



Financial development in adversarial and inquisitorial legal systems

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ABSTRACT

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This paper aims to understand why common law countries have more developed financial markets than civil law countries. One difference between these two legal origins is the procedure of evidence collection for a trial: It is adversarial in common law and inquisitorial in civil law. The adversarial system delegates the collection of evidence to a larger extent to lawyers than the inquisitorial system does. The paper presents a model of law and finance in which investors use courts to enforce their financial contracts with entrepreneurs. Investors are willing to lend more if courts collect evidence more efficiently. Financial markets are more developed in the adversarial than in the inquisitorial system if investors are richer than entrepreneurs or if lawyers are more productive than judges. Manipulation of evidence by lawyers has an ambiguous impact on finance. *Journal of Comparative Economics* 39 (4) (2011) 602–608. University of Lausanne, Extranef, 1015 Lausanne, Switzerland.

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1. Introduction

A puzzling stylized fact about legal origins is the apparent superior economic performance of common law countries compared to civil law countries.¹ La Porta et al. (1997) show that common law countries have larger financial markets and Mahoney (2001) that economic growth is also higher in those countries. Hence the question: Does the legal origin of a country matter for its economic performance? One key distinction between these two legal origins is the procedure to collect evidence for a trial: It is adversarial in common law countries and inquisitorial in civil law countries. This paper investigates whether this difference can explain the better economic outcomes of common law countries.

Both lawyers and judges participate to the collection of evidence for a trial. However, the adversarial system (ADV) delegates the task of evidence collection to a larger extent to lawyers than the inquisitorial system (INQ) does. Such delegation presents advantages and drawbacks: (i) lawyers may be better informed or more productive than judges, (ii) lawyers may present only the evidence favorable to their case, and (iii) the effort of lawyers in collecting evidence may be more contingent on the wealth of litigants than the effort of judges is. At this stage, the effect of ADV and INQ on the economy is not clear and could go either way.

The paper first documents the relationship between a new measure of how inquisitorial a legal system is and legal origins. The evidence shows that judges are given fewer responsibilities in common law than in civil law. This further suggests that ADV is a feature of common law while INQ is more characteristic of civil law.

A model of law and finance is then developed to better understand the channels through which ADV and INQ may affect finance. A lending relationship between an investor and an entrepreneur can potentially lead to a legal dispute, for example,

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¹ Broadly speaking, common law is found in Anglo-Saxon countries and their former colonies, and civil law belongs to continental Europe and its former colonies. See Zweigert and Kötz (1998) for further details.

if in the course of bankruptcy the entrepreneur conceals some assets or if a manager diverts the resources of a firm at the expense of shareholders. If such a scenario arises, individuals can go to court to solve the dispute. Evidence has to be collected to assess the degree of guilt of entrepreneurs. Investors are willing to lend more funds when they expect this process of evidence collection to be more efficient. This model is then used to compare the levels of financial development in ADV and INQ. The two systems only differ in the skills of lawyers relative to judges and on the biases of lawyers relative to judges. Investors can also be wealthier or poorer than entrepreneurs, which allows them to hire more or less skilled lawyers.

The following results obtain. First, if lawyers are sufficiently more productive at collecting evidence than judges are, there is more finance in ADV than in INQ. A similar result obtains if investors are sufficiently wealthier than entrepreneurs and can thus hire more competent lawyers. Second, the biases of lawyers have an ambiguous effect on finance because they entail a higher conviction rate. Both innocent and guilty entrepreneurs are more often convicted in ADV. Thus, the state of nature is better verified if the entrepreneur is guilty and worse verified if the entrepreneur is innocent. This has two contradictory effects: First, investors are better-off and are willing to lend more. Second, entrepreneurs ask to be compensated for the higher likelihood of being unfairly convicted, and investors are willing to lend less as a consequence.

The literature on ADV and INQ focuses on comparing the efficiency of these two systems within the court while this paper analyzes their consequences on the economy. According to Shin (1998), ADV produces more information because the judges receive two signals instead of one in INQ. Dewatripont and Tirole (1999) find that ADV is more efficient because less rents have to be given to two biased parties rather than to one neutral party to ensure effort. In Milgrom and Roberts (1986), Froeb and Kobayashi (2001), the average of two biased pieces of evidence is as informative as the evidence collected by a neutral party. Parisi (2002) analyzes rent-seeking in ADV and INQ.

La Porta et al. (2008) surveys the different channels through which legal origins can affect finance and the economy. This paper is agnostic about which channels matter most and simply notices that none of them rely on ADV and INQ. A first strand of the literature focuses on key differences between common and civil law: (i) In common law countries, judges are more independent from the government, and this fosters the protection of private property against state expropriation. (ii) Legal rules in common law countries are more adaptable to a changing environment because of the ability of common law judges to make the law through precedents. Posner (1972) presents a similar argument, Beck et al. (2003) finds some empirical support for this view, and (Gennaioli and Shleifer, 2007a,b) build models of the evolution of common law. Another strand of literature argues that legal origins are a proxy for something unrelated to law: (iii) The proportion of catholics is higher in civil law countries and is negatively correlated with creditor rights. See Stulz and Williamson (2003). (iv) Politics is more left-wing in civil law countries, thus favoring workers at the expense of investors. See Roe (2000).

This paper is more generally related to the theoretical literature studying the impact of judicial inefficiencies on the economy, like for example Gennaioli (forthcoming), Massenet (2010) on financial contracting and (Shleifer and Perotti, 2010) on contractual codification.

Section 2 shows some empirical evidence on the collection of evidence for a trial and legal origins. Section 3 builds a model of law and finance and compares the level of financial development in ADV and INQ. Section 4 concludes.

2. Evidence collection and legal origins

The idea that ADV and INQ are characteristic of, respectively, the common law and civil law legal origins is a well accepted idea among legal scholars (Merryman, 1990). This section shows additional support to this idea by using data on the functioning of courts in different countries.

I build a new indicator of how inquisitorial a legal system is. I use four variables from Djankov et al. (2003) that describe the procedure to evict a tenant in court: (i) Judge cannot introduce evidence (EVI), (ii) Judge cannot reject irrelevant evidence (IRR), (iii) Mandatory prequalification of questions (PREQ), and (iv) Oral interrogation only by judge (ORAL). These variables are equal to 1 if the corresponding statement is true, 0 otherwise. The first two variables measure how adversarial a system is, while the last two measure how inquisitorial it is. The inquisitorial indicator (INQ) of how inquisitorial a legal system is computed as follows: $4 \cdot \text{INQ} = (1 - \text{EVI}) + (1 - \text{IRR}) + \text{PREQ} + \text{ORAL}$. The same measures are also available for the procedure to recover a bounced check in court and give similar results. Finally, I use the common law dummy variable also provided in the same paper to measure legal origins.

Table 1 lists the inquisitorial indicator for 104 countries and shows its mean for each legal origin. The indicator ranges from 0 to 1, with a mean of .47. A higher value means a more inquisitorial procedure. The mean is equal to .38 for common law countries and to .53 for civil law countries. The difference between these means is significant at the 1 percent level.

The empirical evidence thus confirms that civil law has a more inquisitorial procedure of evidence collection than common law. The remaining of the paper is interested in understanding how this difference could affect finance.

3. A model of law and finance

An economy is populated with entrepreneurs and investors who live for two periods. There are two goods in the economy: capital k and a final good y . Capital is used to produce the final good and can be stored, while the final good is used as numeraire or is consumed. Everybody is risk neutral and consumes during the second period.

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