

ON HEAVEN'S LATHE: STATE,  
RULE OF LAW AND ECONOMIC  
DEVELOPMENT

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**ON HEAVEN'S LATHE: STATE, RULE OF LAW, AND ECONOMIC  
DEVELOPMENT**

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## **Abstract**

We propose a theoretical framework for understanding the evolution of the rule of law state, which is conceived as the equilibrium of a societal game in which actors accept the legitimacy of publicly enunciated legal rules. A meta-norm of respect for the sovereign legal power of the state is not self-forming on the basis of private conduct, but requires the coevolution of impersonal market exchange with effective state capacity to constitute and regulate markets. A functioning legal system must acquire the means not just to control private power but to constrain other organs of government. The emergence of such a 'self-limiting state' is an historical process which, while complementary to a market order, is also contingent and path-dependent, and is not preordained. Illustrating our argument with empirical cases drawn from the contemporary experience of middle income countries, we argue that alternatives to the rule of law state, including interpersonal trust, closed networks and authoritarian political control, can only achieve limited scale and scope effects, and are prone to high deadweight costs arising from corruption and the capture of the public sphere by private interests. We also discuss the potential of transplants of legal rules and institutions to catalyse the transition to impersonal trade based on the rule of law, and present evidence, from time-series econometric analysis, that the diffusion of shareholder protection laws has the potential to support financial development in emerging markets. Evolution towards the rule of law state is, we conclude, one possible developmental path for middle income countries.

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Key words: rule of law, economic development, emerging markets, China, *guanxi*.

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知止乎其所不能知，至矣。若有不即是者，天鈞敗之。

(To let understanding stop at what cannot be understood is a high attainment.  
Those who cannot do it will be destroyed on the lathe of heaven.<sup>†</sup>)

## 1. Introduction

In this paper we advance and defend the proposition that the rule-of-law state is a necessary condition of, but also an evolved response to, economic development. History shows that no country has experienced industrialisation without having significant state capacity to constitute and regulate the market. Among the institutions of a market economy which are critically underpinned by the state are money (Wray, 2012), the banking and financial system (Pistor, 2013), and the labour market (Deakin and Wilkinson (2005)). Alongside a transparent and effective system of taxation and public finance (Daunton, 2001, 2002), a functioning legal system is a core part of state apparatus. The legal system is a mechanism for actualising the power of the state. At the same time, the legal system subjects other parts of the state, including the executive power, to constraints which create a realm of autonomous interaction for individuals and voluntary associations. The result is the self-limiting state, that is, a state which acknowledges limits to its own knowledge, capacities and powers.

Our approach is to be distinguished, on the one hand, from theories which downplay the role of public ordering in the operation of the legal system (Hadfield and Weingast, 2012). Contrary to claims that legal norms can be generated entirely from the spontaneous interactions of economic agents, we see a role for a centralised rule-making power in articulating legal norms which coordinate market activity. In the absence of public norms, functional equivalents to law, such as corruption, force or interpersonal trust, can sustain economic growth, but only up to a point. These alternatives to the rule of law lack the scale and scope effects of public legal enforcement, and cannot support the complex division of labour which characterises mature market economies (Deakin, Gindis, Hodgson, Huang and Pistor, 2015).

Equally, our approach may be distinguished from analyses which emphasise the role of the developmental state to the exclusion of considerations of the rule of law. The rapid growth of East Asian economies over the past half century is often cited as an argument in favour of an active state which can direct the process of industrialisation (Amsden, 1989). In our view, this is only part of the story. It would be a misreading of the developmental model to neglect the role

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<sup>†</sup> *Zhuangzi*, Book XXIII; Ursula Le Guin, *The Lathe of Heaven* (New York: Avon, 1971), ch. 3.

which private law plays, alongside public administration and regulation, in underpinning market-based exchange. Accounts which argue, for example, that East Asian states have experienced high rates of economic growth in the past century precisely because they lacked effective legal support for contract and property rights (Allen, Qian and Zhang, 2009), overstate this case.

We develop our argument in a series of stages. In section 2 below we review recent contributions to the debate over the rule of law in economic development with the focus on the contemporary experience of middle income countries. We suggest that rather than seeing the rule of law and informal institutions as alternatives or substitutes, we should view them as complementary mechanisms for promoting growth. In section 3 we pursue this theme further by developing an analytical framework for the state-market relation which draws on evolutionary game theory and systems theory. At the core of our theoretical approach is the idea that the state and the market are emergent, co-evolving and mutually stabilising social systems, which both express and shape the strategic behaviour of agents. We illustrate this point through a consideration of the China's gradual and still incomplete evolution from *guanxi*-based contracting to reliance on formal legal institutions to govern commerce and trade. In section 4 we draw on leximetric coding of legal-institutional data and time series econometric analysis to review emerging evidence on the impact of legal reforms on financial development. Section 5 concludes.

