

**LABOUR REGULATION, CORPORATE GOVERNANCE AND LEGAL  
ORIGIN: A CASE OF INSTITUTIONAL COMPLEMENTARITY?**

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**Abstract**

We explore the finding of La Porta *et al.* that differences in ‘legal origin’ account for part of cross-national diversity in labour regulation and corporate governance. We suggest that the finding needs a better historical grounding and that a mechanism which might explain it has not been adequately spelled out. In search of an explanation we focus on the role of complementarities between legal and economic institutions, and in particular the part played by the distinctive ‘legal cultures’ of the common law and civil law in setting national systems on separate pathways to economic development.

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## **Labour Regulation, Corporate Governance and Legal Origin: A Case of Institutional Complementarity?**

*The freedom of commerce is not a power granted to the merchants to do what they please: this would be more properly its slavery. The constraint of the merchant is not the constraint of commerce. It is in the freest countries that the merchant finds innumerable obstacles; and he is never less crossed by laws, than in a country of slaves.<sup>1</sup>*

### **1. Introduction**

The diversity of national-level systems of production can be explained, it has been suggested, by differences in their *legal origin*, that is to say, their roots in one of the principal legal families of the common law and civil law. The main contrast drawn here is between the English-influenced systems of the common law, and French, Germanic and Scandinavian groupings within the civil law (La Porta *et al.*, 1997, 1998, 2000). If this hypothesis were correct, ‘liberal market’ systems such as the United States and Britain would owe their liquid capital markets and shareholder-orientated corporate governance, in part at least, to their common law heritage; in the ‘coordinated market’ systems of mainland Europe or east Asia, by contrast, multi-stakeholder forms of governance would be underpinned by civil law practices and precepts (Pistor, 2005). In addition, thanks to transplantation of western legal systems as a result, for the most part, of colonisation and conquest in the nineteenth and twentieth centuries, the influence of legal origin would extend to developing economies (Glaeser and Shleifer, 2002; Djankov *et al.*, 2003).

The legal origin hypothesis has recently been applied to labour regulation: ‘the historical origin of a country’s laws shapes its regulation of labour and other markets’ (Botero *et al.*, 2004: 1340). This finding poses a major challenge in terms of understanding the relationship between law and development. It is not being argued simply that the law is more important than political or other cultural influences as a factor in the formation of markets. The claim is a more specific one: legal origin influences the predominant *regulatory style* of a given country, which leads in turn to a greater or lesser propensity to adopt protective labour legislation (among other things), after taking into account the roles of politics and culture. The intensity of regulation, in turn, has economic consequences. For all this to be the case, the forces giving rise to institutional divergence must indeed be deeply rooted. Yet the mechanisms by which this process might have occurred have not yet been fully explained in the legal origin literature. A host of questions concerning the nature of the historical

development of legal systems, their relationship to the emergence of market economies, and their current trajectory, have been posed, but remain unanswered.

The legal origin claim is mostly derived from the work of a network of economists, centred around the contributions of La Porta, Lopez-de-Silanes, Shleifer and Vishny ('LLSV'). This group has not engaged directly with the theory or discipline of comparative law, aside from making reference to the works of some comparative lawyers in constructing stylized facts about the common law and civil law systems. The empirical findings which are said to verify the legal origin claim are based on indices purporting to measure the strength and weakness of legal rules, a technique unfamiliar to most lawyers. In addition, there are aspects of the hypothesis which appear, at first sight, to be implausible – how could the adoption or imposition of one legal code or system as opposed to another at a point in the nineteenth century still be influencing the path of economic development today; and how can a 'time-invariant' feature such as legal origin account for fluctuations in the degree of regulation over time (Rajan and Zingales, 2003)? But for all that, the legal origin literature has been highly influential, not least in informing the policy and working methods of the World Bank and other international financial institutions.<sup>2</sup>

In this paper we take a closer look at the legal origin hypothesis, with specific reference to its implications for labour regulation and corporate governance. In evaluating its claims we will refer to evidence drawn from comparative institutional studies and from quantitative analyses using a range of data sources. We also attempt to integrate this empirical material into the wider theoretical framework of comparative institutional analysis in economics and law. At some points our claims will be conjectural in nature. This is, we believe, appropriate for a rapidly-developing field in which techniques have been deployed in novel ways and in which a range of hypotheses, some more speculative than others, have been advanced. Our aim is not to offer a resolution of all these issues. Rather, we seek to advance the debate in three ways. Firstly, we show that in the process of framing the legal origin hypothesis within the wider body of work on comparative legal development, aspects of that hypothesis can be clarified. Secondly, this framing process helps us better to assess the empirical and normative claims made by or in connection with the legal origin literature. In particular, it clarifies both the potential but also the limitations of the indexing method for measuring the effects of legal regulation. Thirdly, in locating the legal origin hypothesis by reference to a broad historical understanding of the roots of institutional diversity, we aim to provide new insights on the mechanisms by which legal development influences the economy, and vice versa. In particular, we argue that from an historical and

comparative perspective, the emergence of distinctive legal cultures across the common law/civil law divide provides the key to understanding the influence of legal origin on economic development.

To these ends, in section 2 below we outline in general terms the case for the existence of enduring institutional interdependencies – *complementarities* – between labour relations and corporate governance and, most specifically, between labour law and corporate law. In section 3 we examine the core ‘legal origin’ claim that significant differences in labour law and governance regimes can be explained by reference to the divide between the common law and civil law and to subdivisions within the civil law. We also present empirical evidence on degrees of complementarity between different aspects of labour relations and corporate law, and the influence of particular legal and regulatory structures on economic outcomes. In section 4 we describe some of the historical conjunctures which, we suggest, have influenced the evolutionary path of labour law and corporate law in market economies.<sup>3</sup> Section 5 concludes.

## **2. Legal complementarities in labour relations and corporate governance**

### **2.1 Institutions, complementarities and comparative legal development**

There is a growing belief in the social sciences that institutions matter for economic performance. In this context, institutions are defined as ‘rules of the game’ whose purpose or function is to minimize transaction costs associated with market activity (North 1990). Put slightly differently, they are ‘shared beliefs’ which impart stability and order to agents’ interactions (Aoki 2001). A first critical issue in this line of work is to identify the processes by which such institutions have emerged and evolved alongside the development of markets in capitalist economies. Because institutions have the character of a public good, it cannot be assumed that markets will generate them spontaneously; but since the state is composed, in its turn, of agents and coalitions pursuing their own interests and operating under conditions of uncertainty, nor can it be assumed that the public power will necessarily act in the general interest when setting and enforcing rules. Aoki has framed the issue as follows: how do the rules of the game become enforceable, when the enforcer is part of the game? The answer, he suggests, lies in an evolutionary analysis which is capable of showing ‘how the rules of the game are endogenously generated, and thus become self-enforcing through the strategic interactions of agents, including the enforcer’ (Aoki, 2001: 2).

This implies that institutions are the result, to some degree, of design, but also that ex post adjustment, trial and error, and experimentation play a role in the emergence of stable forms (Streeck, 2005). It further follows that an understanding of more formal institutions, including the legal framework, must be complemented by an appreciation of how they interact with informal norms, social conventions and tacit understandings in shaping behaviour. The phenomenon of ‘order without law’ (Ellickson, 1991) may well be confined to a few, exceptional contexts, but, even so, the operation of the legal system in practice is likely to be indirect at best, and to depend upon the mobilization of a range of extra-legal forces in order to be effective. Enduring institutions have a ‘self-enforcing’ and ‘self-sustaining’ character which cannot be reduced to the formal sanctions and procedures of the law (Aoki, 2001: 5).

A second focus of the new institutional research agenda is on the explanation of diversity. The persistence of different institutional forms across national boundaries, in the face of common technological and market pressures, implies the possibility of multiple equilibria or pathways to economic development. The concept of ‘institutional complementarity’ has been suggested as an important mechanism in the persistence of diversity (Aoki, 2001: 225), but the idea requires some unpacking.

Complementarities arise from the ‘coevolution’ of institutional forms. Coevolution is the process by which adaptations in one institutional context or domain become adjusted or fitted, over time, to those in another.<sup>4</sup> While institutions contain elements of design, the way in which they relate to one another at a systemic level is the result of an evolutionary process whose outcome, to a significant degree, cannot be planned or predicted. Thus complementarities often arise from unexpected contingencies or conjunctions. Once increasing returns set in, arbitrary or contingent initial conditions may become fixed in the manner of what geneticists, referring to certain structural features of DNA, call ‘frozen accidents’ (Crick, 1968) or what social scientists, using the much-cited example of the typewriter keyboard, know as ‘QWERTY phenomena’ (David, 1985; Dennett, 1995). These are sources of ‘path dependence’, or the tendency of systems to become locked into specific historical trajectories. By virtue of the existence of multiple pathways to economic development, cross-national diversity follows.

Complementarities persist because they possess a degree of functionality: ‘the performance of a configuration increases when its elements assume specific properties’ (Höpner, 2005: 333). However, functionality does not imply *optimality*. There *is* a selective process, but because of path dependence, the rules or practices which emerge over a period of time are at best only

‘qualifiedly’ efficient for their environments. They are not ideal, and their defects may be well known, but the costs of unraveling them and starting again from scratch either outweigh, or are perceived to outweigh, the potential gains, or at least to involve an excessive downside risk of regulatory failure (Roe, 1995). Thus imperfect institutions can survive. But at the same time, institutions which *appear* fixed, because of their persistence over time, may well be destabilized, in their turn, by unpredictable external shocks, or through internally generated tensions or ‘incoherencies’ (Boyer, 2005). Institutional change therefore tends to be characterised by ‘punctuated equilibrium’, another idea borrowed from evolutionary biology (Eldredge and Gould, 1985): periods of relative stasis give way at ‘critical junctures’ to phases of accelerated development (Aoki, 2001: 223-4).

The idea of complementarities which has just been outlined can be used to generate a theory of comparative legal development. This begins with the observation that market economies share many of the same legal institutions: these range from the basic forms of protection of individual and collective property rights and recognition of the capacity to contract, to more specific types of support for the business enterprise (limited liability and corporate personality), regulation of the employment relationship (labour law), provision of a welfare state (taxation and social security law), and so on. However, the particular forms taken by these institutions differ across national systems, in ways which reflect variations in the evolutionary path. More specifically, the timing of industrialization, the structure of firms and of labour unions, the degree of liquidity of capital markets, and more generally the role of the state in regulating economic life, are among the many factors which might be expected to influence the evolution of distinctive legal ‘varieties of capitalism’ (Casper, 2001; Teubner, 2001). Thus within the limits set by the market paradigm which all capitalist systems to some degree share, diversity of legal form is to be expected, just as it is for the institutions of governance more generally (Hall and Soskice, 2001).

