

The Practice of Justice



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Findings of Recent Research on Corporate Governance

- ❑ Investor protection is an important determinant of financial development, explaining such outcomes as the size and breadth of capital markets, IPO activity, dividend policies, ownership structures, etc.
- ❑ Quality of investor protection is intimately related to origin of commercial laws.
 - Specifically, common law countries protect both shareholders and creditors better than Civil (especially French) Law countries
- ❑ Law enforcement is also a key determinant of investor protection

Measures of Investor Protection

	Antidirector Rights (0-6)	Creditor Rights (0-4)	Efficiency of the Judiciary (0-10)	Accounting Standards (0-100)
Common Law	4.00	3.11	8.15	69.62
French Civil Law	2.33	1.58	6.56	51.17
German Civil Law	2.33	2.33	8.54	62.67
Scandinavian Civil Law	3.00	2.00	10.00	74.00
World (49 countries)	3.00	2.30	7.67	60.93

Consequences of Investor Protection:

(1) Financial Markets

	External Cap / GNP	# Firms / Mill. Pop.	# IPOs / Mill. Pop.	Debt /GNP
Common Law	60%	35.45	2.23	68%
French Civil Law	19%	11.89	0.28	56%
German Civil Law	46%	16.79	0.12	97%
Scandinavian Civil Law	30%	27.26	2.14	57%
World (49 countries)	40%	21.59	1.02	59%

Consequences: of Investor Protection:

(2) Ownership Patterns

Control of 20 Largest Publicly Traded Firms (20 % cutoff)

	Widely Held	Family	State	W.H. Financial	W.H. Corporation
High antidirector rights	48%	25%	14%	3%	8%
Low antidirector rights	27%	34%	22%	7%	2%
World (27 countries)	36%	30%	18%	5%	5%

These results raise a number of questions:

- I. What is special about legal origin?
 1. general stance of government, i.e. interventionism
 2. structure of the legal system, politicization of judges
 3. common law principles, such as ‘smell tests’

- II. What is the optimal method of investor protection or law enforcement more generally?
What is the role of litigation versus regulation?

- III. What are the possibilities of reform?
Why has not corporate governance reform been more rapid?

In this lecture, I will try to address these three broad questions.

Broad theme: the practice of justice.

I. What is special about legal origin?

1. General Stance of Government

1. French legal origin seems to be associated with greater government intervention in all markets and lower security of property rights.

- Financial underdevelopment may be a consequence of such intervention.
- Under this hypothesis legal rules are just a reflection of a broader political stance.
- What matters is the 'structure' of society, not the law itself.

Regulation of Entry

BY LEGAL ORIGIN	Number of Procedures	Number of Days	Cost /GDP per capita
		<i>Means</i>	
English	7.08	29.04	0.42
French	13.41	64.00	0.71
Socialist	11.37	54.74	0.33
German	9.67	30.83	0.16
Scandinavian	4.50	14.50	0.05
World	10.48	47.39	0.47

Government Ownership of Banks

Share of the Assets of the Top 10 Banks
Owned or Controlled by the Government

BY LEGAL ORIGIN	Gov. Ownership of Banks in 1970	Gov. Ownership of Banks in 1995
	<i>Means</i>	
English	34.53	28.16
French	65.37	45.45
Socialist	100.00	61.76
German	43.59	33.67
Scandinavian	43.44	35.54
World	58.89	41.57
	<i>Test of Means (t-statistics)</i>	
English vs. French	-3.91 ^a	-2.25 ^b
English vs. Socialist	-8.98 ^a	-2.95 ^a
English vs. German	-0.58	-0.37
English vs. Scandinavian	-0.50	-0.46

