Judges' Cognition and Market Order¹

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Abstract

We argue that during the crystallization of common and civil law in the 19th century, the optimal degree of discretion in judicial rulemaking, albeit influenced by the comparative advantages of both legislative and judicial rulemaking, was mainly determined by the anti-market biases of the judiciary. The different degrees of judicial discretion adopted in both legal traditions were thus optimally adapted to different circumstances, mainly rooted in the unique, market-friendly, evolutionary transition enjoyed by English common law as opposed to the revolutionary environment of the civil law. On the Continent, constraining judicial discretion was essential for enforcing freedom of contract and establishing a market economy. The ongoing debasement of pro-market fundamentals in both branches of the Western legal system is explained from this perspective as a consequence of increased perceptions of exogenous risks and changes in the political system, which favored the adoption of sharing solutions and removed the cognitive advantage of parliaments and political leaders.

Key words: legal systems, institutional development, law enforcement.

JEL codes: K40, N40, O10.

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1. Introduction

Some recent studies claim that common law legal systems provide superior solutions to those developed in the civil law tradition.² We develop and test an alternative hypothesis, grounded on judicial behavioral biases and self-selection, according to which both common and civil law supported a transition to the market economy adapted to local circumstances. In particular, we argue that greater judicial discretion, seen by us as the main difference between the two legal systems, was introduced in civil law jurisdictions to protect, rather than limit, freedom of contract against a potential judicial backlash. This protection was unnecessary in England, where free-market relations enjoyed safer judicial ground mainly due to their relatively gradual evolution, their reliance on practitioners as judges and the earlier development of institutional checks and balances that supported private property rights.

We therefore build on the argument that both common law and civil law facilitated freedom of contract and were efficient in the 19th century and that both became interventionist and potentially inefficient in the 20th century as a result of common causes (Rubin, 1982). We argue that both common law and civil law solutions were well adapted to their particular circumstances and point out the agency and cognitive roots of the changes experienced by both systems in the 20th century. This provides a novel perspective on normative issues in this area, suggesting that the value of legal systems depends not only on their specific traits but also on good environmental fit. Our aim here is to identify the local circumstances that defined the balance of the institutional trade-off and the forces that are shaping current tendencies, sharpening the self-

² Mainly, La Porta *et al.* (1997, 1998, 1999), Mahoney (2001) and Djankov *et al.* (2002, 2003).

selection argument we developed in Arruñada and Andonova (2004) in three ways: explaining the behavioral roots of the anti-market cognitive bias; testing the influence of this bias in the creation of common and civil law; and using the argument to explain the convergent, anti-market evolution of both legal systems in the 20th century.

The remainder of the article is organized as follows. In Section 2 we analyze the specialization advantages and costs of the judiciary, and state our hypothesis concerning the evolution of common and civil law. We argue that common law countries featured greater judicial discretion because, given their more gradual evolution away from the Ancient Regime and their reliance on practitioners for judicial positions, judges were in a better position to understand the intricacies of market relations and did not, therefore, threaten the development of a modern market economy. Civil law reformers, in contrast, limited the discretion previously enjoyed by judges who were ill-cultured about the market, and placed more rulemaking in the hands of the legislature in an attempt to shelter free-market relations, especially freedom of contract, from judicial backlash. Both of these policies, promulgating codes and reducing judges' discretion, shared the same goal, that of protecting freedom of contract and promoting freedom of contract where it had been held up by mandatory rules and judicial regulation of private contracts. We then confirm the consistency of our argument by reviewing the relevant historical evidence. In particular, Section 3 analyzes the evolution of both legal traditions, emphasizing their divergence until the 19th century and their convergence in the 20th century. We argue that differences in judicial training first shaped the common tendency towards market-based relationships in England and on the Continent in very different ways. Later on, the convergence experienced during the 20th century was largely triggered by the democratization of political systems, which removed the cognitive advantages previously enjoyed by political leaders.

Section 4 concludes by examining some policy implications and emphasizing the importance of local circumstances for designing market institutions in transition and developing economies.

2. The allocation of rulemaking powers

The two key elements of a market-friendly legal environment are rules and courts. Rules, given by customs, previous judicial sentences and statutes, provide parties with a detailed default contract and also set the terms of trade when the law so mandates. Courts fill in the gaps in the contract and the received rules, define the terms of trade for all remaining unforeseen contingencies and provide last-resort enforcement of contractual agreements. Courts also perform rule-related functions: from merely enforcing statute law to creating and modifying rules. The presence of courts should therefore save on transaction costs for all parties.

2.1. The trade-off of judicial discretion

We assume here that rules may be made by a central authority, like the legislature, or by courts. In addition, rulemaking by courts is more decentralized the greater the freedom each court has when deciding for its jurisdiction. Conversely, judicial rulemaking is more centralized when low-level courts must decide according to jurisprudence exclusively produced by some higher courts. Both of these dimensions of judicial discretion—the rulemaking authority enjoyed by the judicial system versus the legislature and the decentralization of judicial powers—are usually positively correlated, which allows us to treat judicial discretion as a single design variable. From this perspective, the main difference between legal systems therefore hinges on the degree of rulemaking discretion enjoyed by courts.

