

TWENTY YEARS OF 'LAW AND  
FINANCE': TIME TO TAKE LAW  
SERIOUSLY

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## **Abstract**

The Law and Finance School (LFS) has become an important stream of research in management and socio-economic studies. This paper provides the first comprehensive discussion of the first twenty years of LFS literature. Drawing on legal theory, we show that, despite the centrality of law to the LFS, the LFS is based on a surprisingly ‘thin’ theory of law. It does not provide a coherent definition of what primary function law plays in the economy, what criterion makes law ‘valid’ law, and what mechanism links law to actors’ behaviours. Therefore, contrary to existing criticisms of the LFS, we argue that the main issue is not that the LFS overstates the importance of law, but rather that it does not take law seriously enough. We propose ways in which future research could develop a more solid conceptual framework to empirically investigate the impact of law on economic and social outcomes.

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## 1. Introduction

Over the last twenty years, the so-called Law and Finance School (hereinafter LFS) has become an important stream of research in management and socio-economic studies. The LFS was initiated by a series of articles co-authored by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny starting in 1997 (La Porta et al. 1997). At the academic level, the LFS is part of a broader trend of rediscovery since the 1980s of the importance of institutions in determining economic outcomes not just in political science (Hall and Taylor 1996), but also in organisation studies (DiMaggio and Powell 1984) and economics (North 1990; Acemoglu and Robinson 2012).

The influence of this school both in academia and economic policy can hardly be overstated. For instance, Schiehl and Martins' (2016) review shows that two of the LFS variables, 'legal origin' and 'investor protection,' are by far the most common country-level factors used as independent variables in cross-country governance research in political economy, management, economics, and finance.

The two main explanatory factors in the LFS – namely the quality of law and a country's legal origin – are widely used in empirical studies in various fields not only to explain patterns of corporate finance, ownership, and control structures (Volmer et al. 2007; Bedu and Montalban 2013; Colli 2013; Callaghan 2015; Lehrer and Celo 2016), but also public administration regimes (Tepe et al. 2010), features of national labour markets (Schneider and Karcher 2010; Emmenegger and Marx 2011; Darcillon 2015; all citing Botero et al. 2004), the nature and size of the informal sector (Adriaenssen and Hendrickx 2015), and more generally institutionalised trust (Huo 2014; Witt and Redding 2013; citing La Porta et al. 1998 and 2000). Thus, the LFS has become the dominant legal approach not only in comparative economics, but also in comparative management, international business and corporate governance research (for overviews see Jackson and Deeg 2008; Aguilera and Jackson 2010; Schiehl and Martins 2016).

However, despite its extraordinary influence, the LFS has come under a great deal of criticism. Scholars have documented biases in the selection of legal variables, inaccurate and not rigorous coding of laws and endogeneity problems (e.g., Milhaupt and Pistor 2008; Aguilera and Williams 2009; Armour et al. 2009a; Spamann 2010). Another prominent line of criticism points out that the LFS exaggerates the importance of law and neglects the influence of other factors – such as history and politics – on corporate governance and finance patterns (e.g., Coffee 2000; Cheffins 2001; Roe 2006; Dam 2006; Roe and Siegel 2009). In reaction to these criticisms, the LFS has increasingly broadened the

definition of ‘law,’ retracting somewhat from the original claim that the *substantive* aspects of a country’s laws matter for corporate governance and financial development. Instead, what is claimed to matter are differences in enforcement as well as broad features of a country’s legal and political system captured by the notion of ‘legal origin’ (cf. La Porta et al. 2006 and 2008). Contrary to these well-known criticisms, we argue, based on a comprehensive review of the first twenty years of LSF scholarship, that the LFS’s problem is not that it takes law too seriously, but that, conceptually, it does not take it seriously enough. Indeed, our analysis confronts the LFS with several established theories of law in order to answer the question: What theoretical assumptions regarding the nature, function, validity, and impact of law on economic outcomes inform the LFS research programme?

Our systematic review unveils that the LFS, despite two decades of research confidently assuming that ‘law matters,’ is based on a very ‘thin’ theory of law. Indeed, while the LFS does not provide a consistent theory of law, it rather draws on various strands of legal scholarship, which offer at times contradictory arguments of how law deploys its impact on actors. This affects the empirical application of the LFS theory, because it leads researchers to operationalise variables and specify statistical models in ways that are contradictory across studies. This plea for a more nuanced approach can also be seen in other research: for instance, Schiehl and Martins (2016) find four different causal models implicitly underlying empirical studies that link national-level factors to firm-level outcomes in comparative management research, and Aguilera et al. (2013) provide four examples that demonstrate the contextually bounded consequences of regulatory reforms on firm level corporate governance.

This paper proceeds as follows: Section 2 sets the scene by summarising the key claims of the LFS and outlines different theories of law and their key dimensions. On this basis, Sections 3 to 5 analyse what the LFS literature has to say about what law is, what good law is, and how law impacts economic actors’ behaviour. Section 6 concludes with a discussion of the implications of our findings. We suggest that future research should not abandon the investigation of how *substantive* differences in laws affect different economic outcomes. Rather, we propose to develop a more solid theoretical framework, which is explicit about the key assumptions regarding the role of law in the economy. We argue that this includes as a minimum explicitly conceptualising three dimensions of law: the law’s nature and primary function; its necessary content (if any) and its relationship with morals; and how it deploys its behavioural effects on law-takers (see section 2.2, below). Such a conceptualisation of law will allow researchers to design more robust empirical tests of whether and how law matters in the economy, addressing thus one of the key shortcomings of the first twenty years of Law & Finance (see Schiehl and Martins 2016).

## 2. Setting the scene

### 2.1 Overview of the LFS: Quality of law and legal origins

For the purposes of this paper, we have conducted a comprehensive review of the LFS literature relevant to legal or institutional factors. To this effect, we compiled all articles published by the four original authors (La Porta, Lopez-de-Silanes, Shleifer, and Vishny) since 1997. We excluded articles that used legal or institutional factors as mere control variables, including those that focused on areas unrelated to socio-economic issues (e.g. Djankov et al. 2010 on disclosure by politicians). Several articles by other authors were added if they could be considered to be closely related to the LFS tradition, because they either co-authored with La Porta et al. (e.g. Glaeser, Djankov), or because La Porta et al have repeatedly and approvingly cited their work. We also added articles by scholars who co-authored articles with La Porta et al., but then also authored their own articles in the LFS tradition. Overall, we reviewed 56 articles published between 1997 and 2017, which we consider to constitute the core of the LFS.<sup>1</sup>

Starting from the LFS's fundamental assumption that 'law matters' for economic outcomes, the early LFS publications developed two key claims: firstly, that the 'quality' – defined in terms of the strength of minority shareholder protection – of a country's company law determines key features of companies' and countries' corporate governance systems, such as ownership concentration, corporate finance choices, and the size of countries' stock markets (e.g. La Porta et al. 1997, 1998, 1999, 2000). This implies that law also impacts economic growth by favouring companies' growth prospects (Beck et al. 2000; Claessens and Laeven 2003). Secondly, the LFS claims that the quality of law is not randomly distributed across countries, but rather is a function of the country's 'legal origin' in either common law, or different families of civil law (La Porta et al. 1997 among others).

The first of these claims is often referred to as the 'quality of law' thesis ( Armour et al. 2009a), which explains economic outcomes based on substantive features of a country's company law such as the level of property right protection law affords investors (e.g. La Porta et al. 1997). However, rather quickly, the focus of the LFS shifted from measuring the *substantive* quality of different laws – and indeed law *per se* – to the second claim, namely that economic outcomes are determined not so much by the substantive content of laws, but by historically-grown features of a country's legal and political system. The LFS distinguishes four different 'legal origins' based on the grounding of countries' laws in four 'mother systems': English Common Law, French-, German-, or Scandinavian Civil Law. According to the empirical evidence presented by the

LFS, common law legal origins are generally associated with superior economic outcomes, for example, as they provide better investor protection in both company and securities law (La Porta et al. 1998, 2006; Djankov et al. 2008) and quicker jurisdictional procedures such as when it comes to the entry of start-up firms and the duration of trials (Djankov et al 2002, 2003).