Interventionism Regressions

Dependent Variables	Independent Variables				
	Socialist legal origin	French legal origin	German legal origin	Scandinavian legal origin	N [R ²]
Property Rights	-1.1139 ^a (0.2618)	-0.5592 ^a (0.1455)	0.0684 (0.2481)	-0.5310 ^b (0.2619)	0.6311 [124]
Business Regulation	-0.6104 ^b (0.2365)	-0.3457 ^b (0.1329)	-0.8799 ^a (0.2646)	-0.9913 ^a (0.2471)	0.5216 [124]
Top Marginal Tax Rate 1994	11.5953 ^c (6.1884)	4.4868 (2.8969)	6.6684 (6.0867)	10.4847 ^c (5.8976)	0.2758 [79]
Tax Compliance	-1.3561 ^b (0.5349)	-1.3226 ^a (0.2738)	-0.6174 ^b (0.2744)	-0.8640 ^b (0.3392)	0.5718 [48]

Note: Controls include ethnolinguistic fractionalization, latitude, and log of GNP per capita.

I. What is special about legal origin?

2. Structure of the Legal System

2. French Legal Origin, and civil law more generally, is associated with state-employed judges, procedural and substantive codes, and generally 'politicized' judiciaries.

→ This may be bad for security of property rights.

□ *What are the reasons?*

✓ **17th–18th C explanations:**

The sovereign wanted to control the judges (Hayek 1960, Merryman 1985, Schlesinger 1988).

✓ **12th–13th C explanations:**

The weaker law and order environment in France than in England necessitated centralization of adjudication to prevent subversion of Justice (Dawson 1960, Berman 1983, Damaska 1986, Glaeser-Shleifer 2002).

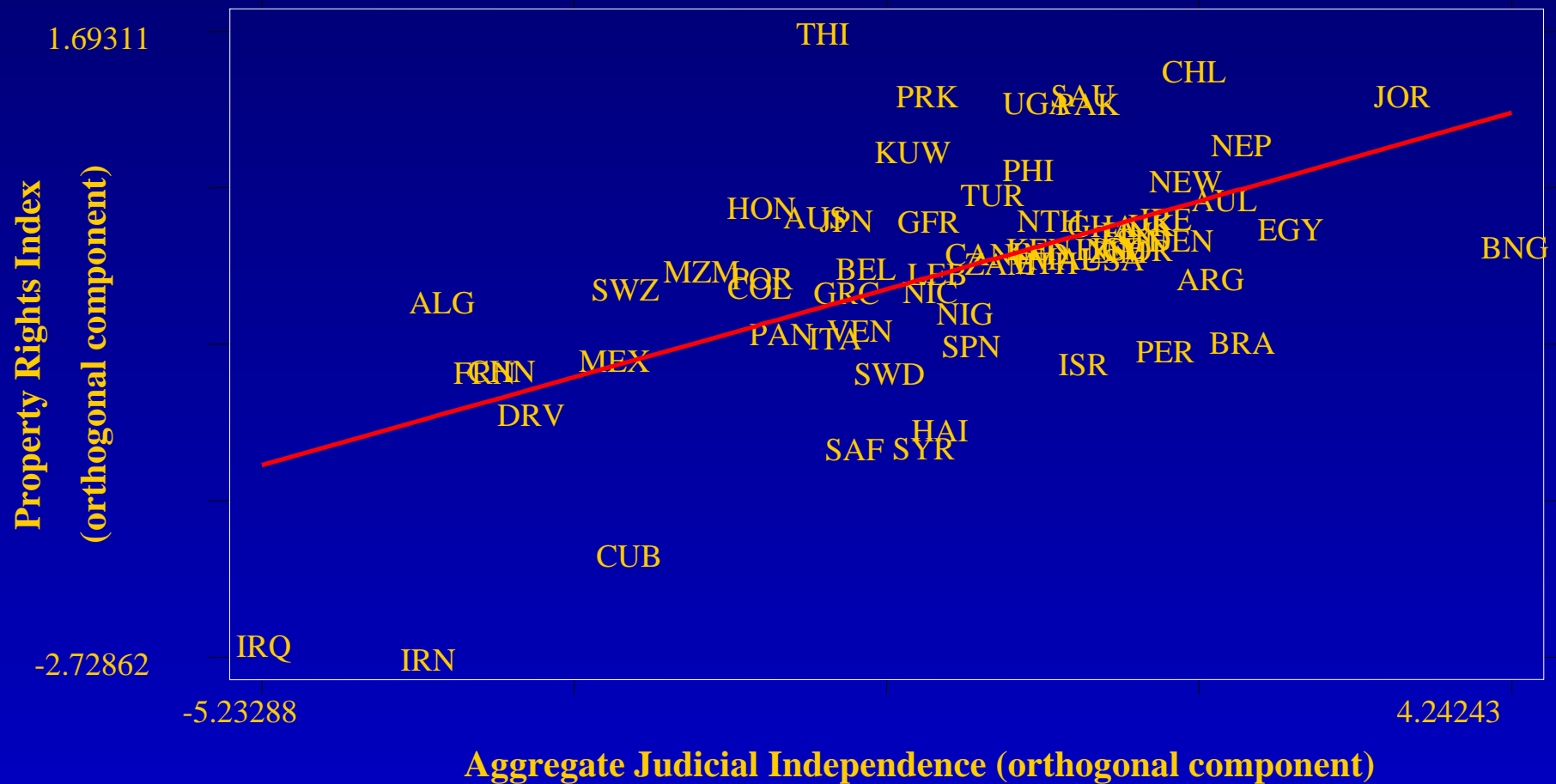
Independent Judiciary is Associated with Better Security of Property Rights