Formal divergence may however be compatible with a degree of functional continuity across systems (Gilson, 2002). This has long been recognized by theories of comparative law. *Functional equivalents* for a given legal mechanism may be found in completely different areas of law, or outside the legal system altogether, at the level of social norms or commercial practices. It is, as the classic restatement of Zweigert and Kötz (1998: 39) asserts, a ‘basic rule of comparative law’ that ‘different legal systems give the same or very similar solutions, even as to detail, to the same problems of life, despite the great differences in their historical development, conceptual structure, and style of operation’; in particular, ‘we find that as a general rule developed nations



answer the needs of legal business in the same or in a very similar way' (Zweigert and Kötz, 1998: 40). In a similar vein, Mattei (1997: 144), who more explicitly incorporates a law-and-economics perspective into comparative law, suggests that there is a 'common core of efficient principles hidden in the different technicalities of the legal systems'.

By virtue of functional continuity, in addition to observing *complementarities within* national systems, we are likely to observe functional *substitutes* or *equivalents* – institutions which substitute for one another, in the sense of performing a similar function in different ways – *across* such systems, and at *different periods* within the *same* national system. Thus the hypothesis of functional continuity is not inconsistent with the claim made above for diversity of form. It requires those who wish to argue that national systems are tending to diverge, rather than to converge, to show that legal diversity correlates to real and enduring differences in social and economic phenomena. But in the final analysis, this is an empirical question, and not one which can be settled by *a priori* reasoning: 'functional accounts of the origins of institutional complementarity must be made compatible with historical-genetic accounts featuring "real" as opposed to efficiency-theoretical causal relations' (Streeck, 2005: 365). We therefore need to look more closely at the detail of cross-national diversity in labour law and corporate governance.

## **2.2 Legal institutions as a source of divergence between national systems of production**

A comparative institutional analysis of the kind just set out can be seen to underpin the distinction widely drawn in the corporate governance field, following Berglöf (1997), between systems based on arms-length or outsider control and those based on direct or insider control, a categorization which broadly corresponds to that between 'liberal market' and 'coordinated market' systems in the literature on 'varieties of capitalism' (Hall and Soskice, 2001). Corporate governance theory views the mechanisms of governance as devices for minimising the agency costs which arise from (among other things) the separation of ownership and control in large, listed companies. The focus is on structures which are to a large degree incentive-compatible and functional; but it also is recognized that different systems can arrive at distinctive solutions to the agency problem.

In 'outsider-orientated' or 'liberal market' systems, dispersed ownership and market liquidity enable outside investors to diversify their holdings, thereby spreading the risk of being subject to managerial opportunism, while at the same time using the capital market to hold management to account, via the

mechanism of the hostile takeover bid. In different systems, different institutions have evolved which facilitate these processes. In the United States, a range of mechanisms, including shareholder litigation and an intensively regulatory regime of securities law, serves to protect minority shareholder interests (Coffee, 1999). In Britain and other common law countries such as Australia, the model of the takeover code, originating in the City of London, plays a key role, and shareholder litigation is rare. This reflects, to a large degree, the collective voice exercised by institutional investors in the British context, which is not matched to the same degree, historically, in the US (Black and Coffee, 1994). Shareholder litigation and takeover codes therefore appear to be substitutes in providing a mechanism for protecting minority shareholders; the presence of one means that there is less need for the other.

By contrast, in the case of ‘insider-orientated’ or ‘coordinated market’ systems, the concentration of ownership allows for direct monitoring and observation of managerial performance, thereby overcoming some of the agency problems which are inherent in the separation of ownership and control in outsider-based régimes.<sup>5</sup> Concentration or ‘blockholding’ takes different forms, depending on context; in varying degrees, corporate cross-shareholdings, bank-led governance and the residue of family-based control and state control can be observed (see the contributions in Hopt et al., 1997). Again, specific legal institutions have developed to complement the presence of mechanisms of direct control. One of these is the institutionalisation of employee voice within the firm; this reflects a sense in which employees are regarded as a core stakeholder group contributing to the sustainability of the enterprise (Rogers and Streeck, 1994). In a few systems, in particular Germany, there is a role for employee-nominated directors on a supervisory board as part of a two-tier board structure. Employee representation within company organs is by no means the general rule, however. In France, most companies have not taken up the option, provided in legislation, of having a dual board, and employee voice, while significant, mostly operates outside corporate structures (Goyer and Hancké, 2003). In Japan, a highly integrative approach to the participation of employees in the firm almost entirely takes the form of social norms rather than legal prescription (Learmount, 2002: ch. 7).

Thus while there may be a common impetus across systems for incentive-compatible solutions to the separation of ownership and control, as agency theory suggests, this cannot account for the diversity of adaptations which are found in different national systems (Aoki, 2001: 18; Aguilera and Jackson, 2003). The solutions which have been arrived at can be understood as stable states or equilibria which are the consequence of the strategic choices made by agents, that is to say, decisions which are ‘rational’ in the sense of being made

with the aim of enhancing their interests, but the institutional forms which characterize any given system are also sufficiently durable to shape those strategic actions. Because of this 'feedback loop' between structure and agency, once systems are set on their separate pathways, there is reason to expect them to continue to diverge.

When this type of analysis is extended to include labour law, further complementarities are observable. The institutions of labour law and employment relations intersect with the mechanisms of corporate governance at two levels. One, the level of the firm, is concerned with the constitution and governance of the enterprise, and with the influence of employees within managerial processes. The other, the level of the market, is concerned with how far basic employment conditions are regulated across the labour market as a whole, or, alternatively, left up to individual or collective agreement in particular sectors or enterprises.

In so-called 'liberal market' systems, the predominant form of employee representation is collective bargaining between employers and trade unions. Collective bargaining operates in a manner akin to setting up a contractual mechanism for negotiation. This can be done by the employer voluntarily recognizing a particular union or unions, which is the norm in Britain, or through various regulatory mechanisms which, as in the United States since the 1930s, have required the employer to negotiate with a certified bargaining agent which can demonstrate that it has majority support in the relevant bargaining unit. Since 2001 Britain also has a system of compulsory recognition, based to a large extent on aspects of the US and Canadian models, but as yet it plays a minor role in shaping the structure of industrial relations. Whatever the degree of state compulsion used to bring about recognition or certification, there are strict limits to how far collective bargaining can go in relation to the core areas of managerial 'prerogative', so that it stops short of co-decision making or codetermination (for the US, see Weiler, 1994; for Britain, Wedderburn, 1986: ch. 4). Outside those areas where employers concede collective bargaining or have it forced on them by public regulation, there is no legal obligation to deal with employee representatives. In their emphasis on collective bargaining, these systems may be characterised as *voluntarist*.

Voluntarism at the level of the enterprise tends to go hand in hand with a partial approach to regulation at market level. Thus although both Britain and the United States have national minimum wage laws and some legislation governing basic terms and conditions such as working hours, the tendency has been for statutory regulation to impose only minimal constraints on the employment contract outside those sectors which are governed by collective

bargaining. As collective bargaining has shrunk, since the 1950s in America and the late 1970s in Britain, so the uneven and *partial* character of labour market regulation has been accentuated within these systems (for the United States, see Weiler, 1994; for the UK, see Deakin and Wilkinson, 1991).

‘Coordinated market’ systems, on the other hand, tend to combine an *integrative* approach to the role of employees in the enterprise with *universalism* in labour market regulation. Integration implies the incorporation of employee voice directly into the decision-making structures of the firm. The form this takes varies considerably across systems. In Germany and the Netherlands, employee representatives sit on supervisory boards; as we have already noted, however, this is exceptional even in mainland Europe. It is more normal for employers to be required to inform and consult employee representatives on personnel matters through enterprise-level structures of various kinds. There are variations; in France, for example, enterprise committees have only a limited say on personnel matters by comparison to works councils in Germany. However, the concept of a general obligation of consultation, which arises independently of whether the employer recognises a particular trade union for the purposes of collective bargaining, is well established in most continental European systems, in part because of the influence of European Union standards (on information and consultation laws at national level and their relationship to corporate governance, see the overviews of Rogers and Streeck, 1994 and Gospel and Pendleton, 2003; on the relevant EU law, see Barnard, 2000).

Universalism in labour market regulation takes various forms. In Germany, sector-level collective bargaining between trade unions and associations of employers sets basic minima. The effects of agreements can be extended to non-federated employers by statutory order. In France, where sectoral bargaining is also observed, a statutory minimum wage and legislation on working time also underpin terms and conditions of employment. Italy does not have a minimum wage, but it does possess legislative and constitutional mechanisms which, by judicial interpretation, can be deployed to extend the effects of collective agreements. In each case, legal devices ensure that all sectors of the economy, more or less, are subject to labour regulation which guarantees workers certain basic protections in the form of ‘social rights’ (Deakin, 1990).

Thus notwithstanding the considerable differences of legal form which exist across the systems of developed market economies, there is a case for identifying certain underlying complementarities between the mechanisms of labour law and corporate governance (see Table 1 for a summary). The

prevailing form of labour regulation at enterprise level has implications for corporate governance because the degree to which employees have rights of consultation and codecision making affects mechanisms of accountability. In particular, codecision making involving employees is not easily reconcilable with the notion of outsider, arms-length control in liberal market systems. The direct line of accountability between managers and shareholders would be blurred, and the disciplinary impact of capital markets, in particular the effects of the market for corporate control, would be blunted, it is argued, by the imposition of a legal obligation upon management to consult employee representatives in advance of major corporate restructurings. It is on this basis that critics of codetermination or codecision procedures claim that they increase agency costs (Hansmann and Kraakman, 2003).

**Table 1 Complementarities in corporate governance and labour law**

	<b>Pattern of shareholder ownership</b>	<b>Protection of minority shareholders</b>	<b>Employee representation at firm level</b>	<b>Regulation of the labour market</b>
<b>Liberal market systems</b>	dispersed	high	voluntarist	partial
<b>Coordinated market systems</b>	concentrated	low	integrative	universalist

In the context of coordinated market economies, on the other hand, this more direct form of employee involvement may fit well with concentrated share ownership. Employee representatives may aid investors in the process of monitoring managers, and may also bring valuable information on organizational processes to bear on the decision making process, notwithstanding possible costs arising from more extended or protracted decision-making processes (Pistor, 1999). Employee representation may also provide a more broadly-based mechanism for building trust between workers and investors and in particular for encouraging mutual investments in firm-specific assets (Rogers and Streeck, 1994). Either way, institutionalized employee involvement in the firm may be said to be complementary to blockholding as a particular form of corporate ownership and control.