Interestingly, the LFS explained these cross-national differences as the result of more fundamental differences between common law countries and others. For example, La Porta et al. (2008: 303, fn 12) initially express the view ‘that legal origin theory is intimately related to the discussion of the varieties of capitalism’, but then also suggest that the former may well replace the notion of varieties of capitalism as an ‘objective measure of different types’. Contrary to the narrow concept of ‘legal quality,’ ‘legal origins’ evolved into a more encompassing and even philosophical category to distinguish types of countries. Thus, Mahoney (2001: 511) claims that the difference boils down to common law countries defining ‘liberty’ based on the Humian-Lockian tradition as individual liberty, while civil law countries follow the Hobbesian-Rousseauist tradition of seeking to achieve liberty through collective goals pursued by the state. This, in turn, implies that the ‘legal origins theory’ is essentially about the level of state intervention in the economy (also La Porta et al. 2008). The increasingly broad definition of legal origins also leads the LFS to the verge of rather culturalist arguments about the superiority of certain civilisations over others: La Porta et al. (1997b: 333) essentially argue that Catholicism and Islam are inferior to Protestantism in terms of economic outcomes, because they prevent the emergence of ‘horizontal trust’ among people; and La Porta et al. (2004: 445) explicitly state that there are ‘significant benefits of the Anglo-American system of government for freedom.’

In parallel to this shift in the explanatory variables from a narrow focus on substantive law, such as shareholder protection, to a focus on definitions of liberty, the dependent variables also become increasingly broad and varied. Initially, it moved from a focus on ownership structures and market capitalisation, to wider outcomes such as firm- and country-level economic growth (Levine 1999; Beck et al. 2000) and political and economic freedom (La Porta et al. 2004). In a review of the first ten years of their main studies, La Porta et al. (2008: 292) list their research on (i) procedural formalism, (ii) judicial independence, (iii) regulation of entry, (iv) government ownership of the media, (v) labour laws, (vi) conscription, (vii) company law, (viii) securities law, (ix) bankruptcy law and (x) government ownership of banks and how those legal topics were related to outcomes such as the time to evict non-paying tenant, property rights, corruption and size of the unofficial economy, participation rates and unemployment, stock market development, firm ownership structures and private credit. Since then, the LFS has further broadened its scope by successively adding new as-

pects of a country's legal system to the explanatory model and applying this model to new outcome variables. Thus, Djankov et al. (2010) find an impact of tax law on investment and level of entrepreneurship, La Porta and Shleifer (2014) uncover evidence for cost of compliance with law on the size of the informal sector, and Djankov et al. (2016) turn to the *perception* of the quality of government to explain Eastern European peoples' happiness (for more in-depth reviews of the link between legal origins, quality of law and economic outcomes see Armour et al. 2009a; Aguilera and Williams 2009; Aguilera et al. 2013).

Despite this shift from substantive law to 'legal origins' and related broad concepts in the academic LFS literature, practitioners in international financial institutions continue to develop reform programmes and policy advice that draw on the LFS's original focus on legal reform as prime means of economic development. Thus, the World Bank's Doing Business Reports (DBRs), annually updated since 2004, directly draw on the LFS regarding shareholder and creditor protection, but have also added further areas, for example, legal rules related to taxation, electricity, construction permits, cross-border trade and public procurement (The World Bank 2004-2017). The DBRs also provide country rankings on various dimensions. While most of these rankings are headed by common law countries, civil law countries have implemented reforms that saw them rise in these rankings. Yet, it has recently been shown that these 'improvements' according to the rankings did not lead to 'improvements' in the countries' real economy (Oto-Peralías and Romero-Ávila 2017). Therefore, the link between legal reform and economic outcomes seems tenuous despite two decades of intensive LFS research.

It follows that, at present, the general state of LFS research is rather unsatisfactory. On the one hand, there has been ongoing criticism of the LFS's conceptualisation and methodology to measure substantive characteristics of, for example, 'good' company law (e.g. Lele and Siems 2007; Spamann 2010). On the other hand, moving from a focus on substantive features of law towards much broader factors dodges the question of the role of law in the economy, rather than contributing to answering it. This is an unfortunate development, because it diverts our attention away from the key challenge of explaining not just *that* law matters, but also *how* it matters. Indeed, a central claim of the present paper is that the shift in the LFS from the 'quality of law' as the main explanatory variable to 'legal origins' has considerably weakened the analytical power of the LFS approach and has undermined the initial attempts to contribute to our understanding of the impact of law on economic outcomes. Rather than continuing the debate about legal origins (e.g. Siems 2007; Deakin and Pistor 2012; Oto-Peralías and Romero-Ávila 2017), we suggest that the LFS needs to renew its initial ambition to investigate the impact of law on economic practices and out-



comes. As an important first step, we propose that the LFS should be confronted with legal theory. We draw on five classical legal theories to assess what the LFS has to say about law in order to identify ways in which we can improve on this concept to make the LFS more robust in its empirical application to political economy topics.

## **2.2 Overview of different theories of law and their key dimensions**

As the complexities of legal theories fill entire libraries, it is not feasible to address all possible theories of law and all their different dimensions in this paper. The necessary selection of the relevant theories is based on our aim to relate those legal theories to the LFS. Thus, since the LFS emerged in the US context of the late 20th century, we focus on contemporary Western and indeed mainly Anglo-Saxon legal theories and neglect non-Western approaches to the law which are very unlikely to have constituted the basis for the LFS. In this regard, we follow Tamanaha's (2017) insight that theories of law have to be understood within the specific social context in which they have emerged.

Specifically, we focus on the following five theories of law: natural law theory, exclusive/strong legal positivism, inclusive/weak legal positivism, legal realism, and Hayek's functional-evolutionary spontaneous order theory of law. Similarly, the corresponding key dimensions of these theories have been chosen with the aim to scrutinise the claims about the understanding and operation of law in the LFS. Based on our reading of the legal theory, we identify three key dimensions that are necessary to fully define the theory of law: the 'nature and primary function of law', the 'content of law' and the 'behavioural effect of law'. Table 1 illustrates the opposing views of legal theorists as well as the linkages between these three dimensions.

We now turn to discuss the LFS literature regarding each one of these dimensions. In each of the following three sections, we distinguish between a first sub-section that positions the LFS in the framework of legal theories and a second sub-section that discusses the relevance of these findings and makes suggestions for future research.

<b>Table 1: Key Dimensions of Different Theories of Law</b>						
		<b>1st Dimension: Nature and primary function of law</b>		<b>2nd Dimension: Content of law</b>		<b>3rd Dimension: Behavioural effect of law</b>
	<b>Modern Representatives</b>	<b>Source of authority / criterion for validity</b>	<b>Importance and primary function of legal rules in the economy</b>	<b>Relationship between law and morals</b>	<b>Definition of good law</b>	<b>Law-takers motivation to obey the law</b>
<b>Natural Law Theory</b>	J. Finnis	God/nature	Important for human society (specificity, clarity, predictability) and property rights	Moral standards as criteria for moral validity of positive law	<i>Substantive:</i> Congruence with natural law	<i>Objective:</i> Practical reason/moral obligation to obey the law
<b>Exclusive (Strong) Legal Positivism</b>	J. Austin H. Kelsen	Sovereignty Basic Rule ( <i>Grundnorm</i> )	Commands important for guiding behaviour/settling disputes/exercising control	Separate	None	<i>Subjective:</i> Habit of obedience/ Fear of sanction

<b>Inclusive (Weak) Legal Positivism</b>	H. L. A. Hart	Social Rule of Recognition	Legal rules important for guiding behaviour/settling disputes/exercising control	Separate	<i>Procedural:</i> Acceptance	<i>Objective:</i> Normativity of law
<b>Legal Realism</b>	O. W. Holmes K. Llewellyn J. Frank	Judges' decisions	Legal rules unimportant (rule-skepticism) – adjudication and its anticipation important to avoid socially undesirable outcomes	Separate	None	<i>Subjective:</i> Fear of sanction imposed by courts (cost-benefit calculation)