## **2. The rule of law and economic growth in middle income countries**

Belief in the favourable economic impact of formal legal institutions was very much in vogue during the 1990s and 2000s, in part as a result of the growing use of metrics purporting to measure the quality of the rule of law. The World Bank's Rule of Law Index, a complex composite index built up from a wide range of data sources on the operation of legal institutions, was invoked to show that the nature of a country's commitment to the rule of law significantly affected its level of economic development. An improvement in the rule of law score by one standard deviation from levels prevailing in Ukraine in the early 2000s would, it was suggested, lead to a fourfold increase in per capital income over the long term (Kauffman, 2004). Other studies, measuring the quality of institutions largely in terms of how far they ensure the protection of private property, claimed to show that a one-standard deviation difference in institutional effectiveness, roughly the difference between Bolivia and South Korea, would produce a 2 log-point rise in per capita incomes, or a sixfold difference in outcomes (Rodrik, Subramanian and Trebbi, 2004).

The belief in the rule of law inspired extensive investment in legal reform programmes led by the international financial institutions. Between 1991 and 2002 the World Bank supported over 300 ‘rule of law’ projects in 100 countries, at a reported cost of some \$3.8 billion (World Bank, 2002, 2003). However, these initiatives came to be questioned as the expected relationship between legal reforms and economic growth failed to materialise in a number of contexts. The value of law-centred reform came to be questioned by research highlighting alternative mechanisms for promoting economic development (Esquirol, 2002; Rajagopal, 2004; Ngugi, 2004).

One such alternative is the phenomenon of ‘economically benevolent dictatorships’ which, according to Ron Gilson and Curtis Milhaupt, describes South Korea under Park Chung Hee (1961-1979), Chile under Augusto Pinochet (1973-1990) and China under Deng Xiaoping and his successors (1978-present). In these cases rapid economic development was based not on the rule of law but on the ability of non-democratic governments to create ‘non-excludable’ public goods for the benefit of the wider population. By comparison to weak democracies, benevolent dictators can better provide credible commitments to respect property rights, enabling private actors to retain the fruits of entrepreneurial activity. Such dictatorships, it is suggested, are less prone to favouring private interest groups which can capture the democratic process and exploit it for their own ends. When it comes to contract enforcement, direct government action may more effective in supporting impersonal exchange than a court-based system.

Franklin Allen, Q.J. Qian and Chenying Zhang (2009) offer a further challenge to the rule of law paradigm. On the basis of empirical studies of Asian systems including China, Taiwan and India they argue that the rule of law is not merely unnecessary but is a potential barrier to development. They characterise the legal system as a monopoly which be captured by private interest groups. The fixed costs of revising the law and modifying legal institutions become highly problematic in emerging markets which may lack effective state capacity but also have the potential for rapid growth, rendering laws out of date. As a result, businesses tend to sidestep the law, relying on reputation, relational contracting and inter-personal trust to support economic and financial transactions, in preference to state-backed legal enforcement through the courts.

These two studies correctly highlight the limits of using law as a mechanism of economic coordination in developing economies. As Gilson and Milhaupt show, it is effective state capacity, and not the rule of law alone, which is generally essential to overcoming collective action problems which may inhibit the production of the public goods on which a market economy depends. Allen, Qian and Zhang demonstrate the extent to which the legal system is often

irrelevant in emerging market contexts. Even in developed economics such as the USA or Britain, contracting between business parties generally takes place in isolation from the court system, which deals with a tiny fraction of commercial disputes. An extensive literature beginning with Macaulay argues that long-term dealing and the existence of communal and/or personal ties between business parties may be more effective in building trust than reliance on court-based sanctions. The relative rigidity of the formal law and its tendency to lag behind economic and technological developments, leading to avoidance strategies, is also well established in socio-legal studies on contracting.

However, the contrast between formal and informal institutions in these critiques of the rule of law orthodoxy may be somewhat overdrawn. A minoritarian but still significant strand in the empirical literature on contracting suggests while informal institutions may provide a foundation for interpersonal, formal laws, where they enjoy legitimacy and effectiveness, constitute important trust-assurance mechanisms in situations of impersonal exchange (Arrighetti et al., 1997). In a similar vein, there is evidence to suggest that the absence of formal legal mechanisms limits the availability of external finance for firms in emerging markets, in circumstances where overseas investors and other non-insiders are unable to access local reputational resources for generating trust (Rajan and Zingales, 1998; Cooter and Schaefer, 2011).

The impartial administration of the law can operate as a check on the exercise of governmental authority and on the power of incumbents in contexts where economic development continues to be shaped by an activist state and informal commercial and business networks (Rajan and Zingales, 2006). More generally, the role of the law in emerging markets is not confined to protecting property and contract rights, but could be understood more broadly as facilitating economic participation and substantive market access through a range of social guarantees (Upham, 2006). Neutral processes of dispute resolution may help maintain social stability in fast growing economies (Peerenboom, 2010).

A distinction may be drawn between ‘private ordering in the shadow of the law’, that is, alternative forms of contracting which operate in the presence of the rule of law, and ‘private ordering under a dysfunctional public order’, that is, forms which operate in the absence of a neutral and effective mechanism for contract enforcement. In developed countries where courts are used as a last resort and business contracting takes place largely autonomously from the legal system, the law still operates as a ‘backstop’ in a way which affects contractual strategies (McMillan and Woodruff, 2000; Chen, 2013a, 2013b). In emerging markets which lack fully effective legal ordering, the costs of using alternative

mechanisms of contract enforcement based on interpersonal trust may become a drag on growth as the economy develops. This implies a sequencing approach to building legal institutions: a given mix of public and private enforcement may work well at early stages of development but may not be sustainable over the longer term (Chen, 2013a, 2013b).