At the level of the market, a universal floor of rights, taking wages and conditions out of competition, also has potential implications for corporate governance. In particular, it affects the relative flexibility or rigidity of labour costs across sectors, and therefore the scope for gains to be made through the

outsourcing or fragmentation of production; it also has implications for the regulation of small and medium-sized enterprises. Thus it is possible that statutory labour standards set an implicit barrier to entry to entrepreneurial start-ups. This is a controversial and empirically unresolved question; there may be countervailing effects arising from the tendency of labour standards to encourage high levels of investment in training and skills (see Armour and Cumming, 2004; and on the role of regulation with regard to venture capital more generally, Black and Gilson, 1998; Gilson, 2003). However, the existence of functional links between universalism in labour standards, venture capital flows, and entry and exit rates for SMEs, is clearly an issue which merits further empirical investigation (see Table 1).

None of the above need be read as implying that the institutional environment uniformly dictates the strategies adopted by firms. The strength of such 'isomorphic' tendencies may well differ from one context to another; the role of strategic choice by managers must not be neglected. In this vein, Gospel and Pendleton (2003) develop a model which seeks to identify the different influences which corporate governance may be expected to have on the approaches of firms to the management of labour. The model is summarized in Table 2.

**Table 2 The impact of institutional complementarities on firm-level decision-making**  
 (source: adapted from Gospel and Pendleton, 2003)

	<b>Focus of managerial performance</b>	<b>Time-frame of decision-making</b>	<b>Link between finance and innovation</b>	<b>Role of financial factors in decision-making</b>	<b>Approach to securing employee commitment</b>	<b>Nature of links with other firms</b>
<b>Liberal market systems</b>	Shareholder value	Short-term time horizon, leading to requirement of high rates of internal return on capital	Requirement of short-term returns favour radical innovation	Use of shareholder value metrics permeates decision making in the firm	In the absence of strong employee voice and likelihood of periodic restructuring, greater use of share options and financial incentives	Weak and fragmented employers' associations; mergers and formal joint ventures preferred to relational contracting
<b>Coordinated market systems</b>	Maximising value for all stakeholders	Longer-term time horizon, lower internally required rate of return	Long-term time horizon favours incremental innovation	Acceptance that some factors of production (e.g. human capital) cannot be fully measured	Mechanisms of employee voice and weakness of market for corporate control encourage job security and employment stability	Strong employers' associations, effective sectoral collective bargaining, employer cooperation on vocational training, relational cooperation in production

There is evidence of enterprises and sectors which go against the trend in all varieties of system; British and American pharmaceutical firms behave very much along the lines predicted for stakeholder-orientated systems (Gospel and Pendleton, 2003), as do many utilities and service providers in regulated sectors (see Deakin, Hobbs, Konzelmann and Wilkinson, 2002). Conversely, some German and Japanese companies have begun to adopt shareholder value metrics and the business strategies associated with them (Lane, 2003; Learmount, 2002). Thus legal institutions do not rigidly dictate firm-level practices.

However, the balance of evidence suggests that a good case can be made for the existence of complementarities across the linked domains of corporate governance and labour law, and for the continuing influence of these linkages at firm level. The relative strength of financial pressures in the different systems, and in particular the pressure for short-term returns in countries with active capital markets, appears to be a factor influencing the demand for skills of a particular type, and the types of innovation which are observed:

the highly liquid capital market of the Anglo-American system, and the ease of entry and exit from markets and associated restructuring, are strengths in high-tech and other sectors undergoing fundamental change. Sophisticated manufacturing industries that depend on a highly skilled workforce and access to the technological expertise of suppliers, on the other hand, are likely to fare better in more stakeholder-oriented systems (Parkinson, 2003: 491).

In Germany and Japan, internal labour markets, constructed around implicit promises of job security and high levels of investment in firm-specific training, have remained in place during the 1990s and early 2000s, when they have become a rarity in the private sector in United States and Britain. There is also evidence that Japanese and German companies have adjusted to the growing role of external investors and to increased capital market pressures in a way which has left intact (so far at least) the social compromises embodied in those systems (Jacoby, 2004; Höpner, 2005). Thus it is far from clear that a tendency to convergence of either form or function is being observed. Even during a period when national systems are increasingly exposed to the effects of transnational capital flows, regulatory competition and the growing acceptance, among policy makers and business elites of a 'shareholder value' norm (see Hansmann and Kraakman, 2001), governance mechanisms remain matched to local conditions and reflect particular trajectories of economic development.



So far we have identified a number of legal mechanisms – in particular, aspects of corporate and securities law which affect the rights and interests of shareholders on the one hand, and laws governing employee representation and providing workers with social rights on the other – which appear to have a functional relationship to patterns of ownership and control at the level of the firm. However, this is far from establishing that the legal system has an independent causal influence on the emergence of particular configurations within corporate governance and labour relations. It is possible that the legal system simply reflects underlying movements within the economy, in the sense of *expressing* the effects of norms and conventions whose origins lie elsewhere. Even a legal system which can be thought of as lending stability to social norms, and thereby imparting to them a greater sense of permanence, would have a limited role to play as a causal factor. It is here that the legal origin hypothesis breaks new ground, and we will now take a closer look at its claims.

### **3. The influence of legal origin on labour regulation**

#### **3.1 The labour index: legal origin matters for labour law**

The legal origin theory developed principally by LLSV holds that that the common law or civil law origin of a given country's legal system is a major cause of its approach towards the regulation of business. According to these authors and their network of collaborators, the common law, originating in England, is associated with 'decision making by juries, independent judges, and the emphasis on judicial discretion as opposed to codes' (Botero *et al.*, 2004: 1344). By contrast, the civil law, as expressed in the rediscovery of Roman law by mainland European systems in the middle ages and the French and German codes of the nineteenth century, 'is characterised by less independent judiciaries, the relative unimportance of juries, and a greater role of both substantive and procedural codes as opposed to judicial discretion' (Botero *et al.*, 2004: 1344-5). It follows that

countries in different legal traditions utilize different institutional technologies for social control of business... Common law countries tend to rely more on markets and contracts, and civil law (and socialist) countries on regulation (and state ownership). [Even if] there were efficiency reasons for the choice of different legal systems in mother countries... since most countries in the world received their legal structures involuntarily, their approach to social control of business may be dictated by the history of transplantation rather than indigenous choice (Botero *et al.*, 2004: 1345).

The influence of legal origin on labour regulation is placed in the context of a wider set of claims made by these authors about the effects of the common law/civil law divide. Thus they argue that common law systems provide superior protection to shareholders and creditors than civil law countries; impose lighter entry regulation; have less ‘formalized’ dispute resolution procedures; and rely on private contracting and litigation, rather than regulation, for the enforcement of securities laws (see La Porta *et al.*, 1997, 1998, 2000; Djankov *et al.*, 2003). As in other cases, the influence of legal origin on the labour market is indirect; it is mediated through the practice of regulation, or ‘regulatory style’. If a system has adopted a particular regulatory approach in one area, it is more likely to so in another. In addition, the marginal cost of adopting the laws of the parent system are lower than attempting to begin anew with new methods and procedures. Thus ‘path dependence in the legal and regulatory styles emerges as an efficient adaptation to the previously transplanted legal infrastructure’ (Botero *et al.*, 2004: 1346). Although no reference is made here to the concept of institutional complementarities, the same basic idea seems to be at work.

The method used by LLSV to test their hypotheses is to construct, in each case, an index which is intended to measure the strength or weakness of laws on a given area in different systems. Individual country scores are then regressed against a number of possible causal factors or independent variables, including legal origin, to see how far they are correlated with them. Possible correlations with a number of economic outcomes are also measured. The coverage of the labour index, extending to both developed and developing nations, is much broader than the range of comparative country studies in the ‘varieties of capitalism’ literature (see Hall and Soskice, 2001); whereas exponents of the latter generally confined their analysis to the developed world, one of the principal rationales for the methodological approach taken by LLSV is the possibility it offers of understanding the effects of legal transplantation on the developing world.

In the LLSV labour index, each country score is built up from a series of sub-indices. These cover, respectively, civil rights; employment law; collective labour relations law; and social security law. The sub-indices in turn consist of various sub-sub-indices which are broken down further into variables which measure the intensity of legal regulation in particular sub-areas. Thus the employment law sub-index is broken down into the following sub-categories: ‘alternative employment contracts’, ‘cost of increasing hours worked’, ‘cost of firing workers’ and ‘dismissal procedures’. A description is then given of the relevant variables; thus ‘alternative employment contracts’ measures

the existence and cost of alternatives to the standard employment contract, computed as the average of (1) a dummy variable equal to one if part-time workers enjoy the mandatory benefits of full-time workers, (2) a dummy variable equal to one if terminating part-time workers is at least as costly as terminating full-time workers, (3) a dummy variable which measures if fixed-term contracts are only allowed for fixed-term tasks, and (4) the normalised maximum duration of fixed-term contracts (Botero *et al.*, 2004: Table I).

In each case the strength of regulation is measured on a scale of 0-1, with 1 indicating a more protective (that is, employee-favouring) law. The various sub-indices are aggregated to give a composite score for each country, normalized again to a 0-1 scale.

The results reported in Botero *et al.* (2004) essentially extend the legal origin hypothesis to labour regulation. Civil law countries are found to regulate the employment contract more intensively than common law countries; the effect is less, but in the same direction, for industrial relations laws. In relation to social security, French and Scandinavian origin countries are more generous than common law origin systems, but German origin countries are not. The regressions also indicate that political power matters: countries with a long period of left-wing government during the twentieth century regulate labour more heavily, as do systems with higher union density (with union density being taken as a proxy for the strength of organized labour as a pressure group). However, the effect is not as strong as for legal origin, leading Botero *et al.* to argue that ‘the effects of legal origin on the regulation of labour are larger and different from those of politics’ (2004: 1371) and thereby to reject the argument of Roe (2003) to the effect that political forces are the main driver of cross-national diversity. When the analysis is extended to outcomes, evidence is presented to show that higher scores on the labour index are associated with lower levels of male labour force participation, higher youth unemployment, and a larger unofficial economy. On this basis the authors conclude that labour regulations do not, on the whole, operate to cure market failures; instead, ‘[t]he results are consistent with the view that legal origins shape regulatory styles, and that such dependence has adverse consequences for at least some measures of efficiency’ (2004: 1378). On this basis they reject the claim that institutions tend, on the whole, to be efficiently matched to underlying economic conditions within national systems.

To evaluate these findings, it is necessary to consider the methodological status of the labour index, and what it is able to tell us about complementarity, efficiency and diversity.