<p><b>Spontaneous Order (Functional-Evolutionary) Theory of Law</b></p>	<p>F. A. Hayek</p>	<p>Tradition Efficiency (as measured by survival)</p>	<p>Important for protection of individual (economic and political) liberty</p>	<p>Law ought to be based on historically grown community standards</p>	<p><i>Meta-legal requirements:</i> Generality Universality Known Certain <i>Substantive:</i> Negativity Market-supporting</p>	<p><i>Subjective:</i> Habit of obedience &amp; Tradition Coercion in the last instance</p>
<p><b>Law &amp; Finance School</b></p>	<p>La Porta et al.</p>	<p>Efficiency of outcomes</p>	<p>Important for protection of property rights</p>	<p>Unclear: mainly separate but some studies refer to role of community standards</p>	<p><i>Substantive:</i> Protecting property rights/favouring trade/economic growth <i>Procedural:</i> Enforceability</p>	<p><i>Subjective:</i> Fear of sanction (cost-benefit calculation)</p>

### 3. Dimension 1: Nature and primary function of law

The term ‘nature of law’ refers to the source of authority and the criterion for validity of law. This poses the fundamental question whether or not there are rules of ‘natural law’, but also more specific questions, say, whether legislation or case law should have primacy (see Table 1 for the corresponding theories of law). The notion ‘function of law’ has no single definition in legal scholarship. It is used to designate the purpose or consequences of law at various levels. It is sometimes very broadly defined as ‘guiding conduct’ (e.g. Fuller 1969) or constituting the rules of the game (the ‘constitutive function’ of law; Deakin et al. 2017a); sometimes somewhat more specific definitions are given, e.g. ‘doing justice’ (Moore 1992), ‘licensing coercion’ (Dworkin 1988) and ‘coordinating activity’ (Finnis 2011[1980]). In this paper, we use the term ‘primary function of law’ in a broad sense to capture what different legal theories see as the fundamental purpose that law fulfils in a society. We call this the *primary* function, because it refers to a more fundamental function than specific laws’ more immediate functions (such as a road code’s function to prevent accidents). Furthermore, we distinguish the primary function of law from the role of law in the sense that the former is not necessarily an empirically verified claim, but rather a theoretical or even normative statement about the fundamental purpose of law in society. Conversely, we use ‘role of law’ to capture a broader range of empirically verifiable phenomena including the effect of law on actors’ behaviours (our third dimension) and on overall economic outcomes.

### 3.1 Positioning the LFS

A first somewhat obvious, but nevertheless crucial observation that emerges from the systematic analysis of the LFS literature is that law has a very important primary function in the economy. This can be contrasted with more libertarian ideas in the field, which consider – based on the Coase theorem (Coase 1960) – that rational actors will find optimal solutions to allocation problems via market forces and private contracts, as long as the contracts are enforceable (Stigler 1964; Fama 1980; Easterbrook and Fischel 1991). On this account, no market regulation is required to achieve optimal outcomes; tort and contract law will suffice. The LFS rejects this view and emphasises the importance of laws and even government regulation in certain – albeit limited – circumstances (La Porta et al. 2000a: 7). For example, Glaeser and Shleifer (2002: 1223) argue that:

‘[e]conomists generally agree that the state's main role in the economy is to protect property rights. [...] The trouble with this imperative is that it does not tell us exactly how the state can design a functional legal system, and what it takes to “protect property rights.”’

Therefore, according to the LFS, the primary function of law is a more extensive and benign one than in more libertarian accounts. State law is not rejected *per se*; rather, identifying the circumstances under which law is the optimal institutional choice to protect property rights is one of the LFS’ main goals (see further section 4.2 below, concerning the content of the law).

More specifically, we find three interrelated arguments in favour of state law and public enforcement – as opposed to private contracting – in the LFS literature. Firstly, state law may be more efficient than a system of pure private ordering in countries where the general level of ‘law and order’ is only ‘moderate’ (Glaeser and Shleifer 2003: 403). Secondly, depending on the ‘enforcement environment,’ public enforcement may be a better choice than private litigation. This is for instance the case when contracts are complex and judges may not have the required specialised skills to enforce them (Glaeser and Shleifer 2002; Djankov et al. 2003: 605). Thirdly, broad socio-economic factors may affect the choice of the optimal regulatory regime. High economic and political inequality favour the subversion of courts by powerful litigants, leading to a situation where the ‘strong’ not the ‘just’ win court cases (Glaeser and Shleifer 2002; Glaeser et al. 2003).

In sum, the LFS treats the choice of the optimal regulatory regime as an empirical question depending on the ‘enforcement environment’ and other factors, which leaves room even for state intervention and regulation. To be sure, state intervention is always a second-best solution and the domain of market failures making it necessary is ‘extremely limited’ (Shleifer 2005: 440; also Glaeser and Shleifer 2003); for example, La Porta et al. (2006) find that in securities law private enforcement is preferred to public enforcement. Still, overall, the LFS ascribes to law a more important and potentially more benign function in society and the economy than related fields of research such as Posnerian Law and Economics (starting with Posner 1973).

The primary function of law according to the LFS can more precisely be defined as one of property rights protection (La Porta et al. 1997: 1149 and 1999: 222; Mahoney 2001: 523). For instance, the protection of minority shareholder rights through company law is necessary because of agency problems, namely the risk of expropriation of shareholders by insiders (see Jensen and Meckling 1976). In such a situation, the law confers shareholders ‘certain powers to protect their investment against expropriation by insiders’ (La Porta et al. 2000b: 3), which in turn creates incentives for financiers to make external finance available to companies, leads to more developed stock markets, dispersed ownership structures, (e.g. La Porta et al. 1997, 1998, 1999, 2000a), and ultimately faster growing firms (Levine 1999).

Milhaupt and Pistor (2008) have criticised the LFS for exclusively focussing on this protective function of law. However, some of the LFS articles do contain a somewhat more variegated view of the functions of law than the usual narrow focus on the protection of property rights, which the LFS shares with much of the economics discipline. Djankov et al. (2003: 596) state that:

‘Since the days of the Enlightenment, economists have agreed that good economic institutions must secure property rights, enabling people to keep the returns on their investment, make contracts, and resolve disputes.’

Here, two additional functions of law are mentioned. Firstly, the phrase ‘enabling people [...] to make contracts’ hints at the enabling or coordinative function of law rather than its protective one. This function consists in providing actors with instruments – such as contracts – that help them coordinate their economic activities with other actors while negotiating the precise allocation of property rights within the boundaries of the law (Milhaupt and Pistor 2008: 7). Secondly, solving disputes is a distinct function of law that mainly relates to the laws’ enforcement through litigation. The effectiveness of enforcement has also

become an increasingly important concern for the LFS and will be discussed in section 5 below.

### **3.2 Discussion and suggestions**

It follows from the foregoing analysis that the LFS does not seem to adopt one clear definition of the nature and primary function of law. The protective function of law is most closely associated with strong legal positivism (see Table 1). The enabling function on the other hand would suggest a certain proximity of the LFS' theory of law with, what legal theory usually refers to, as 'inclusive positivism,' being associated with Herbert Hart (2012[1961]). The dispute-solving function, on the other hand is key to 'legal realism', as first formulated by Oliver W. Holmes and Karl Llewellyn (Green 2005). Legal realism essentially defines law not as what the lawmaker says the law is, but what the judge actually enforces in the court of law (see also Table 1).

While more recent legal scholarship acknowledges that law may simultaneously fulfil more than one function (Milhaupt and Pistor 2008), the problem is that the LFS fails to discuss the implications for the causal link between law and economic outcomes of the multi-functionality of law that they implicitly acknowledge. This is a serious neglect for a research programme on the impact of law on economic outcomes and may explain why empirical studies remain inconclusive. Indeed, as Schiehl and Martins (2016: 195) argue, the weak empirical evidence for a link between country-level variables – the most widely-used ones are legal origin and quality of law derived from the LFS – and economic outcomes is explained by the fact that 'country-level variables are conceived and applied differently across studies', therefore calling for a '[...] more conscientious match between theorized associations and empirical tests'.

In the LFS, the postulated impact of shareholder protection law on economic outcomes (stock market development) is exclusively premised on the first function of law mentioned in the LFS, namely its protective function. Acknowledging that law also performs other functions (such as the coordinative-enabling function theorised in Hart's soft positivism), the postulated causal link between legal rules and economic outcome may not hold anymore. Thus, enabling rules will not allow shareholders to directly protect their interests, but rather gives them certain rights, which may or may not be well protected.

