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Endogenous legal traditions and economic outcomes☆

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ABSTRACT

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Outcomes are deeply influenced by the set of institutions used to aggregate the citizens' preferences over the harshness of punishment, i.e., the legal tradition. I show that while under common law appellate judges' biases offset one another at the cost of legal uncertainty, under civil law the legislator chooses a certain legal rule that is biased only when he favors special interests, i.e., when preferences are sufficiently heterogeneous and/or political institutions are sufficiently inefficient. Thus, common law can produce better outcomes only under this scenario. To test this prediction, I construct a novel continuous measure of legal traditions for 49 transplants, many of which reformed the transplanted institutions, and I devise an instrumental variables approach dealing with the endogeneity of both legal and political institutions. The evidence I obtain is robust across several strategies, confirms the model implications, and stresses the relevance of distinguishing between proxies measuring only the technological efficiency of the law and those picking up also the citizenry's satisfaction with its cultural content. *Journal of Comparative Economics* **44** (2) (2016) 416–433. ACLE, University of Amsterdam 1018 TV, Amsterdam, The Netherlands.

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1. Introduction

The law is deeply influenced by the legal tradition or origin, which is the bundle of institutions shaping lawmaking and dispute adjudication (Zweigert and Kötz, 1998). The two most widespread legal traditions, common law and civil law, have been transplanted generally through colonization and occupation by a group of European countries and display very diverse structures. While common law entrusts a key role to judicial precedents—i.e., case law—and allows some discretion to lower courts, civil law relies on centralized legislation—i.e., statute law—and bright-line adjudication institutions. Exploiting the exogenous assignment of these different institutions and assuming that they have not been reformed later on, the "legal origins" project has provided evidence implying that countries that received civil law display more inefficient governments and courts, less secure investor rights, and stricter regulation than those that inherited common law (LSS, 2008).

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Recent contributions, however, have criticized the ideas that transplanted legal traditions remained intact (Roe, 2004) and can be measured through legal origins dummies (Rosenthal and Voeten, 2007). Inspired by these studies, Guerriero (2015) develops a model implying that countries that received statute (case) law should have optimally reformed their legal order toward a pure common (civil) law tradition where preference heterogeneity is the largest (smallest) and the quality of the political process is the weakest (strongest). This prediction is consistent with data on 155 countries whose initial legal order was either inherited through colonization/occupation or shaped on the model considered most advanced at the time, i.e., transplants (Berkowitz et al., 2003). Contrary to the assumption maintained by the legal origins scholars, 25 transplants reformed their lawmaking institution and 95 reformed at least one among their lawmaking and adjudication institutions. These results raise three burning questions about the relationship between legal traditions and outcomes.

First, how do legal traditions, preference heterogeneity, and the quality of political institutions interact in shaping outcomes? Second, how can we measure the whole bundle of institutions characterizing each legal tradition and deal with its endogeneity? Third, what outcomes should we consider? This last question is better understood as follows. Because of their tendency toward optimality, legal traditions should have no impact on proxies for social welfare. The measures considered by the development literature however gage only the technological efficiency of the law, i.e., a function of the distance between the prevailing law and the legal rule that will maximize social welfare should preferences be completely homogeneous. For instance, the unemployment rate speaks about the efficiency of labor markets to equate the marginal disutility of labor to its marginal productivity, but it does not say much about the psychological reward drawn by societies protecting more workers. Thus, a credible inquiry into the impact of legal traditions has to take into account also what the proxy of interest is actually measuring. This paper builds on the theoretical framework put forward by Guerriero (2015) and data on 49 transplants to answer these three questions.

In the model, I study a simple and yet general society populated by three groups heterogeneous in their preferences over the harshness of punishment. I refer to this diversity as cultural heterogeneity since my test focuses on the cultural component of preferences. While under common law the legal rule is chosen by a randomly selected appellate judge bearing variable costs of overruling a precedent, under civil law it is selected once and for all by a legislator who bargains with coalitions of the groups and has as outside option the socially optimal law, i.e., the mean of the groups' bliss points. Each coalition faces fixed "collective action" costs. While appellate judges' biases offset one another at the cost of legal uncertainty, the legislator chooses a certain legal rule that is biased only when he favors special interests. If cultural diversity is limited, fixed costs discourage bribes and thus civil law is both socially and technologically efficient. When preferences are sufficiently dispersed instead, the legislator selects a law whose bias increases with the inefficiency of the political process, and there are two thresholds of the quality of political institutions such that a deterioration of the quality of the political process makes civil law first only technologically inefficient and then also socially inefficient. As a result, societies endowed with an intermediate quality of political institutions embrace the socially efficient civil law, which in turn produces legal rules whose technological inefficiency—compared with common law—is higher the larger is the extent of cultural diversity and the poorer is the quality of the political process. These patterns are robust to several alternative assumptions, e.g., appellate judges are politically selected or corruptible, the legislator is elected, and institutional design maximizes not only social welfare but also bribes. Crucially, this last robustness check implies that the model normative predictions have also positive implications.

Testing these implications brings two key challenges. First, creating meaningful proxies for legal traditions, their determinants, and both the technological efficiency of the law and social welfare is not obvious. To capture the whole bundle of institutions characterizing each legal tradition, I build on measurement models (Rosenthal and Voeten, 2007) and I select *Common-Law*, which is the normalized first principal component extracted from five indicators measured in 2000, i.e., a case law dummy and four proxies for the discretion licensed to lower courts. For what concerns cultural diversity, I exploit exogenous variation created by the transplantation wave and, in particular, I use the genetic distance between the plurality ethnic group in the country that chose the lawmaking institution and that in the transplant, i.e., *Genetic-Distance*. Turning to the quality of the political process, I follow the extant literature and I employ the Polity IV "constraints on the executive" score averaged between independence and 2000, i.e., *Constraints-on-Executive*. Similarly, I build on Acemoglu and Johnson (2005) and LSS (2008) and I focus on the stock market development, the extent of private credit, and the employment level as measures of the efficiency of the legal system in enforcing contracts and shielding the citizenry from expropriation by the government and powerful elites. Finally, to gage social welfare I use World Business Environment Survey data to measure how much society believes the legal system is able to hit its efficiency targets and how much she is culturally satisfied with the law. Second, even if including *Genetic-Distance* and *Constraints-on-Executive* takes care of the omitted variable bias in the estimates of legal traditions, OLS correlations between political institutions and outcomes do not establish a causal effect because of the confounding impact of the colonizers' settlement strategy on both. To tackle this issue, I build on social evolution theories to identify exog enous instruments.

Consistent with the model, two-stage least squares—2SLS hereafter—estimates reveal that *Genetic-Distance* interacted with *Common-Law* has a positive and significant impact on the proxies for the technological efficiency of the law, and a reform toward a pure common law tradition in developing transplants with smaller (larger) than average cultural heterogeneity will significantly brake (foster) stock market development and the extent of private credit (stock market development). Furthermore, the two legal traditions fare equally well when the outcome of interest captures both society's cultural satisfaction with the law and its technological efficiency. In the basic estimates, the overidentifying restrictions cannot be rejected at a level lower than 0.16 and the instruments enter strongly in the first-stages. To address the concern of whether the

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