### **3.2 What is the labour index really measuring?**

The sources of the values attached to the variables in the labour index are simply stated as ‘the laws of each country’ in the dataset, as they stood in the mid-1990s (Botero *et al.*, 2004: Table I). These are supplemented by a number of cross-country secondary sources including the *International Encyclopaedia of Labour Law and Social Security*, the *ILO Conditions of Work Digests*, and the US Social Security Administration’s *Social Security Programs Throughout the World*. On the face of it, then, the index measures ‘law on the books’ rather than the impact of legal regulation in practice. Indeed, Botero *et al.* (2004: 1347) accept that what they are essentially measuring is ‘formal legal rules’.

If the gap between formal law and law in practice affected all countries *equally*, this would not necessarily pose a problem for the indexing methodology; if, on the other hand, civil law systems ‘wrote down’ more of their regulations, with the common law relying on judicial decisions which were not reflected in statutes, there would be a problem. However, Botero *et al.* reject this critique, for the following reasons:

First, virtually all of labor law is statutory, even in common law countries, so what is written down is indeed what is supposed to be enforced. Second, and more importantly, we have constructed several of our indices, such as the cost of increasing worker hours and the cost of firing workers, to reflect actual economic costs and not just statutory language. For these variables, the distinction between what is written down and what it actually costs does not exist (2004: 1347).

The claim that labour law is *mostly* statutory is open to question. Labour legislation is not self-enforcing; courts, from specialist employment tribunals up to appellate and constitutional bodies, play a pivotal role in the development of the substantive rules of labour law, even when these rules have a statutory origin. However, in defence of the methods used and argument deployed by Botero *et al.*, it can be argued, as we shall see below, that judge-made law is an important source of labour law in *both* the common law and civil law systems. If their approach suffers from a methodological limitation in focusing on the written law, it is not obvious that this biases their findings for or against one of the principal families of legal systems.

What of their second claim that the index reflects real burdens and real costs? What this appears to mean is that in the construction of particular variables, Botero *et al.* have attempted to infer the effects of laws upon employer flexibility (or, conversely, worker protection). Thus if the law on dismissal, for example, restricts the grounds upon which termination may take place, the employer's freedom of manoeuvre is that much less than if it permits termination merely upon the giving of notice.

This is a more serious difficulty. The form taken by a particular law may not tell us much at all about the particular degree of flexibility available to employers. That may depend on factors outside the scope of the labour index, including social and cultural norms beyond the law which govern dismissal.<sup>6</sup> The social or economic effect of a given legal rule can only be understood by seeing rule law as part of a system of interlinked norms, some of which are extra-legal in nature. As we have seen, this is a basic aspect of the method of comparative law developed by, among others, Zweigert and Kötz (1998).

This point can be illustrated with an historical example. Dismissals without notice were often extremely costly to British employers in the period, during the 1950s and 1960s, when union strength in the workplace was at its height and sackings were met by industrial action, which was often spontaneous or 'unofficial' in character. This was before the introduction of unfair dismissal law (see Deakin and Morris, 2005: 386-395 for an overview of the emergence of dismissal law in the UK). At that point, therefore, the UK would have scored a very low mark (a zero, presumably) for 'costs of dismissal' when in practice the situation was quite otherwise. Conversely, the introduction of dismissal legislation in the 1970s and 1980s would have made the law on dismissal *look* more stringent; but in practice, as union strength was declining, social norms against dismissal were weakening, in part because of the very same unfair dismissal law, which was designed to take disputes out of the workplace and subject to them to a legal procedure which some commentators argued 'legitimised' dismissal (Collins, 1995).

This example illustrates the enormous complexity involved in preparing any labour law index. Knowledge of national conditions should qualify the scores attached to particular country variables. However, this magnifies the scale of what is already a huge task.

In this respect, the sheer breadth of the labour index arguably works in its favour. Because it includes such a wide range of variables, it is possible to argue, in its defence, that the offsetting effects of social and cultural norms are going to be captured at some level. Social sanctions such as the effects of an

unofficial strike do not exist in a vacuum; they are affected by the framework of laws governing strikes. Thus if there were a time-series index for the UK, the decline in the effectiveness of the unofficial strike as a mechanism of job protection in Britain in the 1970s and 1980s might be caught by the falling value of the variable measuring the scope of the right to strike during this period (for an index measuring the fall in protection for the right to strike in Britain, illustrating the potential value of an indexing methodology in this context, see Freeman and Pelletier, 1990).

Nevertheless, difficulties remain. The indices represent *unweighted* measures; we do not know how significant each one is in its contribution to the overall labour market environment. Crucially, for a comparative study, within different countries the significance of particular measures may also differ. This follows from the existence of functional equivalence across systems (Zweigert and Kötz, 1998). For example, the mandatory requirement that companies bargain with unions or works councils shapes a great deal about the labour environment in Germany, while the lack of this particular written law may be less significant to shaping the labour environment in Japan, where a different style of consensual company politics prevails, making it less necessary for the formal law to intervene (Learmount, 2002).

One possible answer to this objection is that weightings for cross-national indices are extremely difficult to determine, and that an unweighted index might be less biased than one based on subjective attempts at weighting. The sub-indices constructed in the labour index are arguably most effective without an attempt at 'even factoring' to reduce the values ascribed to laws in particular countries, as this might mean sacrificing some of the carefully constructed detail within the sub-categories.

Some of the criticisms just made would affect any index of this kind. Thus another possible approach is to ask how the index of Botero *et al.* compares to its main rivals. A number of indices attempt to measure concepts such as 'economic freedom' by an assessment of the stringency of the legal and regulatory environment across countries. Think tanks are to the fore here; the Heritage Foundation's *Index of Economic Freedom* is one of the best known (Heritage Foundation, various years). Rather than rely on a categorisation based on types or incidence of legal intervention, the indicators in this Index are broadly determined on a scale of 1-5, with 5 being 'most conducive to economic freedom'. Economic freedom is defined as 'the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself'. It appears, although no account is given, that the indices were

constructed in-house; no survey method or questionnaire was used to gauge general opinion, or at least no account is given of the information used to arrive at coding for each category. It is difficult to avoid the conclusion that the indices simply represent the political opinion of the Heritage Foundation. The indices include such measures as regulation, trade, wages and prices, property rights, and so on. A discussion of weighting is limited to the claim that these issues are equally important (presumably from the point of view of a certain political platform), so they are all weighted equally. In summary, the indices are arguably too subjective to be used beyond the particular aims and purposes of the Heritage Foundation. The dataset of Botero *et al.*, by contrast, consists of assessments on substantive categories of law, using binary variables, rather than an array of scores based on politically-determined categories.

An index which seeks to be more objective than those provided by think-tanks is to be found in the *Global Competitiveness Report*, an annual publication of the World Economic Forum detailing the perceptions of experts and executives on the economic and political environment for business across 50 countries, which surveys over 3,600 experts globally to assemble over 200 indicators (World Economic Forum, various years). The survey asks respondents, among other things, to rate 'how flexible/inflexible labour regulations are' and 'how productive/hostile labour relations are' on a scale of 1-10 for the country in which they are resident. Countries are then ranked based on their average score.

Then there is the work of the OECD including its 1994 report on *Labour Standards and Economic Integration*. Here the OECD attempted to find a cross-national system for classifying information and measuring stringency surrounding labour and working regulations in OECD countries (OECD, 1994). To this end, it considered country ratification of ILO conventions on the existence of minimum wages, wage protection, child employment, employment protection, working hours, weekly rest, paid holidays and occupational health and safety in 20 countries. These indicators are useful because international conventions are necessarily comparable by country (unlike some nationally-originating regulations, which may be incomparable across countries). Secondly, they cover a wide and significant area of labour regulation and protection. Finally, these data have been collected for a significant number of countries.

In addition there are various secondary indicators of the legal environment. For example, we could regard average wage levels as providing some information about the stringency of the legal environment for labour; or consider that union membership offers some information about the protections afforded in the legal environment surrounding collective action and industrial relations. The

difficulty is in knowing to what extent the variable concerned is a valid proxy for the effects of the law. Many factors apart from legislation influence wage levels; and wage levels are determined to a greater extent by government legislation in some countries than in others. Similarly, union membership may have determinants other than industrial relations law.

Thus to test the validity of the employment law index, we correlate it with other measures of employee protection, discussed above, for which sufficient cross-national data were available. In particular, we correlate the employment law index separately with trade union membership (as measured by the ILO), the perception of the stringency of labour regulation as reported in the *Global Competitiveness Report*, and the number of ILO conventions ratified by country (as reported by the OECD). The results are displayed in Table 3 and Figures 1 and 2. First, the employment rights index is not correlated with trade union membership, suggesting that these two ways of protecting employment may function independently of each other. Secondly, the employment law index is highly correlated with managers' and experts' perceptions of the legal environment in countries for which data are available (in other words, the higher the score on the employment law index, the less 'flexible' is the rating given to labour regulation by managers and experts by country). This suggests that the index of Botero *et al.* does capture some of the way in which law is perceived and perhaps the way the legal environment operates on the ground. Finally, the employment law index is correlated, although less strongly, with international indicators of the stringency of labour regulation, as expressed in the number of ILO conventions ratified by various countries.<sup>7</sup>



**Table 3 Correlations between the employment law index and alternative indicators**

		<b>Employment laws index</b>	<b>Trade union membership</b>	<b>Perceptions of labour regulation</b>	<b>ILO Conventions ratified</b>
<b>Employment laws index</b>	Correlation coefficient Significance (2 tailed) Number	1.000 -- 49			
<b>Trade union membership</b>	Correlation coefficient Significance (2 tailed) Number	.095 .519 24	1.000 -- 24		
<b>Perceptions of labour regulation</b>	Correlation coefficient Significance (2 tailed) Number	-.395* .000 38	-.054 .710 24	1.000 -- 38	
<b>ILO Conventions ratified</b>	Correlation coefficient Significance (2 tailed) Number	.411* .014 19	.369 .098 12	-.563* .001 19	1.000

\* correlation is significant at the 0.05 level (2 tailed)

Sources:

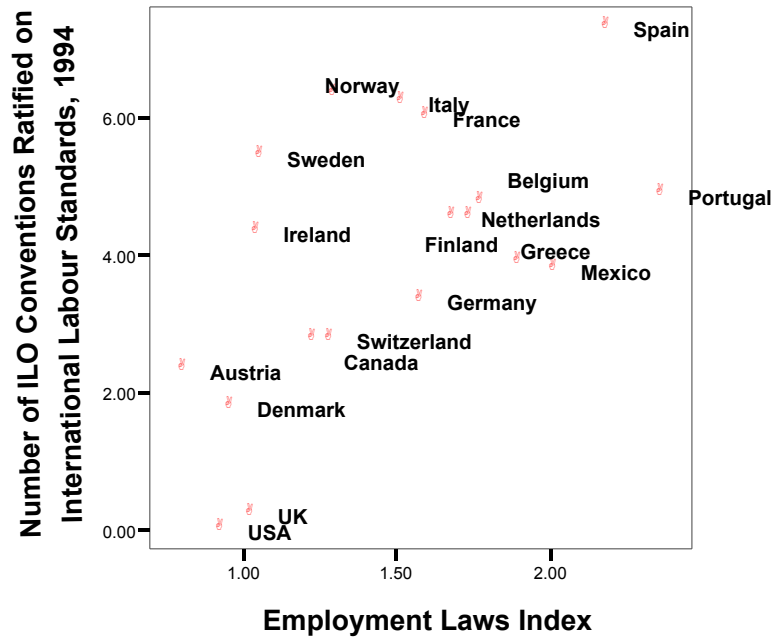
Employment laws index: Botero *et al.*, (2004)

Trade union membership: trade union members as % of total paid employees, as reported by the ILO, *Trade Union Membership* statistics.

