LAW AND ECONOMICS

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Week 13

The law and the economic system

Coase theorem

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Structure of the week

I. Law and economic growth
II. Types of legal systems: law and finance, legal origins theory
III. Empirical effect of legal system – Doing Business
IV. Regulation of bankruptcy and secured credit

I. Law and economic growth

Cooter–Schaefer: ***Law and the Poverty of Nations***

- Requirements of economic growth: cooperation between innovation and capital!

Methods:

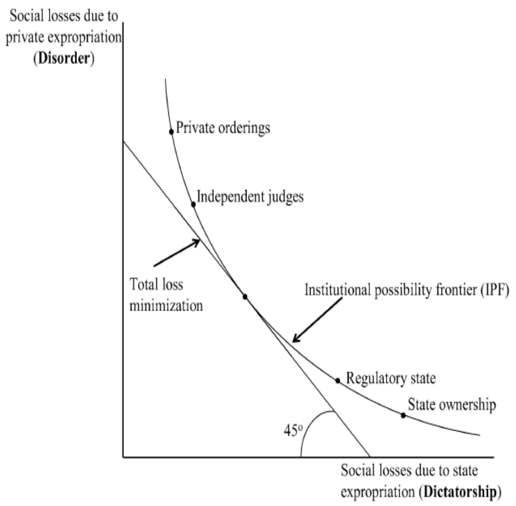
1. Capital in the hands of innovator – needs PROPERTY LAW (intellectual property, safety, etc.)
   - In rem rights (numerus clausus)
   - guarantee against confiscation, expropriation,
   - intellectual property – how to protect it?
   - tort law – negligence vs. strict liability?
2. Credit from capital owner – needs CONTRACT LAW
   - Freedom of contract
   - secured credit,
   - bankruptcy.
3. Unification of capital and innovation (capital takes higher risk) – needs COMPANY LAW
   (and labour law, regulation on accounting etc.)
   - Legal personality,
   - limited liability,
   - defense of (small) investors – against management,
   - regulation of starting business,
   - administration costs.

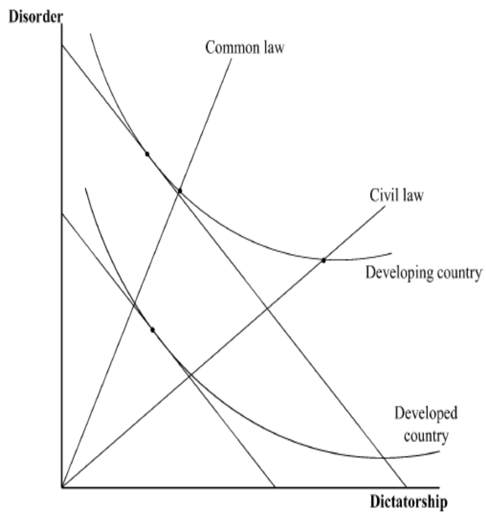
II. Types of legal systems: law and finance

- *Role of courts*
  - Law-making? – c.f. standards

- *Basic institutions in law*
  - Private orderings (~ market)
    - Non-legal enforcement (non-legal methods)
  - Independent judges – private law, private enforcement, default rules, standards, ex post incentives;
    - Problem: increasing inequality (oligarchy): pressure on courts, better lawyers, more patience
  - Regulatory state – ex ante regulations, public control, public enforcement;
    - Problem: imperfect legislators, regulators – imperfect regulation
  - State ownership – government provision

- *Basic trade-off: disorder vs. dictatorship*
  - Disorder: no safety, violence (anarchy, oligarchy)
  - Dictatorship: overpowered government, threat of confiscation
- Technological connection – institutional possibility frontier
  - 'Marginal return': stronger dictatorship reduces anarchy less and less
  - Different position and shape in different countries…
- Objective: minimizing social costs (45° line – no ideological preference)
  - Different IPFs – different optima for different countries





- Shape of institutional possibility frontier?
  - Developing countries further from origin – higher loss: less human capital, less resources, larger problems in tax administration, etc.
  - Steepness – i.e. factors affecting the threat of anarchy:
    - ethnic conflict,
    - lack (weakness) of social capital (i.e. trust),
    - weakness of human capital,
    - inequality.
- *Regulation vs. private law?*
  - *Mandatory vs. default rules*
  - *Public vs. private enforcement*
  - *Rules vs. standards*
  - *Ex ante vs. ex post decisions*