The discussion of functions of law has important implications for empirical research using LFS legal variables (see further section 5.2, below). Most of the LFS studies use simple aggregates of all legal variables, for example, related to shareholder protection, by simply summing up the values of any legal rules that protect shareholders (La Porta et al. 1997; see also section 4.1, below). Howev-



er, recent studies suggest that the function of law may not just vary from one context to the other, or from one law to the other, but each legal rule may fall into a specific category. Thus, Katelouzou and Siems (2015) distinguish ‘enabling’ from ‘paternalistic rules,’ which correspond with different functions of law. Acknowledging the multi-functionality of law may therefore require future empirical work to account for different types of legal rules, for example, by creating sub-indices that show different country preferences for different forms and notions of law.

#### **4. Dimension 2: Content of Law**

A second key dimension that distinguishes legal theories is a conception of whether or not law needs to have a certain content (either procedural or substantive) in order to be considered valid. This also relates to the question about laws relationships with morals is. We summarise this dimension as the content of law. Two fundamentally opposing views exist: On the one hand, the natural law perspective posits that law must respect certain extra-legal standards to be considered valid or ‘good’ law. This can be based on the notion that certain moral rules and principles (e.g. fairness) are objectively good (see for a ‘modern’ statement of this view Finnis 2011[1980]). On the other hand, a strong legal positivist view simply regards anything the sovereign decides to be law is law independently of its content and form. Other legal theories adopt variations of these two views (see Table 1).

##### **4.1 Positioning the LFS**

What is the position of the LFS to this question? In a rare explicit reference to legal theory, La Porta et al. (2008: fn 2) reject legal positivism. They associate it with the socialist legal tradition that conceives of law as the ‘expression of the will of the legislator as supreme interpreter of justice’ (*ibid.*). Rejecting positivism suggests that according to the LFS law must have a certain content to be considered ‘good’ or valid law. Indeed, the LFS extensively uses normative terms like ‘good law’, ‘good governance’, ‘good government’, ‘improve’, ‘better,’ to characterise legal systems (e.g. La Porta et al., 1997a: 1194; La Porta et al. 1999: 505; 2000: 6, 20; Glaeser et al. 2003: 272). In their empirical investigations, the LFS also assumes that laws should have a certain quality, for example, that they have sufficient levels of investor protection (La Porta et al., 1997, 1998, 1999, 2000). Yet, beyond this general position that we should not be agnostic about the content of the law, the LFS is ambiguous about the basis and substance of definitions of ‘good law’:

Firstly, in the early studies, the LFS uses a *technical* definition of the quality of law, which essentially equates the ‘goodness’ of law with the degree to which it protects minority shareholders against insider opportunism (cf. analysis by Pistor 2009: 1647; also Shleifer and Vishny 1997: to ensure they get ‘their money back’). The LFS developed two empirical measures of legal quality, namely the so-called Anti-Director Rights Index (ADRI) (La Porta et al. 1997) and the Anti-Self-Dealing Index (ASDI) (Djankov et al. 2008). Defining the quality of law as the degree to which it prevents certain behaviours implies a *substantive* definition of good and bad behaviours. Consider the following passage in Johnson et al. (2000b: fn 1):

‘[M]any forms of stealing are actually legal in countries with weak legal environments.’

Similarly, Johnson et al. (2000a: 23) define ‘tunnelling’ as including ‘outright theft or fraud, which are illegal everywhere’ and other transactions (e.g. excessive executive compensation), which are not illegal in many countries. Further, Djankov et al.’s (2008) ASDI measures the extent to which minority shareholders can oppose self-dealing transactions by controlling shareholders where ‘a controlling shareholder wants to enrich himself *while following the law*’ (Djankov et al. 2008: 432; emphasis added).

These statements imply that certain behaviours and transactions are categorised as undesirable (or ‘bad’) *even when the positive laws of the country in question do not prohibit them*. The implication is that ‘theft’, ‘fraud’, etc. have an existence independent of the positive law in a given country. The question arises on what normative basis the assessment is made that minority shareholders *ought* to have a right to prevent certain transactions. The most explicit passage in this respect is Johnson et al. (2000: 11):

‘[In civil law countries] [s]elf-dealing transactions are assessed in light of their conformity with statutes and not on the basis of their fairness to minorities.’

Therefore, the reason why ‘self-dealing’ is considered inherently bad appears to be its incompatibility with the general principle of ‘fairness to minorities,’ which is independent of what the positive law says. The ‘quality’ of a country’s laws is hence assessed against extra-legal standards, which are not explicitly part of the country’s positive law (and maybe not even of its social norms). The LFS therefore acts on the assumption that laws must conform to certain normative principles (such as fairness) to be considered ‘good’ or even valid. Yet, it fails to specify from where extra-legal principles such as fairness derive their authority.

A second, rather different, definition of good law in the LFS is based on a *non-substantive* criterion of ‘goodness,’ namely the ease with which a law is enforceable in a given context. Thus, La Porta et al. (2000a: 22) state that

‘(...) good legal rules are the ones that a country can enforce. The strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure.’

Importantly, enforceability is in turn related to the extent to which law reflects the community’s standards. Hay and Shleifer (1998), for instance, define ‘good rules’ via their social acceptability: ‘good legal rules are those likely to be adopted by private parties [...] as well as used by courts’ (Hay and Shleifer 1998: 401). The definition of ‘good law’ is here – contrary to the substantive quality of law claim – a purely pragmatic one (acceptance), which does not presuppose any specific substantive content of legal rules. This hints at an – at times explicitly – customary theory of law. Despite the LFS’s strong emphasis on state law (see section 3, above), Shleifer (2005: 443) explicitly relativises the role of legislation compared to custom:

‘With courts, there is a role for impartial judges enforcing rules of good behaviour. These rules do not need to come from legislation, but may instead derive from custom or from judge-made common law and precedents.’

Similarly, Hay and Shleifer (1998: 402): ‘Whenever possible, laws must agree with prevailing practice or custom.’ Indeed, Glaeser and Shleifer (2002: 1202) suggest that the reflection of ‘community standards of justice’ in the legal system may be one of the reasons for the alleged superiority of English common law over civil law.

Thirdly, one of the main findings of the LFS school is that differences in legal rules influence economic outcomes (see sections 1 and 2.1, above). Therefore, a third definition of good law in the LFS studies is functionalist and outcome-orientated in nature. For example, La Porta et al. (1999b: 223) explicitly define ‘good’ as what is ‘good-for-economic-development.’ Similarly, Hay and Shleifer (1998: 401) state in a passage defining ‘good law’ that ‘some rules facilitate trade better than others.’ The outcome of facilitating trade and economic activity more generally constitutes a substantive criterion for good law.

In short, there are at least three different definitions of good law in the LFS literature. A first one is narrow and focused on the extent to which law protects shareholders’ (property) rights, where rights are defined substantively following

certain principles such as ‘fairness;’ a second one is focused on the efficacy and indeed *legitimacy* of law (in a normative sense)<sup>2</sup> with a view to its enforcement and hence effectiveness; a third assesses good law based on the economic outcomes it produces (growth, trade, markets etc).

## 4.2 Discussion and suggestions

The LFS does not provide any direct clues how these different definitions of good law relate to each other. Indeed, analysing these definitions in light of important legal theories reveals that they may be potentially incompatible. The first, ‘protective’ definition of good law seems closely related to natural law theory. Various LFS studies explicitly refer to the long pedigree of the ‘protective function’ of law, citing Smith (1776), Montesquieu (1748), and Locke (1690) as the main sources for the insight that ‘good economic institutions must secure property rights’ (Djankov et al. 2003a: 596; also Djankov et al. 2003b: 453; Glaeser et al. 2003: 200; 2004: 272; La Porta et al. 2004). Several of these classical authors have affinities with natural law theories (notably John Locke and Montesquieu; see also Table 1), which may suggest that the LFS view is inspired by natural law theory.

The second definition of good law is based on the enforceability of law thanks to its proximity to community standards and hence its ‘acceptability’. As mentioned above, this also leads to the claim that the supposedly decentralised common law may be superior to the allegedly more centralised statute-based civil law.