Perception of labour market regulation: as reported in the *Global Competitiveness Report* (World Economic Forum).

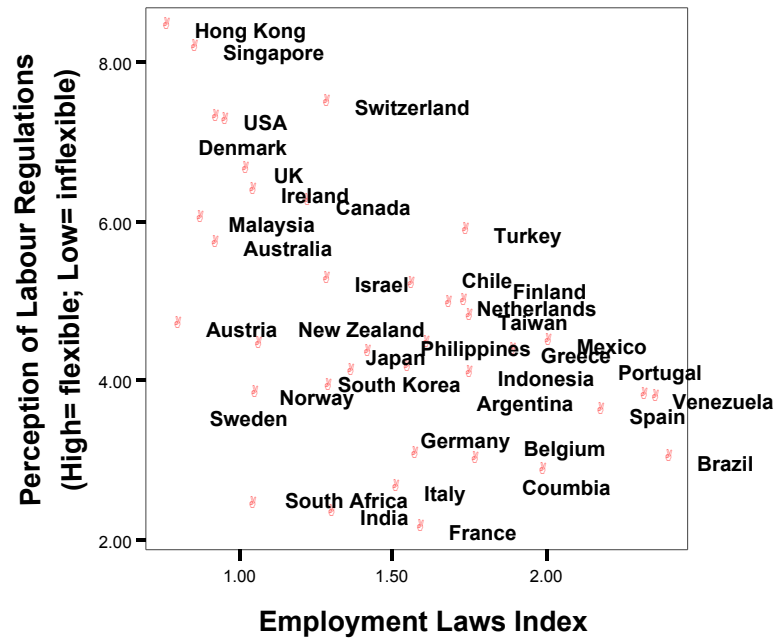
ILO Conventions ratified: number of ILO ratifications per country, as reported in OECD (1994).

Figure 1. Employment laws index and ratification of ILO labour conventions



Sources: see Table 3

Figure 2. Employment laws index and perceptions of labour standards



Sources: see Table 3

To sum up: quite apart from the question of whether the individual country scores attributed by Botero *et al.* to particular variables enjoy universal assent (and there is almost endless scope for argument here), there may well be important aspects of labour regulation which are not well captured by their index, in particular the role played by functional equivalents to regulation beyond the formal law. Legal and social norms affect one another in complex and subtle ways. But it is also possible that the index of Botero *et al.*, even based, as it is, on ‘law in the books’, is a good, working proxy for the social effects of laws. Perhaps more to the point, it is almost certainly the most rigorous and comprehensive one that we currently have.

### **Complementarity, efficiency and diversity**

We now seek to take the argument further by reviewing what the labour index, in conjunction with other data sources, tells us of the claims made for complementarity between institutions of labour law and corporate governance, and more generally between legal origin and economic institutions. The LLSV datasets make it possible to test for the existence of such interdependencies in new ways. A relationship between employment laws and blockholding has been previously suggested, on the grounds that larger blockholdings prevent expropriation by more powerful labour interests (La Porta et al, 1997; Roe, 2003).

We find a strong and positive correlation between the employment law sub-index and blockholder size (see Table 4 and Figure 3). In itself, this tells us little or nothing about causation, but it is evidence for the existence of a particular type of complementarity in the mid-to-late 1990s which is the point in time to which the LLSV datasets relate.<sup>8</sup> Nevertheless, while a close relationship exists for most countries, some outliers deserve consideration. For example, countries such as Austria, on the one hand, and Hong Kong, on the other have very low levels of formal employment law and yet display concentrated blockholdings. The comparison is instructive; Austria’s low score on employment law masks a high degree of reliance upon extra-legal institutions, including sector level collective bargaining and participation by employees in decision-making in the firm, to stabilize the employment relationship. Here is a case where the indexing methodology is unable to capture the role of mechanisms which are not expressed in formal law. In Hong Kong, by contrast, where such institutions are lacking, the low score for employment law seems more likely to correspond to the practice of a fluid (or insecure) labour market. Hong Kong’s case is a reminder that dispersed share ownership is by no means an inevitable accompaniment to light-touch labour

market regulation – the presence of such complementarities is highly dependent on a particular conjunction of circumstances.

**Table 4 Correlations between blockholder size and labour regulation**

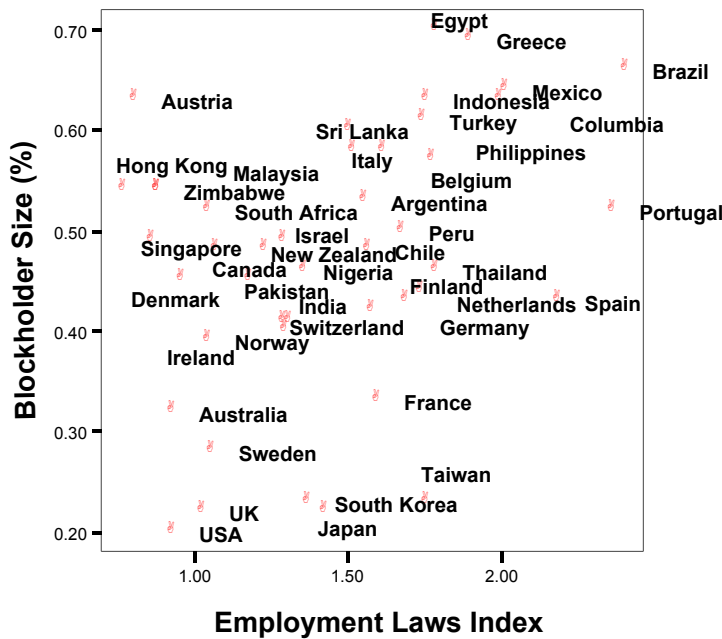
		<b>Blockholder size</b>	<b>Employment laws index</b>	<b>Collective industrial relations index</b>	<b>Social security index</b>
<b>Blockholder size</b>	Pearson correlation Significance (2 tailed) Number	1.000 -- 44			
<b>Employment laws index</b>	Pearson correlation Significance (2 tailed) Number	.347* .021 44	1.000 -- 49		
<b>Collective industrial relations index</b>	Pearson correlation Significance (2 tailed) Number	0.91 .557 44	.578** .000 49	1.000 -- 49	
<b>Social security index</b>	Pearson correlation Significance (2 tailed) Number	-.278 .068 44	.057 .699 49	.156 .286 49	1.000 -- 49

\* correlation is significant at the 0.05 level (2 tailed)

\*\* correlation is significant at the 0.01 level (2 tailed)

Sources: La Porta et al. (1997) (blockholder size); Botero et al. (2005) (employment laws, collective industrial relations, social security).

Figure 3. Employment laws index and blockholder size



Sources: see Table 4

On the other hand, when we regress other measures in the labour index against some of the more important corporate governance indicators, we do not find significant correlations. Thus neither the aggregated variable for social security law, nor that for collective (industrial) relations law, is significantly correlated with blockholder size (see Table 4). One possible interpretation is that while employment protection legislation is quite tightly coupled with the mechanisms of corporate governance and structures of ownership of the firm, this coupling is weak or non-existent in the case of social security and (more surprisingly) the system of industrial relations.

As we have seen, Botero *et al.* (2004) make a wider claim for complementarity between legal origin and modes of economic regulation, with implications for economic outcomes. Legal origin, they argue, shapes institutions independently both of efficiency and politics. They reject an efficiency-based explanation for the form of institutions because, as we have seen, after controlling for differences in wealth between countries (for which average years of schooling are taken as a proxy), they find that the intensity of labour regulation is, in certain respects, positively correlated with a larger unofficial economy, lower

male participation in employment, higher youth unemployment, and higher relative wages for ‘insiders’. If institutions were efficiently matched with economic conditions, these ‘inefficiencies’, they suggest, could not persist. They also reject the hypothesis, associated with Roe (2003), that politics is the main driver of regulation, on the grounds that the political composition of governments and variations in union density (a proxy for worker influence) can only explain a limited extent of the divergence between systems which they observe.

The claim that civil law systems are inherently less supportive of market institutions than common law ones was made initially by Hayek (1960) and has more recently been revived by Mahoney (2001: 505): ‘there are structural differences between common and civil law, most notably the greater degree of judicial independence in the former and the lower level of scrutiny of executive action in the latter, that provide governments with more scope for alteration of property and contract rights in civil law countries’. If legal origin had this effect, we would expect there to be differential growth rates for common law and civil law countries. Botero *et al.* (2004) do not make this claim; in their analyses, GDP is not a dependent variable, but an exogenous factor for which they attempt to control, as we have just seen. Mahoney (2001), on the other hand, does find evidence of a relationship between common law origins and faster rates of real growth in GDP per head in a sample of developed and developing economies between the 1960s and the 1990s. However, if developed nations alone are considered, this relationship disappears. Hall and Soskice (2001: 21) show that coordinated market systems, all of which have civil law origins, enjoyed faster economic growth than liberal market regimes, all of which have common law origins, in the 1960s and 1970s, and that the two groups had roughly the same growth levels from the mid-1970s to the mid-1980s. The position was reversed between then and the late 1990s, but at the end of this period (which is the relevant point in time for the construction of the LLSV indices) GDP per head was still slightly higher, on average, in the coordinated market systems.

In other words, systems with civil law origins seem to have been just as successful as common law systems, among developed economies, in delivering economic growth to their citizens for most of the post-war period. This suggests, again, that institutions approximately reflect particular national conditions and trajectories, and that there is no uniquely successful or predominant route to development.

If there are negative effects of civil law origin, they seem to be confined to developing systems. Here, proponents of the legal origin hypothesis offer an argument based on historical contingency. What they identify as the civil law orientation towards centralized state control of the economy may, they suggest, have been efficient in the mainland European (or, to be even more specific, French) context in which it originated, but it gives rise to inefficiencies in the context of the transplantation: ‘when a civil law system is transplanted into a country with a “bad” government, it will lead to less secure property rights, heavier intervention and regulation, and more corruption and red tape than does a common law system transplanted into a similar environment’ (Glaeser and Shleifer, 2002: 1221).