Country-specific industrial and political factors shape the path of legal and economic change in particular middle income economies. Bank-led finance, which makes fewer demands on judicial and regulatory resources than arms-length finance through equity or bond markets, may be expected to play a major role to play in countries where growth is led by manufacturing and natural resources firms and where judicial and legal institutions are still in the course of developing (Berger and Udell, 1998; Carpenter and Petersen, 2002). State-led finance may be important in industries which involve the replication of existing technologies or the exploitation of natural resources (Eichengreen, 2006), implying a prominent role for government-owned banks in the process of economic transition (Andrianova, Demetriades and Shortland, 2008, 2011).

On one view, as we have seen, China's recent experience shows that formal legal institutions are not needed in order for economic growth to occur in emerging markets (Allen et al., 2011). Instead, this view maintains, the developmental state can act as a substitute for law in building trust. At local level this takes the form of state support for the Town and Village enterprises and the use of local government mechanisms to enforce contracts and property rights (Trebilcock and Leng, 2011). At central level, the party-state apparatus perform a role of bureaucratic mediation between different interest groups (Aoki, 2002). Traditional forms of interpersonal trust and informal networks (*gaunxi*) persist into the era of modernisation, providing a foundation for business relationships (Lubman, 1999).

China also appears to have benefited from the sequencing of legal and financial reforms. The economy has been liberalised gradually, in tandem with efforts to build elements of a more formal legal system and institutions. The government retains ownership stakes in most state-owned enterprises, which have been 'corporatised' via partial listings, rather than transferred in their entirety to private hands (Leng, 2009). At the same time, survey evidence suggests that levels of trust in the formal legal system are increasing, and that there has been a narrowing of the 'implementation gap' between law on the books and law in action (Peerenboom, 2010). The thesis of law's irrelevance therefore does not seem to capture all aspects of China's transition to a market economy (Xu, 2011).



In Russia, by contrast, a rapid liberalization of the economy occurred from the mid-1990s, driven by the view that mass privatisation and ‘shock therapy’ would together make it impossible for the Communist party-state structure to be revived. The immediate transfer of property from the state to the private sector would also, it was thought, create an endogenous demand for institutions and for the rule of law (Boycko, Shleifer and Vishny, 1996). One aspect of this reform programme was the ‘self-enforcing’ corporate law which was intended to put in place bright line rules requiring minimal regulatory supervision or judicial discretion on the basis that the court system was inefficient and corrupt by comparison to the business sector, which was expected to act according to axioms of economic rationality (Black and Kraakman, 1996). The consequence of voucher privatisation and the ‘loans for shares’ programme of the Yeltsin government was that former state assets were soon concentrated in the hands of a small group of dominant firms and individual owners. The self-enforcing corporate law failed to provide effective protection to minority shareholders, in part because of judicial corruption (Black, 2008), but also because corporate insiders found it easy to avoid rules on self-dealing and related-party transactions (Hamilton, 2009).

Since the early 2000s, Russian governments have sought to rebuild state capacity and to promote a number of vertically integrated financial and industrial groups as part of a policy of preserving and developing the country’s oil and gas reserves. Attempts have been made to develop a more liquid and transparent capital market (Prime Minister’s Office, 2011). The legal system has been stabilised and more obvious forms of corruption reduced, but not to the point where impersonal market exchange based on a rule of law state can be said to have been established (Hamilton, 2009; Hendley, 2009). The Russian case can be interpreted as showing that economic liberalisation is not sufficient to trigger the spontaneous emergence of the institutions of a market economy (Pistor, 2000).

India has experienced significant reforms to company law and to corporate governance codes in the past two decades, and also has a common law system with over a century of development, which should in principle facilitate the transplantation of global standards for financial market regulation which are derived from British and American practice (Deakin, Sarkar and Singh, 2012). There is some evidence of a strengthening of investor protection in practice (Black and Khanna, 2007; Dharmapala and Khanna, 2008; Armour and Lele, 2009), although according to some studies it remains no higher than the level attained in many other middle-income countries (Allen et al., 2011). Given India’s reliance on service industries which are more dependent on equity financing than manufacturing or resource-based sectors, this is a potential barrier to future growth, although legal reforms enhancing shareholder rights

can be seen as an endogenous response to the emerging industrial structure. India's court system is extensive and well embedded, with a strong tradition of judicial independence and activism particularly on constitutional issues, but it is also perceived to be slow and inefficient in processing commercial disputes (Armour and Lele, 2009).