The focus on proximity with community standards and on acceptability recalls Hart’s (2012[1961]) ‘practice theory of rules.’ Hart’s positivism relies on the assumption that at least some of the rules in a legal system need to be ‘social rules’ in the sense that they are both commonly practiced and considered legitimate guides for action by most in the community. This pragmatic and non-cognitivist view of rules (Perry 2006) seems in line with the theory of law that the LFS adopts. However, the LFS’s view is also vulnerable to the same criticism as Hart’s conception of rules as social practice as an only partial description of what law is because it cannot account for non-conventional rules that also exist in a society (see Dworkin 1997[1977]).

The second customary/procedural definition of law, as well as the third functionalist and outcome-orientated definition, that we found in the LFS can also be related to Hayek’s evolutionary-functionalist ‘spontaneous order’ theory of law. There are some explicit references to Hayek in a number of LFS studies (La Porta et al. 1999; Mahoney 2001; Glaeser and Shleifer 2002; Djankov et al.

2003; Beck et al. 2003, 2005; La Porta and Shleifer 2009;) and Djankov et al. (2003: 600) also cite Hayek's evolutionary theory in support of their account of how efficient laws emerge.

Hayek (2011[1960]: 115-6) conceives of law as a 'spontaneous order' that crystallises as a result of a process of 'adaptive evolution' through the survival of the fittest – customary – rules. More specifically, he insists on the end-neutrality of any valid law, i.e. law should simply be rules of 'just conduct' that do not impose duties on individuals, other than obliging them to *refrain* from interfering with other individuals in order to protect their liberty (Hayek 2013[1982]: 200; for Hayek as a legal theorist see also Ogus 1989). This is broadly compatible with the LFS's theory of law: it is in line with its narrow definition of the quality of legal rules in terms of the protection they afford individuals against other individuals and against the state (Djankov et al. 2003a). At the same time, in different places, it becomes clear that Hayek does support a substantive definition of valid law, namely that its function is to favour markets and trade (Santos 2006). This is compatible with the LFS's third definition of good law (conduciveness to trade and markets). The association between the LFS and the Hayekian theory of law seems hence close.

However, even in its use of the Hayekian theory the LFS is not consistent. While Hayek rejects any system that aims at instrumentally using law to achieve specific collective goals is subject to the erroneous naivety of 'rational constructivism' and 'pragmatism' (Hayek 2011[1960]), the LFS does contain a clear utilitarian, instrumentalist, and ultimately teleological slant, notably regarding the feasibility and desirability of legal reform (e.g. Hay and Shleifer 1998). The LFS notion of efficiency or optimality of a regulatory regime differs from Hayek's. For instance, Glaeser and Shleifer (2002) and Djankov et al. (2003) consider the rise of the statute-based regulatory state in the US during the progressive era and the relative decline of a purely court-based private litigation system, as an efficient adaptation to a new, more complex economic and social environment. Hayek (2011[1960]; chapter 16) on the other hand saw this evolution as part of the regrettable 'decline of the rule of law,' due to the rise of 'constructivist pragmatism' and socialism, which once again hints at the LFS's more benign view of regulations compared to economic liberals.

Again, we suggest that the LFS's inconsistent and contradictory conceptualisation of law and its content is more than a concern for legal theorists. Indeed, it has very concrete implications for the validity of their empirical studies. Thus, some of the LFS's empirical tools do not reflect *any* of these definitions. Their use of a universal one-size-fits-all coding template of the black letter law (see section 4.1, above) pays no attention to community standards and effective enforcement. Correspondingly, it has been found that much of the LFS templates

are simply based on the existing rules of US law, regardless of whether the US model really represents standards of ‘good law’. For example, this US bias has been evidenced in empirical studies by Lele and Siems (2007) and Deakin et al. (2017b) (both unaffiliated with the LFS) which have applied alternative forms of legal measurement for the strength of shareholder protection and creditor rights. Thus, we suggest that future empirical research on law and finance needs to start with a clear understanding of how ‘good law’ can be defined for a particular question and then develop a consistent index based on this model.

### **5. Dimension 3: Behavioural effect of law**

If we accept the basic idea that law matters because it is an important mechanism of social control that works by guiding actors’ behaviours, the mechanisms through which law achieves this goal becomes a crucial object of inquiry. We call this the ‘behavioural effect’ of law, which designates the immediate effect of law on its subjects and is hence distinct from its impact on broader socio-economic outcomes (such as the development of stock markets). Here, legal theories (see Table 1) can essentially be divided into two groups: those that consider that law provides people with objective reasons to obey (moral obligation and practical reason) and focus hence on the normativity of law; and those who only consider subjective reasons for action (self-interest, fear of punishment, habit of obedience). This section seeks to identify the mechanisms that the LFS postulates and to which theory of law this corresponds most closely.

#### **5.1 Positioning the LFS**

A first observation is that there is no explicit discussion in the LFS of how exactly law makes actors do what it prescribes. However, there are some broad references to the *incentives* that law creates for different actors and influence their behaviour (e.g. La Porta et al. 1997, 1998). Incentives are the domain of rational calculation of the costs and benefits of (non-)compliance by self-interested actors and hence a ‘subjectivist’ explanation of the behavioural effect of law. The LFS therefore adopts an anthropology where actors do not follow the law for the sake of following it, but to avoid sanctioning. It is hardly surprising that the LFS would lean toward the subjectivist explanation, given that it draws on theories such as agency theory that are grounded in rational choice paradigm (e.g. the LFS studies of investor protection; see section 2.1, above). Such theories are in turn based on the *homo oeconomicus* model of man who in their pursuit of maximal utility is not responsive to norms and duties, but only to cost-benefit considerations and incentives.

Several passages illustrate this point. Glaeser et al. (2003: 201) quite explicitly state that the only reason why powerful actors would respect the law is the fear for sanctions: ‘If the politically strong expect to prevail in any court case brought against them, they would not respect the property rights of others’ (also Glaeser et al. 2001). Shleifer and Wolfenzon (2002) explicitly attempt to combine Becker’s (1968) economic model of crime with Jensen and Meckling’s (1976) agency theory. Accordingly, they define the quality of investor protection not through a list of legal shareholder rights, but as ‘likelihood that the entrepreneur is caught and fined for expropriating from shareholders’ (Shleifer and Wolfenzon 2002: 4). This statement is remarkably close to Holmes’s (1897) legal realist ‘prediction theory of law’ according to which law should be defined simply as the prediction of what the likelihood of sanctions will be (see Green 2005). In Holmes’s famous words: ‘If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict’ (Holmes 1897: 459). The proximity of modern economics’ *homo oeconomicus* and the legal realist ‘bad man’ is remarkable and may explain why the LFS has been increasingly drawn towards this theory of law.

Indeed, since around 2007 we observe a ‘legal realist turn’ of the LFS. Since then, a series of articles of the LFS explicitly adopts a legal realist view (Gennaioli and Shleifer 2007a, 2007b, but also Balas et al. 2009; Niblett et al. 2010; Gennaioli et al. 2014). A key tenant of the realist position is that the so-called ‘decision theory’ of law, which states that law is what the *judge* decides not what the legislator says it is. Therefore, the LFS analyses adjudication in common law countries in detail, focussing on questions about the application of legal rules by judges; including their decisional biases, the role of precedents, ‘overruling’, ‘distinguishing’, and discretion in fact finding (Gennaioli and Shleifer 2007a, 2007b, 2008; Niblett et al. 2010).

The omission of objective reasons to obey the law may explain the LFS’s strong focus on law enforcement (see Milhaupt and Pistor 2008: 5). Indeed, for the ‘bad man,’ without enforcement – or at least a credible threat of it –, there is no reason to obey the law. In the LFS, enforcement was initially only reflected in a ‘rule of law’ control variable (La Porta et al., 1997, 1998). Yet, subsequent studies developed the analysis of enforcement much further. Thus, La Porta et al. (1999) analysed the quality of government and its impact on enforcement. Later studies focussed on more specific factors such as the competence and incentives of judges (Glaeser et al. 2001; Glaeser and Shleifer 2002; Djankov et al. 2003) and the degree of subversion of courts by particular interests (Glaeser et al. 2003; Glaeser and Shleifer 2003). Shleifer (2005: 442) even calls his approach to regulation an ‘enforcement theory of regulation,’ because the ‘enforcement environment’ determines the optimal system of social control of the

economy between the two extremes of a purely court-based litigation system and public regulation.