However, the methodological foundation for this claim is weak, in particular in the context of labour regulation. The dataset developed by Botero *et al.*, (2004) since it only measures ‘formal law’, is likely to give an incomplete picture, at best, of the impact of labour law in developing nations, where there is likely to be a significant gap between the legal text and its enforcement. Moreover, the dataset measures the law as it applies to a ‘normal’ employment contract which is full-time and of indeterminate duration (Botero *et al.*, 2004: 1353); it therefore has little relevance in systems with large informal economies, where very few workers meet this description. This is perhaps why Botero *et al.* (2004: 1378) find that the link between legal origins and ‘inefficiencies’ is not borne out when the sample is confined to countries with per capita income below the median. They take this as a further indication of the weakness of the ‘efficiency’ theory, on the grounds that regulation has the most deleterious effects when it is enforced, but it may also reflect the inherent and unavoidable limitations of their dataset in the context of developing systems.

We offer an additional test of the claim that divergence between the common law and civil law locks in inefficiency by considering an alternative dependent variable to those used by Mahoney and Botero *et al.*, namely the Human Development Index (HDI). The HDI is a measure which has been developed as a comprehensive measure of human capabilities by country. It is a composite of indicators on life expectancy at birth, adult literacy and adjusted per capita income in purchasing power parity (UNDP, various years). According to the United Nations Development Programme, ‘the HDI reflects achievements in the most basic human capabilities – leading a long life, being knowledgeable and enjoying a decent standard of living’ (UNDP, 2000). Largely given impetus by the work of Sen on human capabilities (Sen, 1999), the HDI is increasingly widely cited and used. Information for the index has been gathered since 1990 for an increasing number of countries (almost all are covered in the more recent reports) and is published annually in the UNDP’s *Human Development Report*.



We conduct a simple correlation analysis considering a number of legal variables first introduced by La Porta *et al.* (1997) and developed further in subsequent papers, correlated against the Human Development Index for 1999 (which is roughly contemporaneous with most of the LLSV indices, which use legal and other data from the mid- to late-1990s). Table 5 displays the results. First, when we consider the legal origin clusters (English, German, French and Scandinavian), the only cluster with a significant positive relationship to human development is the Scandinavian one. Secondly, employment and industrial relations laws bear no relationship to HDI, but social security law has a highly positive relationship. Thirdly, most of the corporate governance measures developed by LLSV bear no relationship to HDI (and some, such as protection of creditor rights, are negatively correlated).

Again, this analysis tells us nothing about causation, but when set against the regressions run by LLSV, it offers a telling comparison. For an increasingly accepted and particularly comprehensive measure of human well-being, legal origin *might* matter, but not in the way that LLSV predict. There may be a story to be told, as far as human development is concerned, about social security protection. Scandinavian countries, well known for their comprehensive social security systems, produce significantly higher HDI outcomes than the other legal clusters. Countries with high scores on the LLSV social security law index in general score highly on the HDI.

**Table 5. Correlations between the Human Development Index and various legal origin indicators**

		<b>HDI</b>
<b>English legal origin</b>	Correlation coefficient	-.131
	Significance (2 tailed)	.277
	Number	48
<b>French legal origin</b>	Correlation coefficient	-.172
	Significance (2 tailed)	.154
	Number	48
<b>German legal origin</b>	Correlation coefficient	.222
	Significance (2 tailed)	.066
	Number	48
<b>Scandinavian legal origin</b>	Correlation coefficient	.293*
	Significance (2 tailed)	.015
	Number	48
<b>Employment law</b>	Correlation coefficient	-.111
	Significance (2 tailed)	.266
	Number	48
<b>Collective industrial relations law</b>	Correlation coefficient	-.057
	Significance (2 tailed)	.569
	Number	48
<b>Social security law</b>	Correlation coefficient	.467**
	Significance (2 tailed)	.000
	Number	48
<b>Creditor rights</b>	Correlation coefficient	-.299
	Significance (2 tailed)	.007
	Number	48
<b>Anti-director rights</b>	Correlation coefficient	.023
	Significance (2 tailed)	.833
	Number	48

\* correlation is significant at the 0.05 level (2 tailed)

\*\* correlation is significant at the 0.01 level (2 tailed)

Sources: Human Development Index: United Nations Development Programme, *Human Development Report* (1999)

Legal origin indices: La Porta *et al.* (1997), (1998); Botero *et al.* (2004).

To sum up the discussion so far: in the current state of knowledge, the nature of the link between legal origin and economic performance outcomes remains unclear. It is difficult to say that national systems are more or less ‘efficient’; but there is evidence from a range of sources to suggest that systems with different legal origins and configurations may well be more or less well equipped, as a result, to achieve different types of outcome, such as growth versus equality, economic versus human development, and incremental versus radical innovation.

If it is regarded as a proxy for the social and economic effects of laws, the labour index can be used to throw light on the welfare and efficiency effects of regulation and to provide some indications of the likely strength of national-level complementarities between labour law and corporate governance. While the conclusions offered by Botero *et al.* on the efficiency effects of labour regulation are open to argument, they are suggestive, and likely to shape the debate for some time to come. But what of their underlying claim to have identified a causal link running from legal origin to regulatory style and economic outcomes? Here, the central problem is that the nature and identity of the mechanism by which legal origin plays the role attributed to it. As we have already suggested, strong path dependencies must be at work if the adoption of one or another the main legal families at some point in the nineteenth century was still having a preponderant influence on the substance of law at the end of the twentieth. Ultimately, legal origin dummy variables, particularly when used in cross-sectional analyses, are crude instruments which may be picking up any number of social, political and historical factors; they can only give us part of the picture. It is time to shift focus, towards an historical explanation for the origins of complementarities.

#### **4. Explaining the contribution of legal origin to cross-national diversity**

##### **4.1 Historical origins of complementarities: the British experience of industrialization**

Although it is possible go much further back in the search for the origins of modern legal diversity (see Glaeser and Shleifer, 2002), there is general agreement that the period of industrialization in the eighteenth and nineteenth centuries was a formative period in the emergence of modern legal and economic institutions (Pistor, 2005: 8). Today’s legal forms are sometimes thought to be the outcome of a selective process which accompanied industrialization, based upon the gradual discarding of institutions without functional value. Some law and economics scholars claim, for example, that modern institutions of corporate governance can be understood as a functional

response to the problems of asymmetric information which arise in relations between managers and investors:

Consider, in this regard, the basic legal characteristics of the business corporation... there are five characteristics, most of which will be easily recognizable to anyone familiar with business affairs. They are: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. These characteristics are... induced by the economic exigencies of the large modern business enterprise. Thus corporate law everywhere must, of necessity, provide for them. (Hansmann and Kraakman, 2003: 2).

But it is difficult to square this argument with historical analyses which point to the contingent circumstances which accompanied the rise of the legal form of the joint stock company in England around the time of the industrial revolution. In the eighteenth century, at the point when economic growth was beginning to accelerate, there were several different legal forms available for business organization: these included incorporated trading companies established by state charter, such as the Russia Company and East India Company; trusts providing for the management by specialized agents of property owned beneficially by others; and so-called 'unincorporated companies' which were essentially partnerships linking together merchants, managers and investors (Harris, 2000). The approval of the state was needed to set up a corporate entity with separate personality. In other cases, trading as a corporation could attract criminal liability either at common law or under the 1720 Bubble Act, which although not originally enacted with the aim of suppressing corporations, acquired this effect for a while through judicial interpretation in the 1800s and 1810s. Joint stock was in use in certain sectors as a means of spreading risk but it did not normally confer limited liability on investors. The partnership form of most of the early textile and mining enterprises meant that there was a limited degree of integrated management across different industrial sites (Pollard, 1965).

It was as late as 1844, after repeated lobbying efforts, that the United Kingdom Parliament made incorporation through a registration procedure generally available, and in 1855 and (more completely) in 1856 that it attached limited liability to this new corporate form. Far from being in the vanguard, English law lagged behind a number of other jurisdictions, including France and the United States. One of the major factors behind the adoption of the 1855-6 Acts was the perception that increasing numbers of English-based enterprises were being incorporated overseas in order to take advantage of more amenable legal environments – an early instance of regulatory competition in corporate law

(Saville, 1956). But by the middle of the nineteenth century, the ‘the tide had turned, and English company law became the model for Europe’ (Harris, 2000: 289), with French and German legislation of the 1860s and 1870s copying key features of the English system; it also had some influence on US state-level legislation. On the face of it, then, the dissemination of the basic corporate law model owed much to interest group pressure, regulatory competition and transplanted through imitation, the very forces identified today as powerful mechanisms for convergence (Hansmann and Kraakman, 2003: 5); but in the country of its origin, its relationship to the emergence of an industrial economy was anything but straightforward.

Does any of this matter for today’s company law? If company law is the product of selective pressures ensuring, through various means, that rules which do not fit with their environment are selected out, the answer must be ‘no’; a smooth progression ensures that function and form are matched. If, on the other hand, the joint stock company was only one of a number of legal forms which could have met the requirements of business, some of which might have done just as well or better, its contemporary preeminence is yet another illustration of the effects of institutional lock-in. An historical perspective on this issue is that

[t]here is no reason to assume that the new framework of 1844-1856 was evolutionarily selected for the industrial economy because it better defined and enforced property rights, minimized transaction costs, or maximized efficiency in any other strong sense. One can conceive a slightly different historical path in earlier periods that would have led to a different outcome that cannot be readily evaluated as less efficient.... I do not refer here to abstract, or counterfactual, alternative features and conceptions to the real world. What I have in mind are alternatives employed in different enterprises, regions and sectors during different periods. At least some of these alternatives were not rejected because of inherent inefficiency or inferiority in terms of evolutionary selection, but for reasons bound in time and place. (Harris, 2000: 291)

From this point of view, it was the particular or ‘contingent’ conditions surrounding the emergence of the corporation which were of most importance for the development of British capitalism. Because the first phase of the industrial revolution in Britain preceded the advent of the corporate form by several decades, there were limits to how far firms could grow through investment or merger. Most production took place in relatively small-scale and fragmented industrial units. This did not change with the enactment of limited

liability in 1855; through inertia, suspicion of the new legal regime or otherwise, the majority of mining, engineering and textiles companies were slow to incorporate (Holbrook-Jones, 1982). It was only at end of the nineteenth century that a movement to consolidate and rationalize production began, some time after similar steps had been taken in the United States and Germany (Hannah, 1983).

