



# The legal theory of finance: Implications for methodology and empirical research



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## ARTICLE INFO

### Article history:

Available online 15 March 2013

### JEL classification:

A12  
C22  
G18  
K22

### Keywords:

Law and finance  
Law and economics  
Leximetrics  
Time-series econometrics

## ABSTRACT

**Deakin, Simon**—The legal theory of finance: Implications for methodology and empirical research

This commentary on the LTF project highlights the importance of the idea that law ‘constructs’ finance and considers some of its methodological implications. The idea that law shapes finance implies that the legal system can be clearly differentiated in theoretical terms from the economy, and that the independent causal influence of the law on financial outcomes can be measured empirically. It will be argued that this can best be achieved by placing empirical research on law and finance in an evolutionary-theoretical perspective, which draws on related developments in game theory and systems theory, in the statistical study of law (‘leximetrics’), and in time-series econometrics. *Journal of Comparative Economics* 41 (2) (2013) 338–342. Centre for Business Research, Judge Business School, University of Cambridge, Trumpington Street, Cambridge CB2 1AG, UK .

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## 1. Introduction

This commentary aims to draw out some of the methodological implications of the LTF project, summarised in Katharina Pistor’s paper (Pistor, 2013), in particular its claim that finance is ‘constructed’ by the legal system. The commentary will explore what might be implied by moving beyond the dichotomy between the ‘rational actor’ and ‘social embeddedness’ models of law and finance. Specifically, it will make some suggestions on how we might think about the ways in which law ‘frames’ the economy, and explore ways in which this idea might be operationalised in empirical research. Then, in the light of this consideration of theory and methods, it will discuss some of the main findings of the project, namely that that financial systems are ‘hierarchical’, with power unevenly distributed between core and periphery; legal enforcement of financial claims is uneven and incomplete, with flexible enforcement at the core made possible by the strict enforcement on the periphery; and, the overall structure is inherently or ‘endogenously’ unstable. It will be argued that a single, unifying theme emerging from the LTF project is that the financial crisis was the surface manifestation of a deeper, more fundamental disjunction between the legal and financial systems.

## 2. Some starting points

Discussants for the LTF project were asked to clarify the assumptions guiding their own work. I approach the LTF project from the point of view of a legal researcher who is interested in the way law shapes, and is shaped by, the economy. In

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common with other 'law and economics' researchers, I am interested not solely in the doctrinal structure of legal rules (although that is certainly of interest), but also in their economic functioning, and hence in issues of economic theory and methodology, in so far as they touch on law. I share with the framers of the LTF project what may be called a certain disappointment (even disillusionment) with the rigidity of 'mainstream' law and economics approaches, above all their unrelenting emphasis on equilibrium in markets and on the spontaneous alignment of legal rules and economic behaviour. There has been undue neglect, in law and economics, not just of non-neoclassical approaches to institutionalism within economics, but also of contemporary developments elsewhere in the social sciences, including systems theory or what might be called 'evolutionary sociology'. At the end of the day, there is, or should be, just one social science, and it makes little sense to treat sociology and economics (or law) as if they were entirely unrelated fields. The single social science we should be aiming for is one informed by and synthesised from evolutionary models in various sub-disciplines, in particular evolutionary game theory and systems theory (Deakin, 2011). As part of this process, there needs to be some discussion about the methodological shortcomings of the currently predominant models in empirical economics and legal studies, with their excessive emphasis on rationality and equilibrium. Empirical research should be informed by models of the economy and of the legal system which take seriously their dynamic properties, in particular their tendencies towards non-stationarity and disequilibrium. This perspective is, of course, directly relevant to the financial crisis and its analysis. Models of financial systems which assumed stationarity and equilibrium are partly responsible for the crisis and for its continuation now, as policy makers struggle to formulate a coherent response to it.

### 3. The LTF project

The LTF project breaks new ground not just in promoting the idea that the financial system is legally constituted (a claim that many law and economics scholars would not deny), but in providing some highly specific claims on how law does this. It is essential to show specifically how the financial system could not operate, and in practice does not operate, without certain legal rules. Although, in principle, finance could perhaps operate without legal underpinning, in practice it does not do so outside a few isolated and mostly irrelevant cases, so the critical issue is to understand how the financial system we actually have has been shaped, historically, by the law, and how the law continues to influence it today. Here, the LTF model helpfully suggests that 'law is central to finance in at least three respects: law lends authority to the means of payment; it spurs regulatory pluralism by delegating rulemaking to different stakeholders; it vindicates financial instruments and other financial contracts' (Pistor, 2013). Also core to the LTF project is a specific hypothesis concerning enforcement, namely that at the core of the financial system there are more benign survival constraints than at the periphery. The legal system enforces financial claims differentially, so finance, far from being 'flat', is structured hierarchically.

These claims are supported, in various ways, by the empirical case studies of the LTF project, from which, inductively, the theoretical premises of the project have been derived. There may nevertheless be a need to fill out and extend the methodological bases of the project. We might agree that progress in the social sciences, involving shifts from one paradigm to another, generally takes a methodological form. If there is a gap in the LTF project present it is, perhaps, the absence of a more systematic account of the methodological implications of viewing law as having a 'constitutive role' in framing finance, and a clearer picture of the kind of empirical research programme that would be informed by an LTF approach.

### 4. An evolutionary-systemic view of law and finance

An 'over-sociologised' notion of embeddedness is just as much a problem as its opposite, the idea of the wholly autonomous rational actor. Embeddedness implies that economic exchange is rooted in micro-level social relations, and therefore shaped by cultural norms which are specific to particular national, regional or sectoral contexts. While this is no doubt a grain of truth in this, the embeddedness approach risks dissolving the economic into the social, at the same time as marginalising the analysis of formal, public institutions, including those of the legal system (Harvey, 2002). The rational actor model, conversely, dissolves social relations and legal institutions alike into an undifferentiated economic realm.

At the core of the idea of law 'constructing', 'constituting' or 'instituting' finance are two linked claims: law can be differentiated from the economy; and, law exercises an independent causal influence on economic behaviour and outcomes.

It seems intuitively obvious, from the most basic knowledge or study of the law, that legal and economic relations are substantively different from one another and operate at different levels of social interaction, but in fact the opposite has been strenuously maintained by the dominant modes of thought in the social sciences for most of the last century, namely marxism and neoclassical economics. Essentially, they both see law as an 'epiphenomenal' expression of material relations: class relations, in the case of the former, and rational strategic behaviour, in the case of the latter.

The methodological-individualist position of neoclassical economics does not necessarily deny that there are macro-level structures, such as those of the legal system, which can affect incentives and behaviour in certain contexts, but it does claim that these macro structures can be entirely understood as outcomes of the micro-level interactions of agents. Institutional rules crystallise patterns of behaviour which emerge as rational agents' best responses to the fixed parameters of a given environment. Legal rules, notwithstanding their public character, largely give effect to norms which originate outside the legal sphere. As such they exercise no independent causal influence over the economy, except perhaps to impede its operation when, from time to time, they get out of line with agents' expectations. Even then, mechanisms of selection within the

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