Brazil offers a further variant on the response of middle income countries to globalisation and the resulting increase in transnational capital flows. Brazil's stock market was well developed in the early part of the twentieth century but fell into decline in the inter-war period. Subsequent efforts at reform were blocked by insider interests. In the early 2000s an attempt was made to break the logjam by a new listing segment on the stock exchange, the Novo Mercado, which serves newly established firms but also provides an alternative route to equity finance for companies with a principal listing on the main exchange (De Carvalho, 2002; Gorga, 2009). The corporate governance rules applying to firms listed on the Novo Mercado contain many features of financial market regimes applying in western Europe and north America, including proportionate voting (one-share, one-vote) and a system for takeover bids designed to protect minority shareholders (Santana et al., 2008). Part of the attractive of the Novo Mercado for established firms is that they do not have to move their whole listing over to this more shareholder-friendly regime. While operating alongside the more traditional regulatory framework of the main stock market segment, the Novo Mercado has achieved an above-average level of IPOs for a middle-income country (Gilson, Hansmann and Pargendler, 2011). This implies that effective institutions for financial development in emerging markets can be developed on a selective and incremental basis, in order to overcome opposition from incumbents.

### **3. Coevolution of the market and the rule of law state: a theoretical framework and application to the Chinese case**

We may hypothesise on the basis of emerging evidence from middle income countries that a rule of law state is both cause and effect of sustainable economic development. This insight is supported by coevolutionary models of law-economy relations of the kind that are found at the intersection of game theory, systems theory and the economics of law (Deakin, 2011).

According to this theoretical framework, formal legal institutions meet needs which arise in the context of an economy which is moving from interpersonal trust with small numbers exchange to large-scale, impersonal transacting. In this approach, legal institutions are endogenous to the economic growth path of a particular country. It follows that they are unlikely to be functional in the absence of certain social and commercial practices to which public enforcement

is complementary (Lee, 2015). For successful transplants of formal institutions to occur, therefore, a certain pre-existing level of development is needed. Once functioning legal mechanisms are in place, however, they have the potential to foster further growth. Thus the relationship between legal institutions and economic growth is one of incremental coevolution.

While the quality of institutions does matter for economic performance (North, 1990; Acemoglu and Robinson, 2012), the polity is not prior to the economy. Rather, as Masahiko Aoki (2015: 1) puts it,

the polity and economic organisations (and thus economic performance) coevolve through a long historical process, rather than the former [being] prior to the latter as shorter-run observations might often appear to suggest. Theoretically, this view is derived from a game-perspective in which institutions both in the polity and the economy are regarded as emerging, sustaining themselves and changing endogenously through strategic behaviours of agents. Specifically, the political state is identified with a deep stable state of the political game. Then, political institutions and economic organisations/institutions are linked together through complementary and/or substitute relations with and across individual agents' strategic choices. Thus it may sometimes appear that changes in the polity are prior to changes in other institutions, but at a deeper level they can only co-change. Otherwise, they would not be stable and sustainable.

In this game theoretical perspective, the law assists coordination among boundedly rational agents by signalling to them the likely strategies that will be followed in particular market (or other social) settings. Legal rules are 'summary representations' of commonly followed strategies or 'states of play' in society. The law is a 'cognitive resource' which stores information about societal coordination and transmits it to agents operating in the market domain. The state is not so much a sovereign power as an endogenous normative order which reflects the society in which it is embedded. The legal system, as one of the mechanisms of the state, may seek to influence social outcomes in an instrumental way, but that is only one of the routes through which legal norms take effect; inducing 'bargaining in the shadow of the law' may more effective as a regulatory strategy than 'command and control' regulation. The law's role may be residual and indirect, or even hidden from view for many social actors who have no encounter with the court system, but the possibility of court enforcement can be expected to influence which strategies endure, and which are selected out, through the repeated play of agents.

Coevolutionary models in game theory (Aoki, 2001) and systems theory (Luhmann, 2004) both recognise the domain-specific quality of legal rules: in other words, legal relations and market relations are distinct, with neither being reducible to the other. The content of rules of law is indeed endogenous to, and so broadly reflective of, social practices, which accumulate over time as agents' strategies develop and mutate in response to their environment. The development of impersonal exchange and the deepening of the division of labour in a market economy create demand for public mechanisms of contract enforcement and for a contract law which instantiates notions of commercial good practice and thereby serves as a guide for action. However, to say that the law reflects practice and evolves over time in response to commercial developments is not to say that it is reduced to social practice: the law is not simply private ordering writ large.

Legal rules which are *publicly* enunciated and applied have a number of features which complement the emergence and extension of impersonal exchange. The first is their *accessibility*: publicly recorded legal rules are intended to be ascertainable without resort to the specialised meanings characteristic of social norms prevailing among dense networks and clan-type relations. A further feature of publicly articulated rules is their *neutrality*: legal rules in a functioning rule of law state are capable of being applied in a way which is independent of the wealth or status of the parties concerned. Judicial independence from private interests, and not simply from the executive power of the state, is key to the claim of the rule of law state to ensure equality of market access for all citizens. A third feature of public-legal rules is their *stability*. Purely private rule systems such as those based on commercial arbitration or private dispute resolution rarely acquire the features of doctrinal consistency, predictability and constancy which are associated with the legal order.