The comparatively late development of the integrated business form in Britain also had implications for the evolution of the law governing the employment relationship. The industrial revolution was not marked by a straightforward move from household production to factory labour. Workers resisted factory labour in large part because many of the early factories were centred around compulsory workhouse labour for those receiving poor relief, or copied the same model (Pollard, 1965). Not only did ‘putting out’ survive well into the nineteenth century in numerous industries, but even when production was brought in-house, an ‘internal contracting’ system was maintained under which employers normally dealt with labour intermediaries who, in turn, hired other family members or ‘underhands’ to work for them (Littler, 1982; for a study comparing Britain and Germany, where vertical integration proceeded more quickly, see Biernacki, 1995).

The absence of an integrated managerial structure was further reflected in the harsh disciplinary laws passed to control labour. In effect, penal sanctions substituted for effective management – an example of functional equivalents observed across time rather than space. Breach of the service contract was increasingly criminalized in the eighteenth and nineteenth centuries. In one sense, these laws were ‘functional’ to the needs of employers at the time; they were deployed most frequently against craft-based workers who retained a high degree of independence and could command a premium based on the scarcity of their skills. Up to the 1870s there were thousands of prosecutions a year in the industrial heartlands of the north and midlands of England; prosecution rates were driven by the business cycle, increasing in the upturn when labour supply was at its most restricted (Simon, 1956). The disciplinary emphasis of ‘master and servant’ was to have a formative influence on employment law (Deakin, 2001), on the development of collective bargaining (Holbrook-Jones, 1982), and on managerial practice:

the modern industrial proletariat was introduced to its role not so much by attraction or monetary award, but by compulsion, force and fear. It was not allowed to grow as in a sunny garden, it was forged over a fire, by the powerful blows of a hammer. The marks of its origins largely determined the atmosphere within which the

management of labour was attempted. There are few records of cooperation, and they appear almost eccentric. The typical framework is that of dominance and fear, fear of hunger, of eviction, of prison for those who disobey the new industrial rules. (Pollard, 1965: 207-8).

Like limited liability, the master-servant model was also exported; as a by-product of colonization, it spread to most of the common law world in the course of the nineteenth century (Hay and Craven, 2004), and also had an influence upon American law during the early phases of industrialization (Tomlins, 2004). The effects of this particular exercise in transplantation have taken a long time to wear off. Long after the development of integrated organisational forms and modern management techniques reduced the need for the penal enforcement of employment contracts, the legacy of the master-servant model is still discernible within the contractual form of the modern employment relationship (for the US, see Atleson, 1982; for Australia, see Merritt, 1982, and Howe and Mitchell, 2001; for England, see Fox, 1974; Deakin and Wilkinson, 2005). The reluctance of organized labour to support the use of legal means to underpin labour regulation, and the resulting preference for 'voluntarist' solutions outside the law, principally in the form of collective bargaining, owed much to a deep-rooted belief that the law was an instrument of the employer 'class' (see Wedderburn, 1986: ch. 1, in particular at 16-47).

Thus the case of British industrialization illustrates the potential but also the limits of a functional analysis of the evolution of the law. There were far-reaching changes in corporate and labour law in the nineteenth century which accompanied the emergence of an industrial society. However, legal institutions were in many respects not particularly responsive to economic needs; and, conversely, even when they were modified in response to perceptions of what those needs might be, as in the case of the limited liability reforms of the 1850s, industry, in its turn, was slow to respond to the new possibilities created by the law. Thus the notion that the law incrementally evolved by way of adaptation to the needs of the economy is hard to maintain. It would be more accurate to say that legal and economic development, while moving in a broadly coevolutionary dynamic in which each one influenced the other, were out of synch for most of the time, and that the process of mutual adjustment was uneven and sporadic, and often had unexpected consequences: an example of punctuated equilibrium.

Moreover, the particular historical path on which British industrialization proceeded had real economic consequences for what came later. An institutional framework which might have worked well enough for an emerging industrial economy was ill equipped by the end of the nineteenth century, to adapt to increasing vertical integration and the technological requirements of the second industrial revolution: ‘a gap was opening up between the production *institutions* which were developed in Britain – small family firms, a reliance on subcontracting within and between firms, a highly formalized system of collective bargaining – and the needs of production *technology*’ (Daunton, 1995: 564-5). While the consequences of the late consolidation of industrial enterprises in Britain, by comparison to the United States, France and Germany, have been much debated, it seems more likely than not that they were negative for the competitiveness of British industry for much of the twentieth century (Elbaum and Lazonick, 1987).

#### **4.2 Status and contract in the origins of continental European labour law**

It is also possible that the characteristic common law notion of the enterprise as the unencumbered property of the employer, with the workers relegated to contractual claims, at best, on the surplus from production, owes more to the initial conditions of British industrialization than it does to the supposedly universalising economic logic of agency theory. Thus there is evidence that the nature of enterprise was understood differently in continental European systems from the very early stages of industrialization. The continental European entrepreneur of this period ‘had a different conception of his role from the British’ one; in societies with ‘a strong feudal and manorial tradition’, factory owners saw themselves as having ‘duties as well as the privileges that such a position entails’ (Landes, 1969: 191). This type of industrial paternalism owed much to the scarcity of labour supply in systems where the rural population continued to have access to the land, and hence to alternatives to waged employment, long after this had ceased to be the case in Britain (O’Brien, 1996). In addition, attitudes on the continent were also reinforced by ‘public and official opinion’: ‘in [nineteenth-century] France, the government was sensitive to factory unemployment, keeping watch on hiring and firing and utilizing political pressure when necessary to limit the number of jobless, even in- or rather especially in – severe crises’ (Landes, 1969: 192).

The various ‘integrative’ conceptions of the business enterprise which continue to influence civil law systems today also have deep, historical roots from the period of industrialization; but contrary to the claim that the civilian systems operate by reference to ‘regulation’ in preference to ‘contract’, a contractual logic played a major role in shaping the law from the start. The starting point



for the analysis of the process by which the emerging forms of wage labour were grafted on to the traditional Roman law concept of the *locatio conductio* in the post-revolutionary codes. In relying on the model of the *locatio*, the drafters of the codes were grouping work relationships with other types of contracts, the effect being to stress that, in common with them, they were based on exchange. Thus labour, or in some versions labour power – as expressed, for example, in the German term *Arbeitskraft* – thereby became a commodity which was linked to price (not necessarily the ‘wage’), through the contract. The further consequence was to align the work relationship with the law of things rather than the law of persons: the notion of the personal ‘subordination’ of the worker was absent from the formulae used by the codes (Veneziani, 1986; Simitis, 2000). Thus the codes helped to propagate a strongly contractualist notion of the work relationship, at a point when English law and practice was still dominated by the almost ‘pre-industrial’ notion of service: ‘the codes inspired by the revolutionary ideology of 1789 put contractual analysis at the centre of the juridical conceptualization of the work relationship’ (Supiot, 1994: 14).

The contractual model was accommodated to the growth of industrial and labour legislation in the course of the nineteenth century in two distinct ways. In the French-origin systems, the power of the state to regulate conditions of work was instantiated within the legal system through the concept of *ordre public social*, that is, a set of minimum, binding conditions which applied as a matter of general law to the employment relationship. The implicit logic of this idea was that in recognizing the formal contractual equality of the parties to the employment relationship, the state also assumed, by way of symmetry, a responsibility for establishing a form of protection for the individual worker who was thereby placed in a position of ‘juridical subordination’. In German systems, by contrast, a ‘communitarian’ conception of the enterprise qualified the role of the individual contract. This approach was summed up at the end of the nineteenth century by the (conservative) jurist Otto von Gierke’s argument that the ‘eternal juridical truths’ of the modernised Romanist tradition simply served to conceal ‘formulas expressing individualistic and capitalistic assumptions’ (Gierke, 1895: 32). Under Gierke’s influence, the employment relationship was orientated away from the law of obligations and towards the law of persons; thus in contrast to the French approach, German law came to recognize the ‘personal subordination’ of the worker in the form of ‘factual adhesion to the enterprise’ or *Tatbestand*, a process which conferred ‘a status equivalent to membership of a community’ (Supiot, 1994: 18).

It has been argued that ‘there is no European country in which the conception of the employment relationship has not been influenced to some degree by each of these two legal cultures, the Romanist and the Germanic’ (Supiot, 1994: 19).

The influence of communitarian thinking was particularly strong in all continental systems, French-origin included, in the first part of the twentieth century, when it overlapped to some degree with fascist ideologies. But it would be excessively reductive to identify communitarianism exclusively with authoritarian notions of the corporative state. The notion of the ‘interests of the enterprise’, not just as a reference point for defining the mutual obligations of employer and employee but also as a focal point for company law, has had a wider resonance, since it predated the rise of authoritarian regimes and retained an influence after their fall. Its origins may be found in the early concentration of industry and the emergence of vertically integrated and bureaucratically-organised enterprises during the nineteenth century, a process which, as we have noted, began earlier and was more complete on the continent than in Britain. The result was a ‘synthesis’ of contractual and communitarian elements that became a source of ‘structural ambivalence’ in the conceptual framework of continental labour law (Supiot, 1994: 32).

From this necessarily brief overview, it will be clear that the origins of continental labour law were complex. Contrary to the argument of Botero *et al.*, the civil law approach cannot be characterised as more regulatory than that of the common law. Thanks to the liberalizing influence of the French *code civil*, nearly all the continental systems, including those influenced by the German tradition, acquired a liberal-contractual model of the employment relationship not just in advance of the English common law but, in marked contrast to the British experience, *before* industrialization affected more than a tiny proportion of the labour force. As industrialization advanced, legal systems responded to the growing wave of labour regulation in ways which incorporated the principle of worker protection while at the same time recognising the primacy and legitimacy of capitalist modes of economic organization. Thus the civilian approach *was* different from that of that English common law, but not in the way which the authors of the legal origin hypothesis suggest: regulation was not *preferred to* contract, it was *conjoined with* it.

#### **4.3 Legal cultures as ‘carriers of history’**

What we have just been describing is not simply the development of different systems of substantive rules, but the evolution of distinctive *legal cultures*. Comparative lawyers have used the terms ‘legal culture’ and ‘legal style’ in a number of different ways (Zweigert and Kötz, 1998; Markesinis, 1994; Legrand, 1999; Bell, 2001; Samuel, 2002; Pistor, 2005). However, there is general agreement that legal systems generate commonly understood ‘ground rules’ or shared assumptions, as aids to the interpretation of the law. Thus the meaning attributed to superficially similar legal texts may differ from one

jurisdiction to another according to the prevailing juridical style or underlying assumptions guiding legal interpretation. Relevant here are the conceptual modes of thought through which legal discourse creates ‘epistemological maps’ (Samuel, 2002) which describe and categorise economic and social relations. In the terms used by comparative institutional analysis, these cultural reference points are a form of ‘information compression embodied in an institution [which makes] it possible for boundedly rational agents to efficiently collect and utilize the information necessary for their actions to be consistent with changing internal and external environments’ (Aoki, 2001: 14). As such, they are ‘carriers of history’, through which the cultural information of earlier periods is passed on (David, 1994). At the same time, the conceptual discourse of the legal system, although separate from that of politics or commerce, is also (indirectly) shaped by the social and economic forms alongside which the law has coevolved (Fögen, 2002). Thus diversity in the experience of industrialization is embedded in the legal forms which have developed to describe the business enterprise and the related economic institutions of market economies. The influence of legal origin on the present-day substance of labour regulation is the result.

