

LAW, INFORMAL RULES AND ECONOMIC PERFORMANCE -
THE CASE FOR COMMON LAW, Svetozar Pejovich, 2008, Edward
Elgar, Cheltenham, 178 p.

Review*

In the preface to his book *Law, Informal Rules and Economic Performance - The Case for Common Law* Pejovich states that the book is about capitalism and its economic performance. He describes capitalism as the “only system in recorded history that has been successful in pulling the average person above the subsistence level and sustaining a steady, if cyclical, rate of economic development”. However, Pejovich adds that his book is not concerned with advocating capitalism on philosophical or ideological grounds. Rather, his purpose is to explain why the system has done so well. In order to do so, the analysis goes in two directions: 1) analysis of the incentive effects of formal and informal institutions on the economic behaviour of individuals or, put differently, analysis of the effects of capitalist rules on the game itself, and 2) examination of adjustments in the rules over time. In his analysis Pejovich differentiates two major types of capitalism - Anglo-American and Continental, whereby he focuses on the two legal systems upon which the two types depend - common and civil law. His goal is to explain how and why different versions of capitalism have led to different socioeconomic results.

The book is organized in three parts: 1) Basic economic concepts (chapters 1-2), 2) Transformation of medieval community into modern society: the rise of classical liberalism, the rule of law and capitalism (chapters 3-9), and 3) Toward a theory of institutional change (chapters 10-15). In the first part the author discusses some basic economic concepts, transaction costs, the role of institutions, and the meaning of economic efficiency. The author defines informal institutions as “traditions, customs, moral values, religious beliefs and all the other norms of behaviour that have emerged spontaneously, survived the test of time and served to bind generations”. Formal institutions are “constitutions, statutes, common laws and other governmental regulations”. As the author states, the major premise of the book is that the changes in institutions affect the economy, and that changes in the economy have predictable effects on the development and modifications of institutions. To readers who are unfamiliar with the main concepts of institutio-

* Received: February 16, 2009

Accepted: February 25, 2009

nal economics, the first part of this book will provide a good introduction. It is written in textbook style - simple and informative.

At the beginning of the second part the author briefly discusses the birth of capitalism and its dependence on the rule of law. He also stresses the importance of individualism, which “rewards competitive performance, promotes risk taking and views income inequalities as desirable results of entrepreneurship and free trade”. Apart from the rule of law and the culture of individualism, the third cornerstone of capitalism is competitive markets. The author also writes about the judiciary, constitutions and private property rights. Furthermore, he relates the incentive effects of the institutions of capitalism to economic performance. The four basic institutions of capitalism are, according to the author, private property rights, the law of contract, an independent judiciary and a constitution. They are all embodied in the rule of law. The second part of the book also contains a reprint of Buchanan’s paper “Afraid to be free: dependency as desideratum”. In the third part Pejovich proposes and develops “a theory of efficiently-friendly institutional changes that are consistent with both the culture of capitalism and sustainable economic development”. The theory is based on three major factors: the rule of law, the carriers of change (individuals), and the interaction between formal and informal institutions. The gist of the theory (the interaction thesis) is that the rule of law provides incentives for the carriers of change to narrow the gap between the culture of capitalism and the prevailing culture in the community. Pejovich actually attempts to introduce culture into the model of institutional changes.

There are several things worth pointing out regarding Pejovich’s views. Firstly, he believes that, contrary to the English and American experiences, the “role of a powerful state has never been seriously questioned on the European continent, not even by its prominent classical liberals”. In Anglo-American capitalism the government is a predator which the rule of law is to tame, and in Continental capitalism the government is a partner in the economic game. Secondly, the author stresses that an expansion of the role of the state in economic affairs makes the economy less efficient. In the overregulated European Union phenomena like Bill Gates and John Dell are not happening. Thirdly, Continental capitalism privileges social justice over freedom of choice, while in Anglo-American capitalism the system is about freedom of choice and private property rights. Generally, according to Pejovich, Anglo-American capitalism is better at protecting the institutions of capitalism.

Fourthly, Pejovich makes a clear distinction between common law and civil law. Common law is judge-made law, the institutionalization of informal institutions, and it is about “individual liberty, private property rights and free exchange”. Common law judges can choose either to stick with the prevailing precedents or to ignore them and “legislate from the bench”. This means that the judges have discretionary power to make decisions that are not consistent with either the wisdom of the past or existing procedures. In civil law countries legislators debate scholars’ propositions and enact those that pass their scrutiny. Bureaucrats and courts then implement and enforce new formal rules. Furthermore, the legislative process is influenced by various interest groups. In common law countries formal rules appear spontaneously from within the system as a response to changes in the requirements of the game. “Those adjustments in formal rules reduce the tran-

saction costs of exploiting new exchange opportunities and, in doing so, move resources to higher-valued uses”. Formal rules in civil law countries are also made in response to changes in the game, but legislators have incentives to enact formal rules that promise to push human interactions towards the results desired by a majority of voters, the median voter, rent-seeking groups, or all of these. Pejovich believes that the transaction costs of merging the two legal systems are very high.