This stability of legal rules need not, however, imply their immutability. While the rigidity of the law may be a problem in rapidly developing economies, a developed system of commercial law is capable of responding to changes in the technological or commercial context of particular transactions. Legal systems possess mechanisms for and receiving filtering information from society or the economy, for example through litigation which can operate as a mechanism of selection and deselection of rules, or through the legislative process, which can generate knowledge through commissions of inquiry and public debate (Deakin, 2003). Legal discourse may for much of the time be self-referential or 'operatively closed' to direct outside influence yet still, in the language of systems theory, be 'cognitively open', that is, capable of translating information from the economic or political system into the juridical forms and terms which inform legal reasoning (Luhmann, 2004). Thus it is possible to view legal rules

as *exogenous in the short run* – external parameters to or constraints on actors’ choices and strategies – while *endogenous in the long run*, that is, adjusting over time to changes in their economic or political context. The fit between legal rules and their context may not always be precise or exact. Misalignments and lags are more likely than not to occur, particularly in periods of rapid change. Legal evolution displays tendencies towards path dependence and institutional lock-in. But this is not the same thing as saying that the legal system is inherently rigid or fixed, or incapable to adjusting to a changing context.

In a coevolutionary framework, the debate about enforcement can be seen in a new light. It has long been accepted that a distinction needs to be drawn for the purposes of sociological or economic analysis between formal law, or ‘law on the books’, and the practical application or reception of legal rules, or ‘law in action’. The adoption of a rule according to the conventions associated with a given governmental entity’s ‘rule of recognition’, implying its acceptance as positive law according to criteria accepted by public officials, may mean nothing at all in terms of the application or operation of that rule in a commercial or other setting. As Aoki (2001), stresses, for a given law to operate as a social *institution* requires that, at some level and to at least a minimal degree, it is accepted by social actors, and internalised in their practices. At the same time, the non-acceptance of a given legal norm by the community of social actors to which it is addressed does not, in itself, deprive that law of its formal status as a rule of positive law. In a society characterised by the rule of law, the attribution of legal validity to a given norm necessarily creates the potential for the implementation of that norm at the level of social and commercial practice (Deakin et al. 2015).

One way for this to be achieved is through the public sanctioning of conduct which departs from a given norm. However, *enforcement* may be less effective as a strategy than *legitimation*. Strict public enforcement of norms is double-edged: if the rule is not accepted as legitimate, actors will invest in strategies of avoidance. The normative force of legal rules depends on partly on the severity and likelihood of sanctioning but to a greater extent on the extent of its acceptance by the community of actors. A rule of law state is one with the unusual and distinctive capacity to actualise legal rules simply by virtue of their formal adoption as positive rules of law, but this power is not self-generating at the level of the legal system. It cannot be enacted or enunciated using legal formulas. It depends rather on the existence of a meta-norm, shared across a population of actors, of respect for norms which have a public-legal form, irrespective of their precise content.

Empirical studies based on field experiments and similar behavioural methodologies suggest that meta-norms of this kind are more widespread in democracies than in authoritarian states. The incidence of ‘altruistic punishment’ – the phenomenon of actors incurring a private cost to punish uncooperative behaviour – is highest in democratic societies, while the opposite tendency, the punishment those who comply with public norms, is most widespread in autocracies (Gintis, 2009: 82). It would seem that participation in the rule making process, expressed through the institutions of representative democracy, is conducive to the emergence of the societal meta norm of respect for publicly enunciated rules, which is nothing more or less than the ‘deep stable state’, in a game theoretical sense, of the rule of law itself.

China’s recent trajectory illustrates the relevance of a coevolutionary perspective on economic development (see Chen, 2013a). Until the 1978 reforms, private property was effectively extinct and all means of production were vested in the state or its inferior form, the collective. Strictly speaking, there were no transactions in the sense of commodity exchange. All disputes were settled by the government in its capacity as common owner, and legal rules governing market transactions were completely redundant. Even prior to the effective abolition of the legal system during the Cultural Revolution, the legal system had ceased to function in any meaningful sense, as central planning determined the content of economic policy.

The irrelevance of formal law persisted into the early part of the reform era and it was *guanxi* that played a crucial role in attracting foreign direct investment and market building in this period. In order to encourage investment, a formal legal measure, the Law of the People’s Republic of China on Joint Ventures using Chinese and Foreign Investment, was passed in 1979. The law had little impact, however. Foreign investment was deterred by the lack of clear protection for property rights and the fear of policy reversal. In 1983, FDI inflows into China accounted for less than US\$1 billion. Interpersonal trust or *guanxi* between Hong Kong investors and businesses in Guangdong province, rather than the legal framework, was responsible for the subsequent growth of FDI. The majority of Hong-Kong based Chinese originate from Guangdong and they have various familial and lineage-based links to communities based there. Between 1983 and 1995, Hong Kong accounted for 59 per cent of accumulated FDI in China, 56 per cent of which was received by Guangdong.

While at the outset of the reform period there was in effect no market in China and state ownership of the means of production excluded a role for private property rights, private actors were able to access economic resources through *guanxi*-type relations with government officials and managers of state owned enterprises. This led to the emergence of organised forms of production outside the state sector. *Guanxi* helped many newly formed private firms to survive political attacks as they were constituted as town and village enterprises (the 'red hats' phenomenon).