The idealized model of common law, as it finally emerged in the 19th century, presents greater discretion for courts because statute law plays a minor role and each court is relatively free to rule, originally even with respect to precedent. In contrast, the civil law model, as crystallized more or less at the same time, gives priority to legislative rulemaking. Courts are instructed to enforce the received law and, even for filling gaps in rules and contracts, lower-level courts have to comply with the jurisprudence created by higher courts.³

All kinds of rulemaking systems are likely to suffer inefficiencies as a consequence of participants' self-interest, lack of information and limited rationality. Both legislatures and judges may fail to achieve the public good because they pursue private interests or, even when pursuing the public good, they fail to ascertain which rules are most suitable, often triggering rent-seeking by parties to private contracts. We will argue that, in the development of the Western legal system, cognitive failures more than any other factor determine the optimal degree of judicial rulemaking. In our understanding, differences in costs and benefits associated with self-interest were secondary or required a cognitive failure to become relevant.

2.1.1. Self-interest

It is well known that legislatures suffer from agency and collective action problems, which can be palliated but not fully avoided by political competition and institutional checks and

³ The different scope in the rulemaking capacity of the judge is not affected by the fact that even the ideal models of the 19th century share many other features. For instance, in both models, courts form a hierarchy, and superior courts can overrule decisions from lower courts, which in any case have substantial capacity for interpretation, as is evident from the fact the US appellate courts defer broadly to the trial judge's and jury's findings of fact (Posner, 1998: 584-586). The presence of these common

balances. As a consequence, a large number of mandatory rules that today govern private contracting are alleged to neither improve individuals' rationality nor avoid externalities but simply to redistribute wealth.⁴ Decentralized rulemaking by the judiciary is similarly hindered, however, by the private interests of all participants in the litigation process, judges included,⁵ who also show themselves as self-interested agents, sometimes in obvious ways that lead to corrupt judges and congested courts.

We will assume that the rent-seeking costs of legislative rulemaking do not change with the degree of judicial discretion. This assumption is mainly grounded on the fact that the legislature retains full powers whatever the degree of rulemaking discretion granted to courts.

Consequently, even when courts are initially given full discretion, the legislature may enact laws that end up constraining them. This is true historically, as the common law legislature had always enjoyed the authority to change common law rules, while even the highest courts were constrained by precedent (Manne, 1997: 20). One clear example is the final acceptance of the New Deal by the US Supreme Court. We are certainly not arguing that legislation involves no transaction costs but rather that these transaction costs were not significant for the choice between the levels of judicial discretion characterizing the ideal common law and civil law models of the 19th century because of, first, variability in rent-seeking potential across legal fields and, second, legislative residual power. Similarly, the extent of judicial rent-seeking

characteristics should not obscure the existence of a basic difference in the extent of judges' rulemaking discretion.

⁴ See, among many others, Tullock (1967), Stigler (1971), Peltzman (1976), Buchanan (1980), Becker (1983).

⁵ On the objective function of judges, see Posner (1993) and Macey (1994). Judges' behavior is described, for instance, in Baum (1997).

should not be substantially altered by the degree of rulemaking discretion enjoyed by judges, who do not need to be producing rules in order to become corrupt or indolent.

In addition, the fields of law (property, contract, tort) and the prevalence of default rules based on custom and established doctrine, which represent the bulk of legislation in the 19th century (Benson, 1989), did not offer much potential for profitable rent-seeking at the legislative level. On the contrary, these fields may be more profitable for rent-seeking at the judicial level, by litigating specific contracts, but this only happens if the courts suffer cognitive biases that might be used by the parties. Decisions on discretion in judicial rulemaking therefore follow a cognitive rather than a self-interest rationale.

2.1.2. Information

The distribution of rulemaking power between legislators and courts also poses the typical problem of decentralization with respect to availability and incentives to produce the relevant information as well as the costs of transferring information (Aoki, 1986; Sah and Stiglitz, 1988; Jensen and Meckling, 1995).

Decentralized judicial rulemaking is usually thought to be more responsive to local and changing market circumstances because of its limited geographical scope, its proximity to market participants and its relatively speedy process. In addition, in the presence of local courts with overlapping jurisdiction, decentralized rulemaking is driven by competitive forces toward constant improvement (Zywicki, 2003).

In contrast, centralized rulemaking and, in particular, statute law lack similar competitive pressures, especially in the short term (even if international mobility of resources is reducing this difference), but they enjoy an advantage over decentralized rulemaking in codifying default rules

dispersed in custom, jurisprudence and doctrine, as well as in developing standards for new kinds of contracts.⁶ Centralized rulemaking may also be superior in enacting mandatory rules that improve individuals' rationality and avoid negative externalities, with which a decentralized process of rule emergence will often fail to deal. A mandatory statute, in contrast, has the potential to force coordination, internalize network effects, and thus overcome the drive towards local instead of global efficiency which characterizes decentralized rulemaking (Harnay, 2002).