Correlations

	Security of Property Rights Index
Tenure of Supreme Court Judges	0.51 ^a
Tenure of Administrative Court Judges	0.52 ^a
Supreme Court Control over Administrative Cases	0.09
Total Power of Administrative Judges	0.30
Case Law	0.42 ^b
Aggregate Judicial Independence Index	0.49 ^a

Independent Judiciary is Associated with Better Security of Property Rights

coef = .26231375, (robust) se = .05903649, t = 4.44



- Partial Scatter Plot – Controlling for ethnolinguistic fractionalization, latitude, and log of GNP per capita.

Legal Procedures are less Formalized in Common Law Countries

BY LEGAL ORIGIN	Eviction of a Non-Paying Tenant	Collection of a Returned Check
<i>Panel A: Means</i>		
English Legal Origin (42)	2.99	2.70
Socialist Legal Origin (16)	3.82	3.85
French Legal Origin (40)	4.34	4.18
German Legal Origin (6)	3.55	3.07
Scandinavian Legal Origin (5)	3.29	3.09
Mean all countries (109)	3.55	3.45
<i>Panel B: Tests of Means (t-stats)</i>		
Common vs. Socialist	-3.96 ^a	-5.26 ^a
Common vs. French	-7.84 ^a	-7.50 ^a
Common vs. German	-1.77 ^c	-1.10
Common vs. Scandinavian	-0.87	-1.06

I. What is special about legal origin?

3. Common Law Principles

3. Common Law principles:

- ❑ Principles such as Fiduciary Duty, enable judges to use ‘smell tests’ to ferret out investor expropriation and tunneling.
- ❑ Codification and lack of broad legal principles such as fiduciary duty in civil law countries accommodate more conduct detrimental to investors.
- ❑ Examples:
 - ✓ French and German corporate law allow related party transactions that expropriate investors but do not violate statutes.
 - ✓ Belgian billionaire: ‘small minority shareholder, small fool, big minority shareholder, big fool.’

I. What is special about legal origin?

Summing Up

- ❑ Legal Origin matters more pervasively than just “investor protection.”

- ❑ There is some support for each of the three broad theories:
 - Interventionism
 - Legal structure
 - Legal principles

- ❑ These three theories, however, may be part of one, more general theory of organization of law and order.
 - That is, different pieces might all go together.

II. What is the optimal method of investor protection or law enforcement more generally?

- ❑ So far, we have focused on courts and judges, and private litigation.
- ❑ But many societies have an alternative strategy of addressing the problem of harmful conduct: Regulation.
- ❑ In Coase=s logic, there is no reason to choose one or the other. Protection of property rights can be accomplished by either.
- ❑ *So what are some ingredients of the choice?*
 - ✓ Largely, choice between litigation and regulation is shaped by considerations of enforcement.