Let us now analyze the author’s views, starting from the role of the state. Is the difference between Anglo-American and the Continental capitalism regarding that issue really that strong? Reisman (2008) points out several things about the United States. Firstly, government spending in the United States currently equals more than forty percent of national income, and that is without counting any of the massive off-budget spending (e.g. recent bailouts). According to Reisman’s view, this means that more than forty dollars of every one hundred dollars of output are appropriated by government against the will of the citizens who produce that output. Secondly, in the US there are presently fifteen federal cabinet departments and more than one hundred federal agencies and commissions. Thirdly, in 2007 the Federal Register contained fully seventy-three thousand pages of detailed government regulations, which is an increase of more than ten thousand since the late 1970s. Apart from that, there is a massive apparatus of laws, departments, agencies and regulations at the state and local level. It is also questionable that in Europe government is viewed as a partner in the economic game. This is too general. It is highly likely that entrepreneurs in Europe have an opposite view of the state. Also, a powerful state has never been accepted in Switzerland, and it was quite successfully challenged by leading German liberals such as Kant and von Humboldt. Furthermore, recently a fiscal stimulus of \$787bn was approved in the US, although not backed up by the Republicans, showing that government in the US might not be generally viewed as a predator.

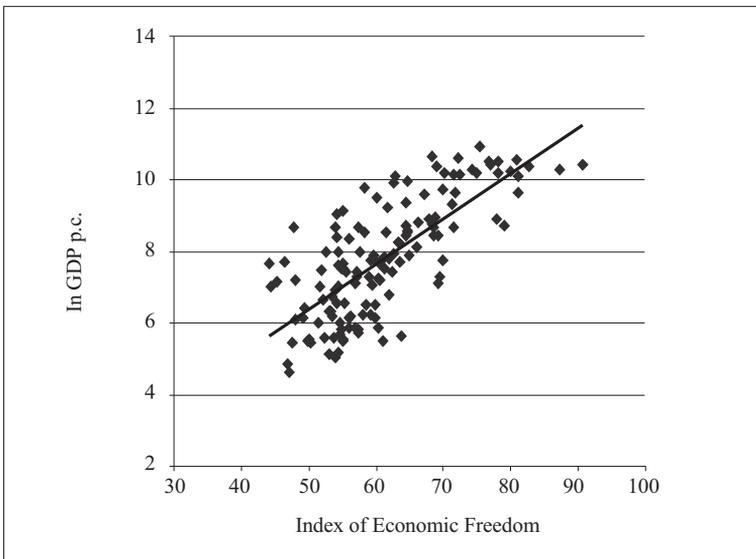
Pejovich uses the Index of Economic Freedom to assess whether Anglo-American or Continental capitalism is better at protecting the institutions of capitalism.¹ It turns out that economic freedom is higher in Anglo-American capitalism, i.e. common law countries. In 2007 the index for common law countries on a scale from zero to 100 was 81.3, and for civil law countries 72.7. The first group of countries consists of the United States, England, Ireland, Australia, Canada and New Zealand. In these countries common law is the dominant legal system. In the second group (all western countries, in a cultural sense, that use civil law) are Portugal, Spain, France, Luxembourg, Germany, Belgium, Holland, Italy, Switzerland, Austria, Sweden and Denmark. Pejovich left out Greece because it was dominated by the Ottoman Empire for centuries, Finland because “it has remained between the West and the East”, and Norway because it uses both common law and civil law. Hong Kong and Singapore are left out “because it is not clear whether they are part of Western civilization”.

