

## **Abstract**

Much attention has been devoted in recent literature to the claim that a country's 'legal origin' may make a difference to its pattern of financial development and more generally to its economic growth path. Proponents of this view assert that the 'family' within which a country's legal system originated—be it common law, or one of the varieties of civil law—has a significant impact upon the quality of its legal protection of shareholders, which in turn impacts upon economic growth, through the channel of firms' access to external finance. Complementary studies of creditors' rights and labour regulation have buttressed the core claim that different legal families have different dynamic properties. Specifically, common law systems are thought to be better able to respond to the changing needs of a market economy than are civilian systems. This literature has, however, largely been based upon cross-sectional studies of the quality of corporate, insolvency and labour law at particular points in the late 1990s. In this paper, we report findings based on newly constructed indices which track legal change over time in the areas of shareholder, creditor and worker protection. The indices cover five systems for the period 1970-2005: three 'parent' systems, the UK, France and Germany; the world's most developed economy, the US; and its largest democracy, India. The results cast doubt on the legal origin hypothesis in so far as they show that civil law systems have seen substantial increases in shareholder protection over the period in question. The pattern of change differs depending on the area which is being examined, with the law on creditor and worker protection demonstrating more divergence and heterogeneity than that relating to shareholders. The results for worker protection are more consistent with the legal origin claim than in the other two cases, but this overall result conceals significant diversity within the two 'legal families', with different countries relying on different institutional mechanisms to regulate labour. Until the late 1980s the law of the five countries was diverging, but in the last 10-15 years there has been some convergence, particularly in relation to shareholder protection.

**Keywords:** legal origin, corporate governance, company law, insolvency law, labour law

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## 1. Introduction

Much attention has been devoted in recent literature to the claim that a country's 'legal origin' may make a difference to its pattern of financial development and more generally to its economic growth path. Proponents of this view assert that the 'family' within which a country's legal system originated—be it common law, or one of the varieties of civil law—has a significant impact upon the quality of its legal protection of investors, which in turn impacts upon economic growth, through the channel of firms' access to external finance. Complementary studies of, amongst other things, creditors' rights and labour regulation have buttressed the core claim that different legal families have different dynamic properties. Specifically, common law systems are said to be better able to respond to the changing needs of a market economy than are civilian systems. This literature has, however, largely been based upon cross-sectional studies of the quality of various aspects of corporate and financial law at particular points in the late 1990s. Whilst some correlations between patterns of financial development and legal institutions have been established, the issue of causation remains contentious.

Given this background, at least two types of study can potentially contribute to our understanding of the links between law and financial development. One approach, which focuses on *outcomes*, would be to investigate the links between legal rules and indicia of financial market development, and economic development more widely, over time. This would call for the construction of time series data on legal variables of interest. Quantitative methodology could be used to test the hypothesis that changes in legal rules precede financial market development (or indeed the inverse). A related approach, focusing more on *mechanisms*, might examine the way in which the strength of the protection of particular types of constituency changes over time. Panel data comprising some civil and some common law countries would allow for examination of whether there are systematic differences in the pattern of evolution in different legal systems. If, as posited, the mechanisms of legal evolution are significantly different in common and civil law systems, we would expect to see change occurring at different speeds, and plausibly in different directions, in systems of each variety. Conversely, we might not expect to see as much variety between members of the same legal origin as between members of different legal origins.

This paper follows the second approach outlined above. Further, it uses a quantitative methodology, which may also be called 'numerical comparative law' or 'leximetrics' (Siems 2005a; Lele and Siems 2007a). We present new longitudinal indices of legal rules applicable to business enterprise—grouped

along the dimensions of shareholder protection, creditor protection, and labour regulation—for five countries, over a 35 year period. These are three ‘parent’ systems, the UK, France and Germany; the world’s most developed economy, the US; and its largest democracy, India.<sup>1</sup>

Our findings in this paper focus on the patterns of change within and between the indices we have constructed. We do not find that there are significant differences between the way in which legal change, as measured by our indices, occurs in civil and common law jurisdictions. Instead, our results also show that the pattern of change differs depending on the area of law under examination, with creditor rights and labour rights demonstrating much more divergence and heterogeneity than shareholder rights. We interpret this as casting doubt on the plausibility of the mechanisms that have been said to underpin the links posited between legal origins and financial development. The pattern of legal change in civil and common law countries implies that differences in the ‘adaptability’ of legal systems to changes in the wider economic context are unlikely to be a significant explanatory factor.

The rest of this paper is structured as follows. In section 2, we review the law and finance research programme and motivate our current enquiry by identifying gaps in our understanding. Section 3 explains the methodology employed in the construction of our new longitudinal indices of legal institutions. Sections 4, 5, and 6 present results relating to the development, respectively, of legal rules protecting shareholders, creditors, and employees. Section 7 synthesises the principal results and concludes.

## **2. The ‘law and finance’ research programme and its limitations**

### ***2.1 Principal claims***

Systematic research on the relationship between a country’s legal institutions and its corporate governance and financial systems began only in the late 1990s with the pioneering and highly influential work of La Porta, Lopez-de-Silanes, Shleifer and Vishny (‘LLSV’: see La Porta *et al.*, 1997, 1998, 1999a, 1999b, 2000, 2006, 2007, 2008; Johnson *et al.*, 2000; Djankov *et al.*, 2003, 2007, 2008; Glaeser and Shleifer, 2002, 2003; Botero *et al.*, 2004). This literature connects with other recent work on the relationship between financial system and economic development (see Levine, 1997; Beck *et al.*, 2003a, 2003b; Berkovitz *et al.*, 2003; Pistor *et al.*, 2003, Claessens and Laeven, 2003). Moreover, this research has a significant practical importance because the World Bank uses it in order to assess and promote a particular way of legal development (World Bank, various years).