## 5.2 Discussion and suggestions

The increasingly realist stance of the LFS and the focus on enforcement reveal an underlying theory of law which realism shares with strong positivism, i.e. that the threat or anticipation of sanctions is the main motivation for people to obey the law. This has been termed the ‘coercive view’ of law and goes back to Austin’s (1832) positivism. However, the strong positivist/realist view of the mechanisms through which law deploys its effects contradicts both the rejection of positivism regarding the source of valid law and the previously established proximity of the LFS with Hayek’s theory of law. Hayek considered that habit and tradition were what drives compliance with law, while coercion only was a last resort (Hayek 2011[1961], chapter 9). This idea also resonates with Max Weber (1968[1921]: 81) who argued that the public’s belief in the legitimacy of the law is crucial as the state is unlikely to be able to enforce all violations of the law by force.

More generally, the LFS’s focus on subjectivist explanations of the behavioural effect of law leads it to neglect any other behavioural effects of the law, in particular normative ones. This makes the LFS theory of law incompatible with theories that are based on the notion that law creates ‘objective reasons for action’ (see Table 1, column 7). Thus, the Beckerian-Holmesian view of human motivation starkly contrasts with Hart’s theory, which is based on the law-abiding citizen rather than the ‘bad man’ Hart (2012[1961]: 40) famously asked in reference to Holmes’ bad-man argument: ‘Why should not law be equally if not more concerned with the ‘puzzled man’ or ‘ignorant man’ who is willing to do what is required, if only he can be told what it is?’. Hart observed that the majority consider it their *duty* to obey the law for the sake of obeying the law, rather than as the result of a conscious calculation of costs and benefits associated with the likelihood of sanctions.

It follows from the foregoing analysis that future LFS research needs to understand more fully how law guides actors’ behaviour. The rich literature on behavioural law and economics (cf. Zamir and Teichman 2014; Mathis 2015) may be particularly suitable for the LFS given its characterisation as ‘the second wave of law and economics’ (Michales 2009). In addition, Friedman (2016) recently pointed out that the way law affects behaviour is a cross-disciplinary topic with extensive research in political science, sociology, economics, criminology, law, and psychology. Similarly, recent socio-legal and regulatory studies show that modern states combine different types of regulatory tools – including laws – that deploy their impact on the ‘law takers’ in ways that are different



from the Austinian ‘command-and-control’ idea (Schneiberg and Bartley 2008). It is hence doubtful that the narrow focus on sanctions, enforcement, and rational utility maximisation appropriately captures the way in which law impacts economic actors.

This omission is more than a theoretical issue as it may at least partly be responsible for the inconsistent empirical evidence that LFS-inspired studies have produced. A more precise and encompassing conceptualisation of how law affects actors’ behaviours can, for example, be relevant for the many studies that empirically investigate shareholder protection. In the LFS, this topic is largely reduced to questions of incentives that investors have to invest or refrain from investing in stock due to effective protection of their property rights or the absence thereof. While this is certainly part of the story, this conceptualisation disregards the other main addressees of legal rules on shareholder protection, namely the ‘insiders’ (directors, managers and blockholders) who are, according to agency theory, the ones doing the expropriating. The LFS simply seems to assume that insiders comply with legal rules of shareholder protection due to the fear of sanctions. However, this may not be the only channel through which law deploys its effect on economic actors. For example, rules of company and securities law may reflect prevalent ethical standards and are mediated through market forces. As such, law may work through a signalling effect that invokes actors’ moral dispositions by signalling the appropriate behaviour. The strength of this effect may be quite independent of enforcement (cf. Deakin et al. 2017a).

Again, neglecting these theoretical limitations is not just an aesthetic flaw, but leads to misconceptions and misspecification of empirical research designed to test law and finance hypotheses. To give but one example, most empirical studies simply use general measure of legal minority shareholder protection, such as the Anti-Director Rights Index (ADRI) and the Anti-Self-Dealing Index (ASDI) (see section 4.1, above) to measure the legal level independently of whether it contains any legal rules directly affecting the practices under investigation. Thus, Schepers and Guillen (2004) use the ADRI to investigate the impact of law on hostile takeover activity, although this legal measure does not contain any rules on hostile takeovers. Similarly, Cuomo et al. (2012), in a study investigating the link between legal reforms and companies’ corporate governance practices in Italy, use the ADRI and other country-level measure of legal shareholder protection, none of which capture all aspects of the legal reforms that have taken place in Italy.

More importantly, these macro-level legal measures do not focus on the same aspects of corporate governance that Cuomo et al. (2012) use as dependent firm-level variables. The ADRI does not contain any measures for ownership structures, the existence of pyramid structures, or syndicate agreements among

shareholders, which are the control-enhancing mechanisms that Cuomo et al. (2012) investigate. An increase in the ADRI does hence not directly affect any of the investigated firm-level practices. This research design is not necessarily absurd, of course. Indeed, based on the above-mentioned signalling effect of law, which is compatible with the weak positivist or the natural law theories of law, we could indeed expect that a general increase in shareholder protection (regardless of which aspect in particular) signals to economic actors that shareholder-orientated practices are the appropriate expected behaviour.

However, such research designs are incompatible with the dominant coercive view of law, which would suggest a relative limited impact of law on corporate practices, i.e. *ceteris paribus* only when a specific practice is directly targeted by the legal change would we expect a company to react by changing its practices. If a company practice goes against the spirit of the law (e.g. increased shareholder protection), but not against its letter, we would not expect the company to worry about it. Indeed, if fear of punishment is the main driver of compliance, there is no reason to believe that companies would change their behaviours unless they are threatened with punishment.

Consequently, if the coercive effect were the only, or even the main effect of legal rules on corporate practices, empirical studies should focus on investigating the direct correspondence between legal variables and firm-level variables, for example, the prohibition of dual class shares in the law and their existence at firm level. Surprisingly, however, very few studies adopt this empirical strategy corresponding to their implicit conceptualisation of legal rules, as coercive and authoritative orders. This illustrates the mismatch between the implicit assumptions about how law is expected to matter and the empirical procedure used to test whether law matters (for a similar point see Schiehl and Martins 2016).

## **6. Summary and conclusion**

We find that the LFS, despite the importance it ascribes to laws and regulations, is surprisingly vague regarding key issues of law's role in the economy or their implications. In particular this concerns the questions: What is the primary function of law in the economy? What criteria does 'good' or 'valid' law have to fulfil? How does it impact actors' behaviours? Indeed, some of the – often implicit – assumptions that emerge from the analysis of these articles appear at least in part to be contradictory.

Thus, the LFS rejects legal positivism's claim that the validity of laws is determined simply by the will of a sovereign. Instead, it adheres to the view that laws need to fulfil certain substantive criteria to be considered 'good' law. Conversely, not everything that is enshrined in the law can be considered 'valid' legal

rules. For instance, legal rules that do not conform to certain higher principles such as fairness or efficiency are considered sub-optimal. This hints at a quasi-naturalist, non-positivist view of law, which states that law needs to conform to certain extra-legal standards. The definition of what exactly these standards are, however, remains vague. ‘Good law’ must protect individual (property) rights, favour trade and economic growth, but some of the LFS studies also refer to the need to reflect a community’s own (moral) standards and practices. The LFS does not tell us which one should prevail if these goals are not aligned (what if the community practices privilege solidarity and redistribution over individual property rights for instance?). Moreover, it is not entirely clear on what this substantive definition of the validity and quality of law is based. While the LFS literature does contain references to natural law theories of property rights, it seems more likely that the underlying theory of law can most closely be associated with a Hayekian evolutionary view of law.