If this is the case, we have a rather different explanation for the significance of legal origin than that provided by LLSV and their colleagues. They have argued that common law systems have an inherent tendency to produce rules which are market-compatible, by virtue of their greater reliance on judicial adjudications and other decentralized forms of law making, in contrast to the civil law which relies to a greater extent upon centralised regulation, and thereby gives rise to greater potential for governmental interference with property and contract rights. The main problem with this line of argument is that it is not an accurate description of the common law/civil law divide, either in general terms or in the specific context of labour regulation. The idea that common law judges have discretion to shape rules to changing economic circumstances, while civilian judges are bound to apply, through rigid deductive logic, the strict legal text of the code, is, as Mattei (1997: 79) has shown, ‘dramatically misleading, being based on a superficial and outdated image of the differences between the common law and the civil law’.<sup>9</sup> Arguments about whether judicial decisions are a formal ‘source’ of law in civilian systems aside, the prominent role of judicial decision-making in the civil law is now clearly established (see Markesinis, 2003). Notwithstanding the efforts of the drafters of the French civil code to limit judicial influence and curb the doctrine of judicial precedent, ‘neither before nor after the French codification could any of the civil law systems be fairly characterised as the one described by the French post-revolutionary scholars’ (Mattei, 1997: 83). Many of the doctrines which are thought to be most characteristic of a distinctive civilian approach to

economic regulation, such as the application of the concept of good faith to commercial contracts, were judicial innovations (see Teubner, 2001; Pistor, 2005).

When the sources of labour regulation, specifically, are considered, the systems are closer together than Botero *et al.* suppose. The civil law codes of the nineteenth century were flanked, almost from their inception, by statutory provisions dealing with specific areas of labour regulation, including labour mobility and factory conditions (see Veneziani, 1986). Legislation played a very similar role in supplementing judge-made law in the common law systems. If anything, it was the civil law codes which played the major role in dissemination freedom of contract in employment relations in the nineteenth century; the main export of the English legal system during this period was not freedom of contract, but the statutory, and status-based, law of master and servant (Hay and Craven, 2004). There was certainly no lack of governmental ‘intervention’ in the labour market during this period (Deakin and Wilkinson, 2005). The interplay of judge made law and legislation is, as we have seen, a feature which has been common to all the European systems of company law and labour law since the industrial revolution.

But for all that, there were, and are, differences between the common law and the civil law, at the level of core concepts and guiding assumptions. What Pistor (2005) calls ‘legal ground rules’ allocate responsibility for the control of economic relationships differently in the common law and civil law. Civil law judges have considerable power to shape the terms of contractual relationships through the application of open-ended ‘general clauses’, such as the principle of good faith, in ways which have no equivalent in the common law. Thus in the civil law, the tendency is for ‘freedom of contract’ to be ‘socially conditioned’ when, in common law systems, it is, formally, ‘unconstrained’ (Pistor, 2005: 9). This fundamental difference in approach permeates many contemporary features of labour and corporate law. However, it is not so much the differences in substantive rules which matter; many of these are transient in nature. The enduring difference between common law and civil law systems operates at the level of the ingrained assumptions and understandings which are deployed in legal analysis, and in the values which they serve to perpetuate. Above all, the common law and civil law systems operate on different assumptions about the nature of the enterprise and the role of the legal system in regulating it.

We are still only just beginning to understand the historical processes which gave rise to the emergence of distinctive legal cultures, and their economic consequences. However, if we focus on the period surrounding industrialization, and the legal innovations which accompanied it, the outlines of the argument

start to become clear. The common law approach to labour regulation was to a large extent the institutional legacy of a certain mode of industrialization, one in which, thanks to the timing of economic change, the law came to instantiate a ‘contractualist’ notion of the enterprise, based on a strong conception of the employer’s property rights as the basis for managerial prerogative. Conversely, ‘integrationist’ forms of labour law regulation and corporate governance on the continent of Europe reflect the more gradual experience of industrial development in those systems and the different trajectory from that of Britain, which, as a result, most continental economies assumed.

The differential experience of industrialization in England and its main continental European rivals in the course of the nineteenth century provides no reason to think that there was anything inherently superior about the common law route. The pace of industrialization may have been impeded in France and Germany by the slow movement of labour from the land and by the retention of pre-industrial notions of employer responsibility. But few would now suggest that ‘Britain’s earlier industrial revolution can be represented by even the most panglossian of historians as the best of possible paths to the twentieth century’ (O’Brien, 1996: 242).

The predominant response of the civilian systems to industrialisation was not a propensity to constrain or interfere with economic development. Rather, the view emerged that property and responsibility were two sides of the same coin. In the French tradition, the exercise of public power for the protection of workers, and in the Germanic tradition, the communitarian conception of the enterprise, counter-balanced the support provided by the legal system to freedom of contract and property rights. This was a particular legal conception of a market economy and society, a different one from that which came to predominate in the English common law, but not one which was inherently less compatible with market-based forms of governance.

## **5. Conclusion**

In this paper we have sought to clarify and evaluate some of the central propositions of the legal origin hypothesis, in particular as it relates to corporate governance and labour regulation. We began by noting the relevance to the legal origin claim of the concepts of path dependence, coevolution and complementarity. These concepts provide a theoretical framework for understanding the basis on which multiple pathways to economic development could have developed, within the general framework of market or capitalist economic relations. They suggest that for the legal origin claim to be

substantiated, deep path dependencies must have influenced the trajectory of legal and economic systems since the early nineteenth century. Yet the precise mechanisms through which this could have occurred have not been effectively spelled out. This is in part because the legal origin literature relies upon an overly reductive understanding of the common law/civil law divide. Proponents of the legal origin claim present a picture of a ‘decentralised’, market-friendly common law, and a ‘centralised’, government-friendly civil law, which relies excessively upon a few stylized facts, and which modern comparative legal analysis has (rightly) rejected.

Additional problems arise from the methodological position adopted in the legal origin literature. The indices which purport to capture the impact of legal rules measure only the formal law; they take no account of functional equivalents to legal regulation beyond the law; and they are not weighted so as to take into account variations in the importance of particular legal measures in given jurisdictions, as comparative law theory suggests that they should be. However, we also saw that, despite these difficulties, the various legal origin indices can be regarded as good working proxies for the social and economic impact of legal rules. The indices point to the existence of institutional complementarities whose nature can be explored in more depth using historical evidence and country-specific case studies.

Our historical analysis pointed to contingencies surrounding the emergence of the legal forms which serve define the modern enterprise: the employment relationship and the business corporation. The way in which these concepts developed within different common law and civil law systems was, we argued, a reflection of the timing and nature of industrialization in those systems. Britain’s industrial revolution preceded the emergence of mature institutional forms for describing organizational and corporate structures. This was to have a profound and destabilizing effect on legal and economic institutions. In the field of labour regulation, the predominant influence of English law on other systems was not freedom of contract in labour relations, but the export and transplantation of a pre-modern master-servant regime. On the continent of Europe, by contrast, many of the institutional changes associated with the shift to a market economy came before industrialization, in large part thanks to the liberalizing influence of the legal codes of the nineteenth century. The transition to a market economy was, as a result, less abrupt, and less socially destabilizing than it was in Britain, a trend reflected in the legal doctrines by which social values were infused into contract and property law.

The normative implication of our analysis is to reject the claim that any one system represents a uniquely successful path to legal and economic development. For the most part, laws are matched to national conditions, placing a limit on what can be achieved, or what should be attempted, through transplantation or regulatory competition. There is much to be said for a policy position which accepts the enduring nature of this institutional diversity, and which respects its contribution to the sustainability of market systems.

## Notes

<sup>1</sup> Montesquieu, *De l'esprit des lois* (1748), Book 20, Chapter 12, in the translation by Thomas Nugent (1751), at p. 373. See Supiot, 1994: 180-181, for discussion of this passage.

<sup>2</sup> See, for example, World Bank (2004).

<sup>3</sup> On the importance of an historical analysis in understanding the role of legal origin, see also Berkowitz, Pistor and Richard (2003). Their analysis focuses on transplantation, whereas ours, in section 4 below, focuses on the roots of labour and corporate law in systems of origin in western Europe.

<sup>4</sup> The notion of an institutional domain has a precise meaning in the work of Aoki, to refer to contexts within which agents interact. Aoki identifies the market ('trade'), the firm ('organisation') and the governmental system ('polity'), among others, as separate domains. An 'institutional complementarity' arises when there are interdependencies across domains; thus 'market-supporting moral codes (first-party mechanism) and a just system of the rule of law (formal third-party mechanism) can be complementary' (Aoki, 2001: 87). The idea that societal differentiation gives rise to distinctive 'domains' is similar to the idea, within autopoiesis, of distinctive social sub-systems, such as 'law' and 'economy' (Luhmann, 1995; Teubner, 1993). There is potential for the integration of economic and autopoietic approaches to this issue, but a consideration of this question falls outside the scope of the current paper. It is discussed by Carvalho and Deakin, 2005.

<sup>5</sup> It should be noted that this need not imply the absence of laws protecting shareholder interests, which are often highly effective in civil law countries. However, in coordinated systems it is arguable that laws of this kind function to protect minority shareholders against the risk of expropriation by majority blockholders, rather than to protect them from rent extraction by managers. See Siems, 2005.

<sup>6</sup> Siems (2004) and (2005) makes the same point in relation to the LLSV index for securities law.

<sup>7</sup> This is, of course, only an approximation, since ratification of an ILO Convention by a given country does not necessarily indicate that the relevant standards are well observed in practice; and the converse may be true.

<sup>8</sup> Roe, 2003, makes a similar finding.

<sup>9</sup> The so-called 'adaptability channel' identified by Beck, Demirgüç-Kunt and Levine (2003), according to which the common law evolves incrementally as a consequence of judicial interpretation, while the civil law moves forward episodically as a result of (re)-codification and legislative change, appears to be based on a similar misunderstanding of the nature of the common law/civil law divide. At any rate, the claim that the common law and civil law evolve in such fundamentally different ways requires empirical verification, and cannot simply be assumed or presented as a stylised fact.



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