The Case for Regulation

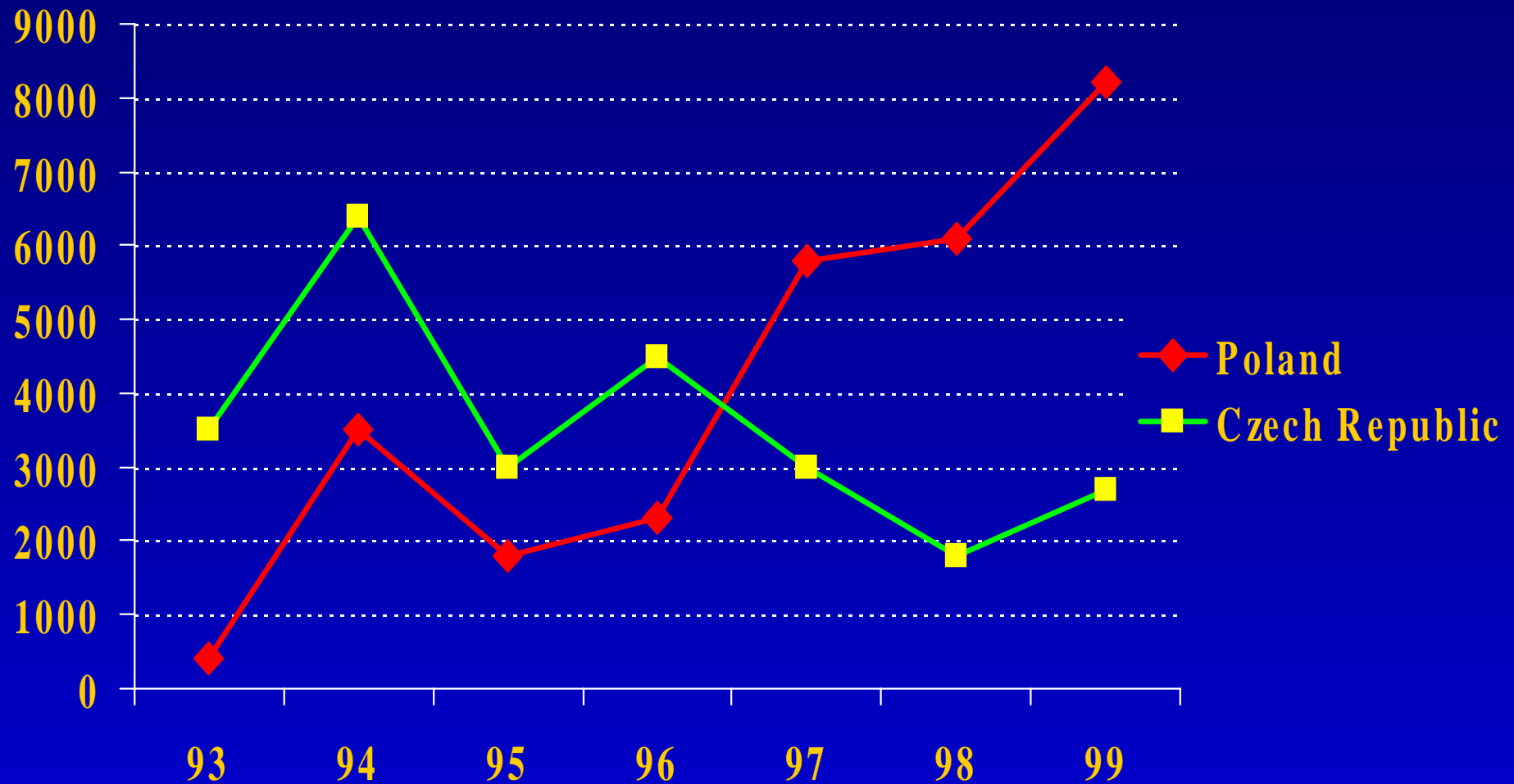
(1)