Regarding the precise mechanisms linking law to actors’ behaviour, the LFS clearly focuses on subjective reasons for obeying the law, not objective and normative ones. In this respect, despite the rejection of positivism regarding the source of authority and the definition of law, the LFS does seem close to the Austinian strong positivism and the Holmesian legal realism (cf. Austin 1832; Holmes 1897). Both of these theories adopt the ‘command’ or ‘coercive theory of law’, which sees fear of sanctions as the only reason why subjects would obey the law. This also makes the LFS conception of law compatible with modern economic theories about rationality and motivation, in particular with Becker’s (1968) work. The focus on fear of sanctions as main effect of law on its subjects, also explains the important place that enforcement occupies in the LFS. In this respect, judicial decision-making is key to different LFS arguments. Initially, judges applying broad *legal principles*, as opposed to ‘bright-line legal rules,’ to specific cases was considered a key advantage of common law systems over civil law ones. This insight has a distinct Hayekian ring to it. Increasingly, however, the LFS has moved to a more pessimistic and explicitly legal realist understanding of the role of courts and judges. In this model, judges are equally selfish utility maximisers as the contracting parties themselves and cannot be assumed to pursue the shareholders’ best interests.

This discussion of the dimensions of the theory of law underlying the LFS has to be seen against the backdrop of a more general trend in the LFS literature towards a *decreased* importance of law as an explanatory variable. Indeed, the above-described move from a series of quite specific substantive features of a country’s company law as captured in the ADRI (La Porta et al. 1998) and ASDI (Djankov et al. 2008) to very general features of its political, cultural, and socio-economic environment implies that law has lost considerable ground in terms of explanatory primacy. Therefore, we observe a shift from an, arguably

problematic, but precise and substantive operationalisation of law, say, based on a measure of minority shareholder protection, towards an increasingly broad and vague definition (at first ‘legal origin’, then ‘regulatory style’). The latter concepts are essentially void of any substantive meaning and may boil down to cultural rather than legal differences among countries. To be sure, cultural factors are important country-level determinants of economic outcomes. However, we maintain that legal factors need to be taken seriously as antecedents of firm-level practices in their own right rather than just a moderator as recent studies have done (Griffin et al. 2017). In this respect, however, the LFS fails to provide any precise empirically testable hypotheses regarding the question of what links law to actors’ behaviours and which substantive elements of law matter.

Some of the LFS studies go even further adopting practically a non-institutionalist position. Thus, Glaeser et al. (2004) argue that *policies* of investment in human capital are a more important driver of economic development than institutions and the ‘rule of law.’ Indeed, on this account, ‘good’ policies are often adopted by dictatorial regimes, and ‘good institutions’ follow afterwards (Glaeser et al. 2004: 271). Therefore, one could argue that the more recent scholarship in the LFS tradition can hardly be considered to be about law *per se* anymore and that the name *Law* and Finance School has become somewhat of a misnomer. This latter development is regrettable, because it means that the LFS has reacted to difficult questions raised by the initially confident statement that ‘law matters’ not by attempting to answer the important question ‘how does law matter?’ but by avoiding the debate altogether, shifting the focus onto more fundamental features of different countries’ socio-political system rather than refining the causal theory of law in the economy.

Our analysis also shows that the theory of law underlying the core LFS articles is partial at best and contradictory at worst. The key question that arises from this observation however is: Why does it matter? Is it not sufficient for a theory in the area of applied economics to correctly predict the outcomes of interest (cf. Friedman 1966[1953])? The problem with this view is that the LFS has been challenged not just on theoretical, but also on empirical grounds. The predictive power of the theory does not seem anywhere near as strong as it may appear based on the popularity of the theory (e.g. Spamann 2010; Armour et al. 2009b). Partly, the lack of robust results may precisely be due to the lack of a coherent conceptualisation of how law matters, which leads to questionable empirical strategies that, in turn, undermine the LFS’s theoretical contribution to corporate governance research. In order to develop robust empirical tests of its main claims, it would seem that the LFS’s main problem is not that it takes law too seriously, but rather that it does not take it seriously enough.

Thus, the surprising conclusion is that the LFS – although bringing law back into the comparative corporate governance research – actually has very little to say about what law is and how it affects economic actors and outcomes. Indeed, the LFS seems mainly to be an attempt to apply economic theory and econometric methods to legal phenomena rather than the other way around. Our analysis does reveal certain recurring themes that constitute an embryo of legal theory in the LFS. Yet, the legal theory underlying LFS is tentative, underdeveloped, and at times contradictory.

The different legal theories we confronted the LFS with in this study suggest that besides the coercive view of law that the LFS privileges, there are at least three additional ways in which law matters, namely by signalling appropriate behaviours, by creating legal obligations, or by creating moral ones. Each one of them would lead us to different empirical strategies to test the impact of law on economic actors and outcomes. The failure to take into account such a more fine-grained understanding of law's role in the economy may, to an important extent, explain why the empirical evidence for the confident LFS claims remains questionable (cf. Schiehl and Martins 2016; Armour et al. 2009b). Remedying this shortcoming would seem particularly important given that the LFS has arguably become one of the most widely-used academic theories that have had a profound impact not just on academia, but also on policy makers at the international and national levels.

Overall, we therefore suggest that insights from current legal studies could enrich the LFS theory of law in order to make it both analytically and empirically stronger. In other words, designing more robust empirical approaches to the question ‘under what circumstances does law matter?’ requires first to be clearer on how we can expect law to matter. We hope that our analysis of the LFS literature provides different promising ways of starting to address this question.

## Notes

1 See Table 2 in the appendix. Conversely, we did not review the vast empirical literature that applies or empirically tests the LFS concepts, because such empirical studies do often not contain *any* theoretical development about the role of law and legal origin in the economy, but simply refer to the La Porta et al. articles (Schiehll and Martins 2016 provides a partial review of that literature).

2 Normative legitimacy, i.e. justification of power, is to be distinguished from sociological legitimacy, i.e. acceptability (see Green 2013: 489: Weberian understanding of legitimacy, i.e. that, in general, laws are accepted to be binding).

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**Appendix: Table 2: The Law and Finance School: Core Studies Analysed for this Paper**

<b>Year</b>	<b>Authors</b>	<b>Reference</b>	<b>Legal variable of interest</b>
1997	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	‘Legal Determinants of External Finance’, Journal of Finance (JoF), 52(3): 1131-1150	Anti-director rights index (ADRI) Legal origin (LO) (used as instrument variable)
	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	‘Trust in Large Organisations’, AEA Papers and Proceedings, 87(2): 333-338	Efficiency of judiciary (control)
1998	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	‘Law and Finance’, Journal of Political Economy (JPE), 1006(6): 1113-1155.	ADRI LO (instrument variable)
	Hay, J. & A. Shleifer	‘Private Enforcement of Public Laws: a Theory of Legal Reform’, AEA Review Papers and Proceedings, 88, 398-403.	Legal reform: what facilitates private enforcement of public rules?

1999	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	'The Quality of Government,' Journal of Law, Economics and Organization, 15(1): 222-279.	LO (used as a proxy for political system (interventionism) alongside a second political variable (ethnolinguistic heterogeneity))
	La Porta, R., F. Lopez-de-Silanes, & A. Shleifer	'Corporate Ownership Around the World,' JoF 54(2): 471-517	ADRI LO (instrument variable)
	Levine, R.	'Law, Finance, and Economic Growth', Journal of Financial Intermediation, 8: 8-35.	LO Creditor rights Efficiency of the legal system in enforcing contracts Accounting standards

2000	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	'Investor protection and Corporate Governance', Journal of Financial Economics (JFE), 58: 3-27.	Shareholder & Creditor protection
	Johnson, S, La Porta, R., F. López-de-Silanes, A. Shleifer, & R. Vishny	'Tunnelling,' American Economic Review (AER), 90(2): 22-27	Use of general legal principles in court: Duty of care Duty of loyalty
	Johnson, S, Boone, P., Breach, A., Friedman, E.	Corporate Governance in the Asian Financial Crisis, JoFE, 58: 141-186	ADRI Rule of Law
	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	'Agency Problems and Dividend Policies Around the World', JoF, 55(1): 1-33.	Investor protection: Dummy based on ADRI sample median
	Beck, T., R. Levine, N. Lozyza.	'Finance and the Sources of Growth', JFE, 58: 261-300	LO
2001	Mahoney, P. G.	'The Common Law and Economic Growth: Hayek Might Be Right,' The Journal of Legal Studies (JLS), 30(2): 503-525	LO
	Glaeser, E, S. Johnson & A. Shleifer	'Coase versus the Coasians', The Quarterly Journal of Economics (QJE) (2001) 116 (3): 853-899.	Type of contract/law enforcement regime (court based vs. public regulator)

