. More basically, trying to develop financial markets in polities that are otherwise hostile or indifferent to them may be a hopeless task. Some countries may take the Washington-consensus-type developmental advice, build the judicial and related institutions of investor protection, and still no one may come to the party. Embittered, they may turn their backs on further development advice of this sort, although they may need it later, once the polity is ready to accept strong financial markets.

Hence, we can conclude with what seems to be a now plausible, although surely controversial conjecture, one that Dam points us toward and which he almost states: that the origins theories are too often inaccurate in terms of how legal systems really work to justify the support they won in some sectors of the World Bank, reflected sometimes in the World Bank's famous and influential *Doing Business* reports, such as, World Bank (2004: ix, 25-26, 49-51, 64, 84-89; 2006). Too many talented economists climbed on to the origins' horse too quickly, when a conversation with a legal expert such as Dam might have made them skeptical of origins being so basic to financial development and induced them to go back to reexamine their data, in ways we suggest above still need to be accomplished. The new finance literature deepened inquiry into how institutions and financial development relate, but the horse they ought to have been riding when searching for the strongest impediments to financial development was not the legal origins one but the political economy one. Some did so for a short while, but then stopped. Others in finance, we believe, will pick up the political economy reins. When they do, and when they

account for Dam's objections, many of which are fundamental to the understanding of legal origin, we will better understand the bases for financial development and for financial backwardness.

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