The rapid expansion of market relations in China during the 1990s cannot be attributed to the legal system. Rather, trust-based mechanisms of the kind identified by the literature on informal contracting – the threat of loss of future trading opportunities and the costs of exclusion from dense, interpersonal networks – enabled the economy to grow. However, even from this early stage the limits of *guanxi* were becoming clear. FDI was concentrated in the coastal areas where *guanxi* was well established. As a result, the income gap between the coastal provinces and other Chinese regions grew rapidly, and became a challenge to economic policy and to the maintenance of social order. Maintaining *guanxi* came at a cost. According to the Hong Kong Independent Commission on Corruption at the end of the 1990s, the costs of outright bribes and equivalent gifts and payments in mainland China amounted to 3-5 per cent of operating costs or between US\$3-5 billion worth of FDI. Although *guanxi* worked as a coping strategy for dealing with abuses of bureaucratic power, it also catalysed new forms of bureaucratic corruption. *Guanxi*-type relations made it possible for political insiders to make fortunes from the sale of quotas and permits. Corruption of this kind was a direct trigger of the 1989 Incident, the gravest political crisis after 1978.

The limits of *guanxi* have become clearer as the economy has continued to grow. *Guanxi* is a localised phenomenon and its benefits are generally confined to members of closed networks. *Guanxi* engenders high transaction costs as firms have to invest in building interpersonal ties each time they enter a new market. The larger the firm, the greater the investment it has to make in *guanxi*.

At some point the deadweight costs of the *guanxi* system will begin to outweigh its benefits. As private enterprise has continued to grow to the point where it has outstripped the state sector, demand for formal legal rules which would limit the costs of relying on *guanxi* has developed. This accounts in large part for the rapid increase in the rate of adoption of new commercial laws since the 1990s. While many of the components of these laws are borrowed from mature market economies, they also reflect social practices within China and are increasingly tailored to meet the needs of market actors based there.

In so far as China's legal development reflects a shift in the demand for formal legal institutions and not simply a top-down response to the social pressures associated with rapid growth, we might expect new laws to be self-enforcing to a large extent. However, the gap between 'law in the books' and 'law in action' remains substantial, and legal norms often lack both enforcement and legitimation effects. The result is a prisoner's dilemma: although effective enforcement and observance of laws would be in the long-term interests of all market actors, it is not necessarily in the interests of individual players. Parties have strong incentives to tilt the interpretation and application of legal rules in their own favour. Unless there is an independent court system which has the remit of ensuring that laws are impartially and neutrally enforced, the potential of formal laws in reducing transaction costs and providing a basis for impersonal exchange will not be realised.

A feature of emerging markets is that the societal meta-norm of respect for publicly enunciated legal rule is lacking. A meta-norm of this kind can only be established once there is a common belief in the ultimate sovereign effect of the legal order, that is, its equal application to all actors including those of the state itself. As long as some actors stand above the law and state power is intermingled with private interests, complying with legal norms will not become the first best strategy of most social or commercial actors. Bringing political elites within the reach of the legal process and recognising the domain-specific character of legal rules are complementary strategies for embedding the rule of law in emerging markets.

#### **4. Legal transplants and financial development: evidence from 'leximetrics' and time-series econometrics**

One means of catalysing the rule-of-law state in emerging markets is the diffusion or transplantation of legal norms and institutions across national boundaries. Alongside theoretical advances in the analysis of the law-economy relation, the empirical study of legal diffusion has been revolutionised by methodological advances in the quantification of legal rules ('leximetrics') which began in the mid-1990s. The impetus for this process started with econometric studies which sought to test for correlations between cross-national variations in shareholder and creditor protection, on the one hand, and the extent of financial development across regions and countries, on the other. Early results from this line of work appeared to show that higher levels of protection for investors and creditors had tangible effects on flows of equity finance and bank lending (La Porta et al., 1998). They also showed that common law (or English legal origin) systems were generally more protective of shareholder and creditor rights. These complementary results generated the legal origin hypothesis, the claim that there was a causal link running from the infrastructure



of legal systems through to the content of specific norms to outcomes which were reflected in financial market variables (La Porta et al., 2008).

Legal origin theory addressed a need in econometric analysis to overcome the problem of the endogeneity of institutions to their economic and social context. Since institutions respond to economic and social conditions as much as they shape them, a statistical correlation between institutions and growth does not equate to causation. Legal origin theory seemed to offer a solution: a single variable, in the form of the common law or civil law origin of a country's legal system, could be seen as genuinely exogenous, in the sense of being unconnected to country-specific industrial and financial conditions. This is because, with the exception of a small number of parent systems, in which the infrastructure of law making emerged alongside specific patterns of economic growth and development, whether a particular country inherited its legal institutions from the common law or civil law was largely a matter of historical accident. Indigenous economic factors were less important than military conquest and colonisation in driving legal diffusion; during the formative period of legal development in the nineteenth and twentieth centuries, very few systems were in a position to make a conscious choice in favour of one mode or type of legal infrastructure over another (Glaeser and Shleifer, 2002).

In panel data econometric analyses, the legal origin indicator which initially appeared as an instrumental variable was now adapted to provide a direct causal explanation of cross-national variations in economic performance (La Porta et al., 2008). At a time when the limits of globalisation were starting to become clear, this result provided an explanation for the persistence of diverse national conditions which could be explained in terms of deep-rooted path dependencies. At the same time, common law modes of law and governance continued to be seen as inherently more suited to the creation of national environments for 'doing business' (World Bank, various years).