2002	Djankov, S., La Porta, R., Lopes-de-Silanes, F., & Shleifer, A.	'The Regulation of Entry,' QJE, 117: 1-37.	Entry regulation: Number of procedures Min. time and min cost to establish a business LO
	La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. Vishny	'Investor Protection and Corporate Valuation' JoF 57(3): 1147-1170.	ADRI LO
	La Porta, R., F. Lopez-de-Silanes & A. Shleifer	'Government Ownership of Banks', JoF, 57(1): 265-301.	ADRI LO (proxy for state intervention) RoL
	Shleifer, A. & D. Wolfenzon	'Investor Protection and Equity Markets', JFE 66 (1): 3-27.	Investor protection measured: Likelihood of punishment
	Glaeser, E. & A. Shleifer	'Legal Origins', QJE 117 (4): 1193-1229.	Extent of centralization of sovereign control over judiciary

2003	Djankov, S., E. Glaeser, R. La Porta, F. Lopez-de-Silanes, & A. Shleifer	The New Comparative Economics, Journal of Comparative Economics (JCE), 31(4), 595-619.	'Disorder' (expropriation by 'neighbours') v. 'dictatorship' (expropriation by government) trade-off
	Djankov, S, R. La Porta, F. Lopez-de-Silanes, & A. Shleifer	'Courts: The Lex Mundi Project,' QJE 118(2): 453-517.	Legal formalism (in eviction procedures and in collection of bounced checks)
	Glaeser, E., & A. Shleifer	'The Rise of the Regulatory State', Journal of Economic Literature (JEL) 41 (2): 401-425.	Type of law enforcement regime: i. Private litigation ii. Gvt regulation iii. Combination of i and ii iv. Do nothing
	Glaeser, E., J. Scheinkman, & A. Shleifer	'The Injustice of Inequality' Journal of Monetary Economics 50 (1): 199-222.	Subversion of institutions (courts) Aspects of LO: Judicial independence, judicial review
	Beck, T., A. Demirguc-Kunt, & R. Levine	'Law and Finance: Why does Legal Origin Matter?' JCE 31: 653-675.	Aspects of LO: Adaptability of legal system Political independence of the judiciary

2004	Glaeser, E., R. La Porta, F. Lopez-de-Silanes & A. Shleifer	‘Do institutions cause growth?’ Journal of Economic Growth (JEG) 9: 271-303	Polity’s constraints on executive power LO
	Botero J., S. Djankov, R. La Porta, F. Lopez-de-Silanes & A. Shleifer	‘The Regulation of Labor,’ QJE, 119: 1340-1382.	Labour regulations LO
	La Porta, R., F. Lopez-de-Silanes, C. Pop-Eleches, & A. Shleifer	‘Judicial Checks & Balances’, JPE, 112(2): 445-470.	Judicial independence and constitutional review LO
2005	Mulligan, C., & A. Shleifer	‘The Extent of the Market and the Supply of Regulation.’ QJE 120 (4): 1445-1473	Regulatory density (number of pages of regulation in different US states)
	Shleifer, A.	‘Understanding Regulation.’ European Financial Management 11 (4): 439-451.	Enforcement theory of regulation choice: Tradeoff between disorder and dictatorship
	Beck, T., Demirguc-Kunt, A. & Levine, R.	‘Law and Firms’ Access to Finance’, American Law and Economics Review 7(1): 211-252	Aspects of LO: Adaptability of legal system Political independence of the judiciary
	Levine, R.	‘Law, Endowments and Property Rights’, Journal of Economic Perspectives (JEP), 19(3): 61-88.	Protection of property rights LO

2006	La Porta, R., F. Lopez-de-Silanes & A. Shleifer	2006. 'What works in securities laws?' JoF 61: 1-33.	Security law rules: prospectus disclosure, liabilities etc
2007	Gennaioli, N. & A. Shleifer	'Overruling and the Instability of Law.' JCE 35 (2): 309-328.	'Overruling' as one mechanism of revising precedents under common law
	Gennaioli, N. & A. Shleifer	'The Evolution of Common Law.' JPE 115 (1): 43-68.	'Distinguishing' a mechanism of revising precedents under common law
	Djankov, S., C. McLiesh, and A. Shleifer.	'Private Credit in 129 Countries', JFE 12 (2): 77-99.	Legal creditor rights Private & public registries (information-sharing institutions) LO

2008	La Porta, R., F. Lopez-de-Silanes, A. Shleifer	'The Economic Consequences of Legal Origins.' JEL 46(2): 285-332.	Review paper LO ADRI
	Djankov, S., R. La Porta, F. Lopez-de-Silanes & A. Shleifer	'The Law and Economics of Self-Dealing' JFE 88 (2008) 430-465	Anti-Self-Dealing Index (ASDI)
	La Porta, R. & A. Shleifer	'The Unofficial Economy and Economic Development', Brookings Papers on Economic Activity: 1-65.	RoL Cost of complying with labour laws
	Djankov, S., O. Hart, C. McLiesh, & A. Shleifer	'Debt Enforcement around the World' JPE 116 (6): 1105-1150.	Measure of efficiency of debt enforcement (case: bankruptcy of a hotel) LO
	Gennaioli, N., & A. Shleifer	'Judicial Fact Discretion,' JLS 37 (1): 1-35.	Judicial discretion in fact finding
2009	Balas, A., R. La Porta, F. Lopez-de-Silanes, & A. Shleifer	'The Divergence of Legal Procedures' American Economic Journal: Economic Policy, 1(2): 1-45.	Formalism of legal procedure (Djankov et al. 2003 extended to a 1950-2000 period)



2010	Aghion, P., Y. Algan, P. Cahuc, and A. Shleifer.	‘Regulation and Distrust,’ QJE 125 (3): 1015-1049.	Determinants of demand for regulation
	Djankov, S., T. Ganser, C. McLiesh, R. Ramalho & A. Shleifer	‘The Effect of Corporate Taxes on Investment and Entrepreneurship,’ American Economic Journal: Economic Policy, 2(3): 31-64.	Corporate tax rates
	Djankov, S., C. Freund & C. S. Pham	‘Trading on Time’, Review of Economics and Statistics, 92(1): 166-173.	Restrictions to cross-border trade
	Niblett, A., R. Posner & A. Shleifer.	‘The Evolution of a Legal Rule.’ ‘The Evolution of a Legal Rule,’ JLS 39(2): 325-358	Evolution towards efficiency of legal rule (economic loss rule, ELR)
2013	Botero, J., A. Ponce & A. Shleifer.	‘Education, Complaints, and Accountability,’ Journal of Law & Economics 56(4): 959–996.	Education Quality of government
	Gennaioli, N., R. La Porta, F. Lopez-de-Silanes, A. Shleifer.	‘Human Capital and Regional Development’ QJE 128(1): 105-164	Human capital
2014	La Porta, R. & A. Shleifer	‘Informality and Development,’ JEP, 28(3): 109-26.	RoL Cost of complying with labour laws
	Gennaioli, N., R. La Porta, F. Lopez-de-Silanes & A. Shleifer	‘Growth in Regions’ JEG 19: 259-309.	Legal/regulatory barriers to factor mobility across regions LO (control)

2015	Bordalo, P., N. Gennaioli, and A. Shleifer	‘Salience Theory of Judicial Decisions,’ JLS, 44(1): S7-S33	Judicial decisions (decision-making biases – notably salience)
2016	Glaeser, E., G. Ponzetto, A. Shleifer	‘Securing Property Rights,’ NBER WP	Subversion of justice
	Djankov S., E. Nikolova, and J. Zilinsky	‘The Happiness Gap in Eastern Europe’, JCE, 44(1): 108-124	Perceived corruption and government performance
2017	Djankov, S. D. Georgieva, and R. Ramalho	Determinants of Regulatory Reform WP	Regulatory reform as DV
	Bordalo, P., N. Gennaioli, R. La Porta and A. Shleifer	‘Analyst Expectations and Stock Returns: A Tale of Two Tails’ WP	Stock returns as DV