Three 'enforcement' arguments for regulation:

1. Regulators may have greater expertise and better incentives than judges.
 - ✓ Judges, especially independent ones, may not have the zeal or career concerns in controlling undesirable conduct.
 - a. James Landis and the SEC
 - b. Securities regulation in Poland and the Czech Republic.
 - ✓ Czech Republic in mid 1990's: no securities regulation, no independent SEC, few rules restricting tunneling.
 - ✓ Poland in the mid 1990's: US-style regulation, independent SEC, extensive regulation.
 - Result: Massive tunneling in the Czech Republic, collapse of market, no IPOs or equity issues, better performance in Poland.

Poland versus the Czech Republic

Stock Market Capitalization (mil. \$)



The Case for Regulation

(2)

2. Regulation may be easier to enforce by third parties because 'quantities' may be easier to observe publicly.

✓ Examples:

- Blue laws (no liquor sales on Sunday)
- Pacific salmon fishing
- Safety equipment/warning labels
- Pollution quantity controls

The Case for Regulation

(3)

3. Regulation may be less subject to ex post subversion by the powerful than litigation

→ Because detection of violations is more certain, fines to assure enforcement can be lower.

✓ ‘Boil them in oil’ does not work because people fight too hard to subvert justice.

- Example:

Progressive Era and the Rise of the Regulatory state in the US.
Regulation was introduced between 1880 and 1917 as a response to the subversion of courts by robber barons.

II. What is the optimal method of investor protection or law enforcement more generally?

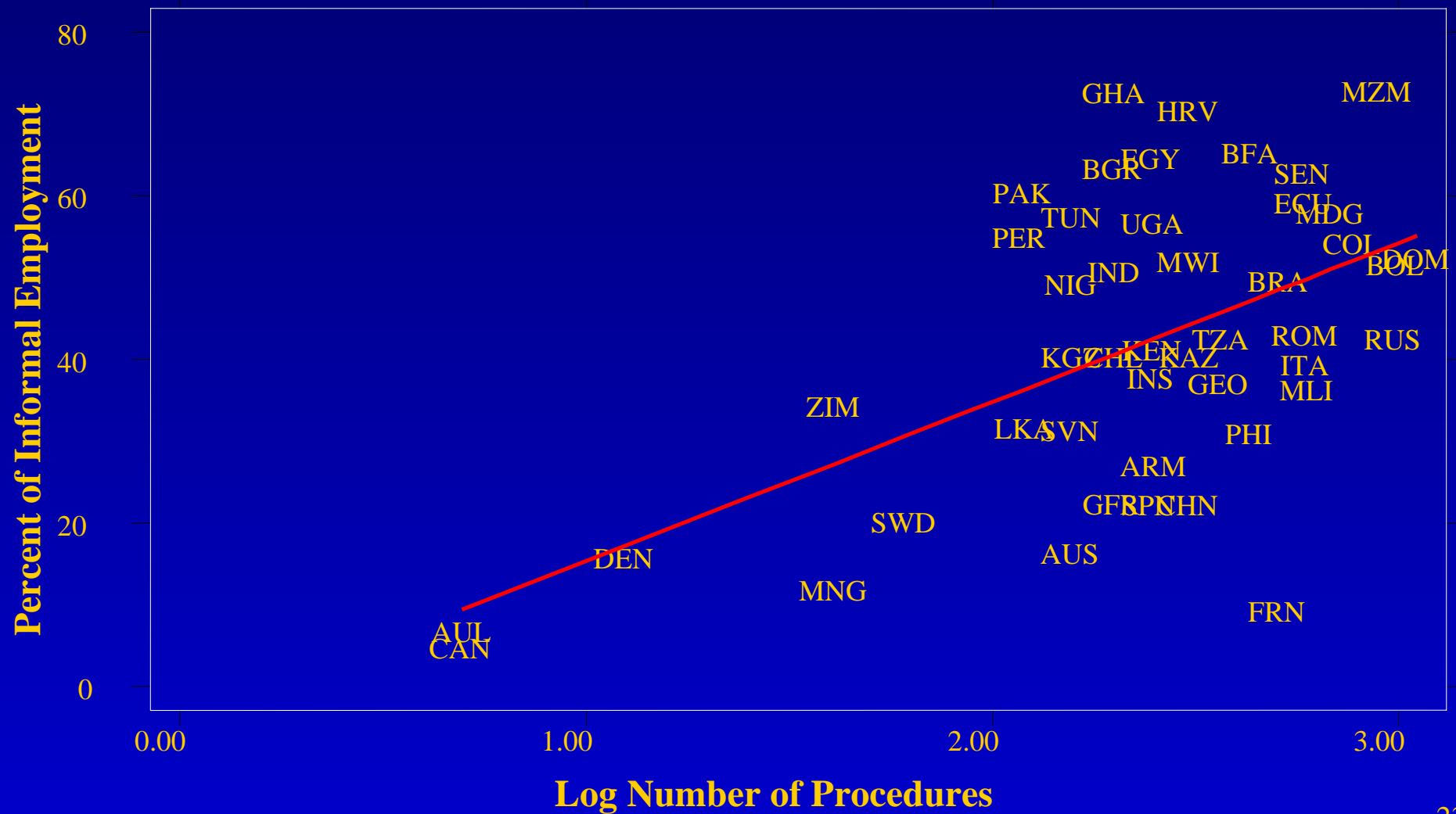
□ Bottom line on regulation:

- ✓ It appears to be efficient from the enforcement viewpoint in many cases, and there are many successes.
- ✓ It also appears to fit more naturally with the civil law tradition.

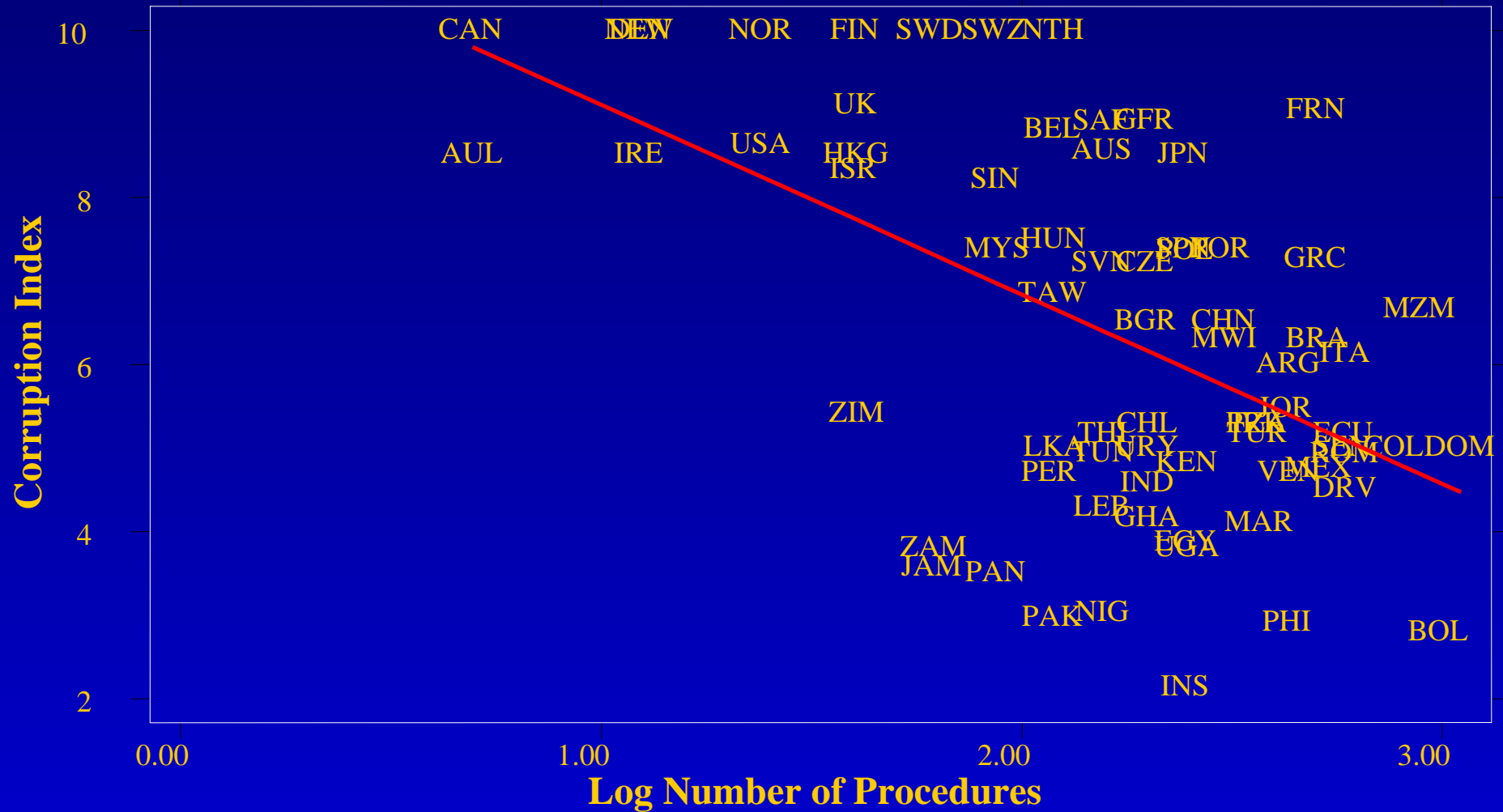
□ But...