The legal origin hypothesis engendered a huge response, much of it highly critical, but over time a debate over methods has developed, which has resulted in some refinement of the initial data coding efforts, while a more diverse range of econometric techniques has been used to test for relationships of causation and correlation. 'Leximetric' coding methods have been used to develop a more fine-grained approach to the coding of legal data which has produced multi-year time series of trends in legal development. These longitudinal datasets make it possible to test for lags or delays in the consequences of legal change and to take into account the possibility of multi-directional causal flows, with economic development affecting legal change as well as vice versa (Armour, Deakin, Sarkar, Siems and Singh, 2009; Armour, Deakin, Lele and Siems, 2009).

Longitudinal data series in law and finance generally possess the statistical property of ‘non-stationarity’ according to which exogenous shocks can generate persistent movements away from equilibrium variables. Techniques developed within econometric theory for dealing with non-stationary data include the family of cointegrated vector autoregression (CVAR) models, which view the economy ‘as a highly complex dynamic system, the properties of which must be inferred from data reflecting a single (nonreplicable) realisation of a multivariate, path-dependent process’ (Hoover et al., 2008). These techniques can be used to test for the short-run effects of legal changes on the economy, which can be modelled as fluctuations around a stable equilibrium, and for long-run deviations from the equilibrium path. Thus they can be used to test for the immediate effects of legal changes on financial indicators, which may be substantial but short-lived, and for more lasting consequences of legal change, which can shift economies from one equilibrium path to another. These methods are accordingly well suited to testing the dynamic changes which occur within emerging markets as they adjust to the combined effects of economic and institutional change.

There are few studies which directly compare the experience of developed and developing countries. Deakin, Sarkar and Singh (2012) undertake such a study using the longitudinal Shareholder Protection Index (SPI) which tracks the impact of legal reforms in a panel of 25 developed and developing countries over the period 1995-2005. The panel includes the larger middle-income countries including China, India and Brazil. The SPI measures the rate of legal adoption of pro-shareholder reforms in these countries. Thus relevant indicators include those tracking the degree to which countries have adopted norms on board structure, shareholder voice and voting rights, and protection of minority shareholder interests in the context of takeover bids. These laws and regulations are largely drawn from the experience of developed common law countries, most notably the UK and USA, during the 1990s. Longitudinal data show that while common law systems are generally more protective of shareholder rights than civil law ones, the latter have been ‘catching up’ with former since the early 1990s. The dataset also shows that company law reform has been a global phenomenon, with emerging markets, and in particular transition systems, adjusting most quickly to the diffusion of norms of investor protection over this period (Figures 1 and 2).

When these data are regressed against outcome variables in the form of country-level measures of financial development, drawn from the IMF’s Financial Structure Dataset using the CVAR approach to estimate the long-run impact of legal changes, they indicate a positive impact of legal change on stock market values (stock market capitalisation over GDP) for developing countries. There is also evidence, in the developing world, of reverse causation, suggesting that

investor demand has, in part, been driving the rate of legal change in emerging markets. For developed countries, by contrast, the analysis reports a positive impact of reforms on stock market capitalisation for common law countries only; there was no effect in civil law systems in the developed world. In contrast, analysis shows that in emerging markets the positive impact of legal change on financial development operates across the common law-civil law divide (Deakin et al., 2012). This line of work implies that corporate governance reforms aimed at protecting shareholder rights can have positive impacts in emerging markets where equity markets are still developing and where firm-level governance remains weak, but where, equally, there is scope for an improvement of corporate governance standards and practices.

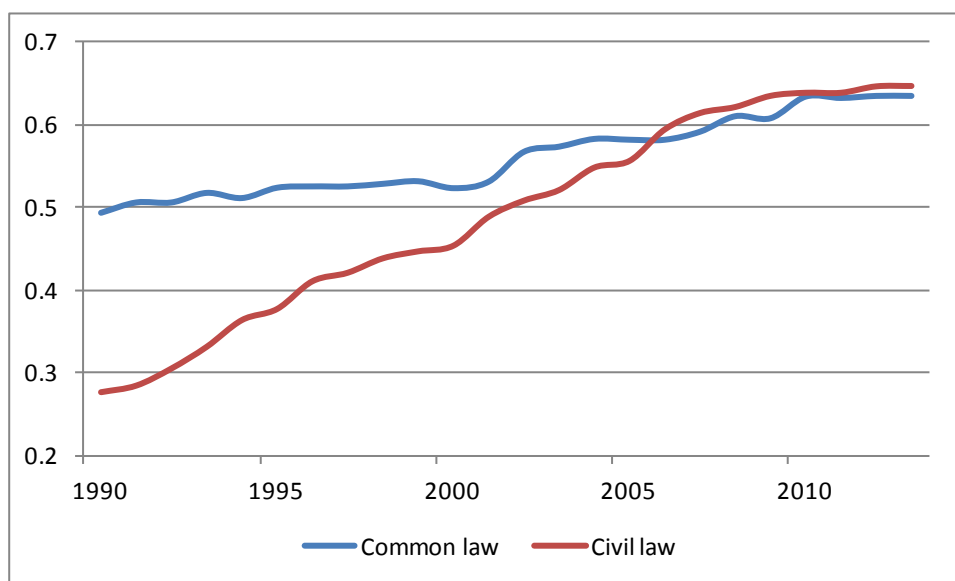


Figure 1. Shareholder protection in 30 countries, 1990-2014, comparing common law and civil law origin countries. Source: CBR Leximetric Database (<http://www.cbr.cam.ac.uk/research/projects/project2-20output.htm>).