There are several problematic issues regarding Pejovich’s analysis by using the Index of Economic Freedom. He acknowledges that it is not a perfect measure. However, it is

¹ Economic freedom is defined as that part of freedom that is concerned with the material autonomy of the individual in relation to the state and other organized groups (Heritage Foundation, 2008). The Index takes into account ten “variables”: business freedom, trade freedom, fiscal freedom, government size, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption and labour freedom.

still the only one he uses. In addition, is the difference between 81.3 and 72.7 so significant for the conclusion of the superiority of Anglo-American capitalism to be made? Even the author's interpretation of which countries are included and which are not is a bit fuzzy. If the author mentions Hong Kong and Singapore, which have the highest index score, how come he does not mention India, which modelled its legal system on England's and yet had an index for 2007 of 54.1? In general, what about the Asian countries? This especially holds for China, a country that achieved high economic growth despite its weak rule of law (index score in 2007 was 51.8). Another problem with using the Index of Economic Freedom is that it does not cover a long time period; it starts from 1996. It is highly possible that forty years ago some continental countries, such as West Germany or Switzerland, provided more economic freedom than the UK, Ireland or New Zealand. Finally, Pejovich fails to notice that there is a strong correlation between a country's GDP p.c. and the index score (see graph 1). In other words, countries that are richer have more economic freedom. It is not necessary for those countries to have a legal system based on common law. Pejovich also fails to notice the possibility of reverse causality: maybe countries have more economic freedom because they are richer, and not vice versa.

Graph 1 Correlation between GDP p.c. and the Index of Economic Freedom for 2007



Source: Heritage Foundation (2008) and World Bank (2008); author's analysis.

Let us now focus on the common law vs. civil law issue. One endnote contains Colombatto's argument that in civil law countries precedent is becoming more and more important in many public administration cases, where judges can interpret the law as they like but are under pressure to justify differences with respect to previous, similar cases.

Furthermore, Pejovich mentions several times, but casually, that the difference between common law and civil law is not black and white. The former does rely on statutes and the latter does pay attention to previous courts' decisions. The difference lies in the relative importance of the two models in making formal rules. If the distinction between those two legal systems is not that large, why push the common law argument that hard? Weber (1972:471) claimed that England became economically successful not because of its legal system, but partly despite of it. Namely, only the propertied classes had access to the royal courts, which used the common law, while everybody else was "sentenced" to Khadi-justice, or completely denied justice. This changed in the course of the 20th century. In addition, Posner (1998:2) claims that some American states, which have highly politicized judiciaries of questionable professional competence, are nevertheless economically successful. Pejovich's argument that the legal process in Europe is influenced by rent-seeking groups, while in the US it is not, simply does not hold. Why does the strong lobbying industry in the US even exist? Furthermore, Lele and Siems (2006) have shown that, in contrast to earlier research, there is no legal distinction regarding shareholder protection in civil law and common law countries. Moreover, Pejovich's view that legal systems based on civil law are typically worse at taking into account informal institutions than legal systems based on common law could also be challenged. See for example Pawlowski's (1999) book on judicial decision making, especially regarding interpreting the shared legal rules in different parts of the Habsburg Monarchy. The judges took into account informal institutions when making their decisions. Finally, the author does not differentiate between the subcategories of civil law: scholars of comparative law usually subdivide civil law into three groups: German, French, and Scandinavian civil law.

Pejovich's interaction thesis is worth quoting: "When the members of the community perceive the consequences of a new formal rule to be in conflict with their prevailing culture, the transaction costs of integrating that rule into the institutional framework will be high, consume more resources, and reduce the production of wealth. The actual economic outcome is the joint product of the interaction of a new rule with the prevailing informal rules." In order to prove his thesis Pejovich just compares the Index of Economic Freedom scores for central and east European countries, but he divides them in two groups: those with greater Western influence and those with lesser Western influence. The former have a higher average of the index which, according to Pejovich, is "striking" evidence in support of the interaction thesis. Countries with more Western influence had stronger institutional restructuring. In other words, countries where collectivism and egalitarianism were less widespread could more easily accept the institutions of capitalism. Although the interaction thesis is interesting, it is not new. By now it has become almost conventional wisdom, which was not true at the beginning of transition. It is a pity that Pejovich did not study transition economies and their legal systems in more detail.

Most of Pejovich's basic ideas, especially those about institutional changes, are difficult to disagree with. However, Pejovich oversimplifies matters. Despite the author's intention not to defend capitalism on ideological grounds, some conclusions in the book that are not well supported by empirical evidence might be interpreted as doing just this. The author of this review has to put the essential question regarding the general idea of this book: what is the point in proving that common law is better than civil law, espe-

cially because with time there seems to be a convergence between them? Many would argue that countries are path-dependent; they have to work with what they have got. Also, the author neglects other possible determinants of economic growth, apart from institutions (see e.g. Temple, 1999). Finally, in his analysis Pejovich focuses on several countries which are probably clear-cut examples of common law or civil law systems. But in between, there are many other countries which do not fit, and each of them has its own specifics. In the words of the Raconteurs, who are an American rock band, “there’s so many shades of black”.

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