10. Market Institutions and Judicial Rulemaking

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1. Introduction and Summary

The proper functioning of a market economy requires that freedom of contract be protected effectively. This can be achieved in different ways. A major design decision concerns the rulemaking discretion that the legislator delegates to the courts. When taking this decision, the legislator should take into account the specialization advantages and transaction costs that come with more or less specialized rulemaking. Factors influencing this trade-off explain the different solutions adopted in the two main legal traditions of the West. Common law evolved keeping more rulemaking powers in the judiciary, and thus was characterized by unspecialized rulemaking. The civil law tradition, however, was transformed during the 19th century, reserving greater rulemaking power for the legislative branch and thus reducing the discretion that judges had enjoyed during the Ancient Regime.

By stressing this difference, some recent studies claim that common law legal systems provide superior solutions to those developed in the civil law tradition, in which judges have less rulemaking power. This chapter criticizes these claims by developing and testing an alternative "self-selection" hypothesis, according to which both common and civil law supported a transition to the market economy adapted to local circumstances. In particular, judicial discretion, which is seen here as the main difference between the two legal systems, is introduced in civil law jurisdictions to protect, rather than limit, freedom of contract against a potential judicial backlash. This protection was unnecessary in common law countries, where free-market relations enjoyed safer judicial ground mainly due to their relatively gradual evolution, their reliance on practitioners as judges and the earlier development of institutional checks and balances that supported private property rights.

From this adaptation perspective, we see that much of the discussion on the "efficiency" of both legal traditions (pioneered by Posner, 1973; Priest, 1977; Rubin, 1977, 2000; and further developed by Cooter and Kornhauser, 1980; Terreborne, 1981, and Katz, 1988) focuses on relevant but relatively minor matters. This is compounded in recent comparative studies by the difficulty for such empirical comparisons of distinguishing causalities from correlations and by the fact that performances are observed only for those choices that were

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effectively taken, while the relevant comparison would be between the chosen option and its unobserved alternative. Such analyses therefore provide shaky grounds for policy recommendations and this may explain the recurrent paradox that, even though these empirical comparisons support the claim that common law is superior to civil law for the development of financial markets (e.g., La Porta *et al*., 1998: 1148) and economic growth (Mahoney, 2001), both transition and emerging economies opt for statute law for creating the legal basis of such markets, following the regulatory model of developed economies, which for many decades has been based on statutes.[1]

Our discussion therefore broadens the argument by Rubin (1982) that both common law and civil law facilitated freedom of contract and were *efficient* in the 19th century. Without claiming anything regarding "efficiency," however, we argue that both common law and civil law solutions were well adapted to their particular circumstances. Considering that the value of legal systems depends not only on their specific traits but also on good environmental fit, we aim to identify the local circumstances which defined the balance of the institutional trade-off. Further work is needed, however, to develop and test the conjecture that the problem of transition and developing economies resembles the challenge of creating market institutions in 19th century Europe rather than the remote, evolutionary emergence of such institutions in common law countries.

The remainder of the Chapter is organized as follows. In Section 2 we state our hypothesis concerning the evolution of common and civil law. We argue that common law countries featured greater judicial discretion because, given their more gradual evolution away from the Ancient Regime, judges did not threaten the development of a modern market economy. Civil law reformers, in contrast, placed more rulemaking in the hands of the legislature and limited the discretion of judges in an attempt to shelter free-market relations, especially freedom of contract, from a potential judicial backlash. Both of these policies, promulgating systematized default rules and reducing judges' discretion, shared the same goal, that of protecting freedom of contract and promoting market relationships and economic prosperity in areas previously suffering from mandatory rules and judicial regulation of private contracts. We then confirm the consistency of our argument by reviewing the relevant historical evidence, in Section 3, and the alternative explanations provided in recent comparative performance of legal systems, in Section 4. In particular, Section 3 analyzes the historical evidence on the evolution of both legal traditions which seemingly culminated at the end of the 19th century. Then, in Section 4, we compare our argument with those produced in the recent debates on the comparative efficiency and performance

[1] This selection of statute law has even been interpreted as a selection of specific legal origins within civil law, as in the first of the annual *Doing Business* reports, which are based on methodologies developed within the "Law and Finance" literature and, specially, La Porta *et al*. (1998) and Djankov *et al*. (2002, 2003). In particular, *Doing Business 2004* classified 19 of the 30 jurisdictions which had formerly been considered of Socialist legal origin within that literature (La Porta *et al*., 1999) as of either French or German legal origin. At the same time, 11 of these 30 countries remained classified as being of Socialist origin, and none was reclassified as having a common law origin (World Bank, 2004, 115–117).