Note: The countries in the dataset are Argentina, Austria, Belgium, Brazil, Canada, Chile, China, Czech Republic, Cyprus, Estonia, France, Germany, India, Italy, Japan, Latvia, Lithuania, Malaysia, Mexico, Netherlands, Pakistan, Poland, Russia, Slovenia, Sweden, South Africa, Spain, Switzerland, Turkey, UK, USA.

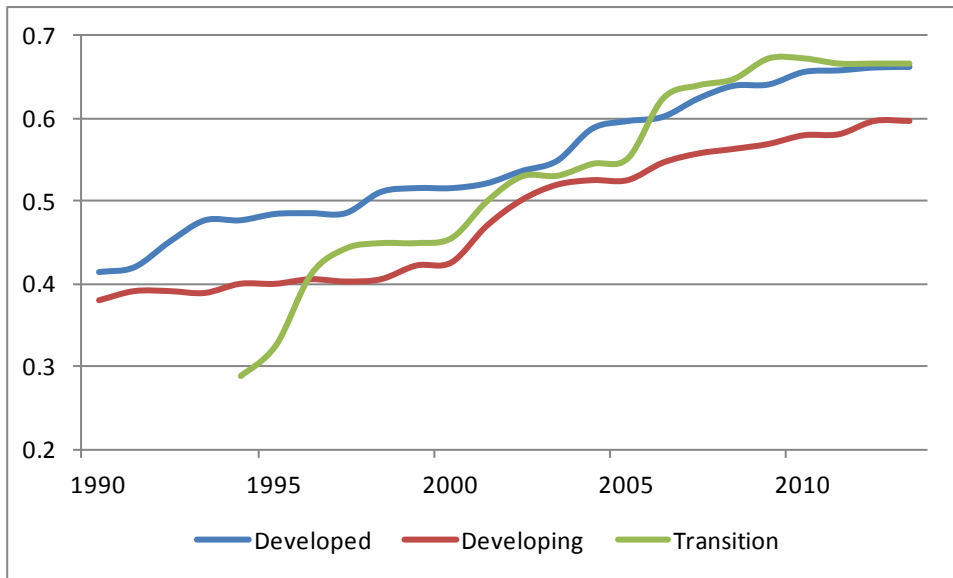


Figure 2. Shareholder protection in 30 countries, 1990-2014, comparing developed, developing and transition countries. Source: see Figure 1.

## 5. Conclusion

Steve Lee (2015) has recently argued that for law and development to advance as a research field, an analytical framework is needed for understanding how legal institutions contribute to sustainable economic development. This implies a multi-level approach spanning theory and empirical research. We need a better theory of law and state, and an improved understanding of the historical role of both in seeding the process of industrialisation in the west, in order to assess the conditions for sustainable economic growth in today's low and middle income countries. We also need to deploy new social science methods including a variety of statistical and econometric approaches. Our paper can be seen as a contribution to the project that Lee has set out.

We have argued that public ordering – governance of agents' strategic behaviour through publicly articulated legal rules – is superior as a mode of economic coordination to alternatives based on private ordering through interpersonal trust, on the one hand, and authoritarian politics, on the other. Private ordering within a dysfunctional public realm cannot progress beyond (relatively) small numbers bargaining based on regional and familial networks, and will tend to degenerate into corruption, generating deadweight costs for society. Authoritarian rule, conversely, can only go so far in supplying the public goods needed for market exchange, before it too becomes weighed down by high transaction costs associated with private capture of the state apparatus. Many emerging markets currently suffer from a mix of clan-based contracting

and authoritarian political control which, we may hypothesise, is rapidly reaching its limits.

Since the 1990s a huge investment has taken place across the world in rule of law programmes which have sought to transplant elements of western models of law and governance into emerging markets. These initiatives were not inherently misguided: the rule of law is a critically important public good in advanced industrial economies. All too often, however, rule of law initiatives failed to bed down in contexts for which they were ill suited. The proponents of the western liberal model neglected or overlooked the sense in which the rule of law state was the product of centuries of evolution in the west which was frequently stalled or even reversed, and which often turned on contingencies and chance events.

For there to be a rule of law in which property and contract rights are protected against predation, there must first be a state with the capacity to undertake the task of constituting the market. Part of that state's apparatus must be a legal system which has the means to control not just abuses of private power but other elements within the state, including the executive power of government. This rule of law state is not self-forming, but requires complementary institutions in the realm of the market and of society more generally in order to flourish. Thus the rule of law cannot simply be implanted in emerging markets by an act of legislative will or through the borrowing or mimicking of institutions from outside. Yet the emergence of a rule of law state from initial conditions which include network-based exchange and authoritarian political control cannot at all be ruled out. Middle income countries which have experienced rapid economic growth without relying on formal legal institutions to get to their present condition may be well placed, by virtue of the level of development they have achieved, to make the transition to becoming rule of law states. At least we can say that this is one feasible path among others for emerging markets, and predict that some of them will take it in coming years.

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