- *Path-dependence:*
  - *Legal families / legal origin: see figure – common law vs. French system: legal system determined by this, not by local optimum…*
  - Why differences?
    - Theory of medieval origins: in 12-13th Centuries France faced anarchy, oligarchy (need for centralized power – centralized administration of courts) vs. England: court as a defense against king's autocracy.
    - Explanation based on revolutions: England: courts supported the Glorious Revolution (i.e. defense against king's autocracy) vs. France: courts sided with the centralized power of Ancien Regime.
    - Colonisation – French paradox: former colonies stick to the French system (after independence) vs. France returns to stronger courts (private law).
  - Empirical differences among legal families today
    - Law and Finance literature.
    - World Bank Doing Business program (www.doingbusiness.org)

III. Doing Business

- Main points important for economic growth
  - See model of Cooter and Schaefer
- Critics: based on common law
  - Law and finance model: common law (and other Anglo-Saxon institutions) are not appropriate for every countries.
  - Example: financing innovation from institutional credit or equity (capital market). More or less: Continental vs. Anglo-Saxon institutions.
  - Credit market, institutional credit more advantageous (than capital market) if
    - severe classical agency problem – creditor = strong control
    - many small companies – high fixed cost for entering the capital market,
    - only few new companies – banks are worse in assessing special risks (capital market: different sources specialise at different types of risks),
    - physical innovation is typical – disadvantage of banks in risk-assessment,

        - weaker courts – equity investors (especially small investors) need strong courts more (credit contracts are easier to interpret and enforce).

Institution	Output	Doing Business
Procedural formalism	Time to evict nonpaying tenants Time to collect a bounced check	Enforcing contracts (procedures, time, costs) Regulating secured credit (creditor right)
Judicial independence	Property rights	Registering property (procedures, time, costs)
Regulation of entry	Corruption Unofficial economy	Starting business (procedures, time, costs, minimum capital) Dealing with construction permit – warehouse (procedures, time, costs) Paying taxes (procedures, time, costs) Trading across border (procedures, time, costs)
Company law, security law	Stock market development Firm valuation Ownership structure Control premium	Protecting investors
Bankruptcy law	Private credit	Regulating credit market (secured credit, information) Closing business (procedures, time, costs)
Government ownership of banks	Interest rate spread	
Government ownership of media		
Conscription		

IV. Bankruptcy and secured credit

- Safety for creditors (promisees): what if non-performance?
    - Individual guarantee (secured credit) vs. collective guarantee (bankruptcy)
        - Individual: no need for others – call for payment, enforcement (seizure), pledge …
- *Problems*
    - Selection (information): signaling, information about quality of debtor
    - Moral hazard – owners (shareholders, managers) receive profit but do not bear loss

- Wasteful competition – bankruptcy
    - Individual interest is to compete for the assets
    - If it is too early – assets are extracted which would enable efficient operation (i.e. reduce payment to others)

- *Secured credit*: priority
  - Numerus clasusus – 'runs with asset' (except buyer in good faith without information)
  - Forms : possessory and mortgage
    - Possessory: possessed by creditor vs. mortgage (non-possessory): debtor can use in production
  - Enforcement
    - Role of court – theoretically, court must order foreclosure (vs. USA: repossess without court, role of sheriff)
    - Division of payoff between creditor and borrower: if sold the difference goes to the borrower or remains as unsecured debt (vs. USA: recourse loan – foreclosure finishes the credit relationship, no unsecured debt)
    - BUT: in Hungary – agreement about 'joint sale' is possible (no need to involve a court, enforcement of sale)
      - BUT mandatory rule: lex comissoria (no transfer of ownership to the creditor), and payoff rule
    - Why? Defense against *fire sale*: creditor is not interested in searching for higher price if credit is covered (due to search costs)
  - Registration – information for third party
- *Bankruptcy*: temporary moratorium of payments – during this: chance for agreement
  - Trustee (appointed by court) manages the process (reduced decision rights of management).
  - Creditors are assorted into payment priority groups. (Those who are lower in the priority order are paid only after higher priority groups have been wholly satisfied.)

Solutions: how to handle the problems?

- Adverse selection
  - secured credit
  - basic assumption: good debtors offer collateral – lower chance of non-performance, lower chance of losing
  - But PARADOX: inflexibility (e.g. possessory or due to the transaction cost of transfer) => good debtor may have a *higher* cost of collateral due to higher cost from inflexibility
- Moral hazard
  - Indirect effect: residual claimants are created (first group not fully paid),
  - Residual claimants interested in control,
  - BUT: collective action problem =>
  - bankruptcy law: by grouping creditors, it reduces the size of groups (number of residual claimants)
  - Direct effects of secured credit: loss is paid (partially) from debtor's assets
- Wasteful competition
  - Constraining payments, foreclosure (e.g. Hungarian law – no foreclosure after declaring bankruptcy)

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We welcome any questions, critical notes or comments we can use to improve it.
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