- ✓ It has more serious problems of capture and, more importantly, of political abuse.
- ✓ The evidence on regulatory performance is very poor, especially in developing countries.
- ✓ Stricter regulation is associated with:
 - ↑ Employment in the Informal Economy; and
 - ↑ Corruption.

Unofficial Employment & Regulation of Entry



Corruption & Regulation of Entry



III. Possibilities of Reform: Functional Convergence

- ❑ Functional convergence = decentralized, market-based changes, which do not require legal reform per se.
 - ✓ Contracts
 - but problems enforcing non-standard contracts;
 - ✓ ADRs
 - but only encourages disclosure; most ways to expropriate remain; delisting is the worst penalty;
 - ✓ Acquisition by a company in another legal regime
 - but there would be no Mexican firms left.

- ❑ Functional convergence may not be enough to replace *bona fide* legal reform.

III. Possibilities of Reform: Legal Convergence (1)

- ❑ Legal convergence = changes in rules and enforcement mechanisms towards some desirable standard.
- ❑ To achieve effective investor protection, most countries would need extensive legal, regulatory and judicial reform.
- ❑ Politics of legal reform are difficult. Forces against reform include:
 1. Families in control of large corporations:
 - Investor protection = lower value of control.
 2. Banks:
 - Uninterested in bankruptcy reform if they have to write down the value of bad loans and inject fresh capital
 3. Labor:
 - Some receive rents from the existing arrangements.

III. Possibilities of Reform: Legal Convergence (2)

- ❑ Increased connections in financial markets, and emerging market crises foster legal reform, as insiders look for funds:
 - ✓ Institutional (foreign) investors
 - ✓ Entrepreneurs that raise capital abroad

- ❑ Legal reform is possible when special interests can be appeased or destroyed:
 - ✓ Japan after WWII;
 - ✓ U. S. Securities Regulation 1933-1934.
 - ✓ Chile in the 1980s
 - ✓ Polish Securities Regulation

Some Conclusions

- ❑ Financial development relies on investor protection through laws, regulation, and their enforcement.
- ❑ Reforms can be successful, and take the form of both legal and regulatory change. Appropriate institutions may vary across countries.
- ❑ The transplantation of laws and legal procedures during colonization had some undesirable effects, especially in civil law countries, and leaves room for legal and judicial reform.