As in many decentralized decisions in all kinds of organizations, these opposing factors are hard to add up to a unique criterion. If anything, one could argue that the greater scope of markets after the industrial revolution, especially after the advent of transportation technologies, called for more centralized solutions. We are also inclined, however, to discard the availability and production of information as a decisive factor in explaining the observed differences in the rulemaking power allocated to courts by common and civil law. The reason is that larger markets may call for greater coordination of rules, but this can be achieved by strengthening the binding character of precedents, as common law did during the 19th century.

⁶ Compare Schwartz (1994, 1998), who suggests that the role of the state should be minimal because the cost of creating rules is too high when parties are as heterogeneous as they are today and standards are too imprecise to be of much value. Moreover, information asymmetry hindering private contracting cannot be avoided by the state doing in law what the parties cannot do in contract (which may also explain experimental results such as those in Korobkin, 2000). Schwartz's view deals with serious limitations of law-making but probably underestimates the private and social costs of contracting in the absence of default rules and standards, as well as minimizing the role of rules in reducing the impact of information asymmetry. See Goetz and Scott (1985), Ayres and Gertner (1989), and, for a brief account and references on the power of default options, Choi *et al.* (2003).

2.1.3. Biased rationality

Following the growing literature on decision biases and heuristics,⁷ much attention in this field has been paid recently to the biases that judges may suffer when issuing sentences. Guthrie, Rachlinski and Wistrich (2001) show empirically, by means of a questionnaire answered by 167 federal judges in the US, that these judges fail mainly by relying on irrelevant starting points to construct inferences (“anchoring effect”), by overestimating both the ex ante predictability of events after they occur (“hindsight bias”) and their own ability to reach correct decisions (“egocentrism”). Judges also treated equivalent gains and losses differently (falling prey of “framing effects”) and ignored relevant background statistical information in favor of irrelevant individuating information (a conduct known as “representativeness bias”). Experimental results are difficult to interpret conclusively, however. For instance, in their seemingly biased responses, judges may well be considering the allegedly irrelevant cue provided by experimenters (such as a defendants’ move for dismissal when testing for anchoring effects) in the context of their previous court experiences, which could deny the alleged irrelevance of such a move.

Perhaps the most interesting of these biases is related to hindsight, that is, the tendency to attach greater probabilities to events that have occurred than to those that have not.⁸ Its presence in the legal system and the strategies used to handle it have been studied mainly in the context of negligence judgments (Rachlinski, 1998), but hindsight bias may have wider effects when the legal system allows judges to consider the balance of compensation between the parties, as it did

⁷ See, in general, Kahneman and Tversky (2000) and Gilovich, Griffin and Kahneman (2002); in law and economics, Korobkin and Ulen (2000) and Sunstein (2000); and, for a general discussion, Smith (2003).

in the Ancient Regime under the influence of Canon law. In such cases, judges will tend to give too much weight to ex post apparent imbalances without taking into account that such imbalances are often only the result of random events which could have led to different outcomes in which the net balance of compensation would have been different. Consequently, the bias motivates parties to devote resources both to using the bias in their benefit and to preventing it, so that contracts were often structured in order to avoid this type of opportunism. The presence of hindsight bias may therefore support a policy constraining the freedom of judges to evaluate the balance of compensation between the parties.

Most of these decision failures may be contained by reducing judicial discretion. For example, Rachlinski (1998) explains the set of constraints used by the legal system to reduce the effect of the hindsight bias in courts' decisions. These constraints include taking compliance with norms as evidence of reasonable care in negligence cases; using secondary evidence of non-obviousness in patent cases; requiring more evidence than injury as proof of negligence; suppressing evidence on subsequent adoption of remedial measures, which would exacerbate the hindsight bias; and adopting a "no liability" rule for certain situations, as with the business judgment rule in corporate law.⁹

These biases, however, cannot explain the different path followed by common and civil law, because both judiciaries suffer these biases to a similar extent. If anything, greater reliance on popular juries would advise less discretion in common law, the opposite to the historical pattern.

⁸ Evidence on hindsight bias, a phenomenon first described by Fischhoff (1975), has been accumulating over time (Christensen-Szalanski and Willham, 1991).

⁹ See Section III in Guthrie, Rachlinski and Wistrich (2001) for a broader analysis.

2.1.4. Ecological rationality: The unnaturalness of markets

Decision failures of this kind are arguably not the most important cognitive bias for the optimal allocation of rulemaking power. In particular, courts may be systematically biased towards considering an evolutionary outdated concept of justice. A more comprehensive explanation of *both* types of failure can be given in terms of “ecological” rationality (Simon, 1956; Tooby and Cosmides, 1992; Gigerenzer and Todd, 1999), which is bounded not so much because it is subject to constraints as because it is adapted to certain environments: first, to our common ancestral “environment of evolutionary adaptedness” (Bowlby, 1969; Barkow, Cosmides and Tooby, 1992; Crawford, 1998) and, second, with more malleable consequences, to our learning environment.¹⁰ Therefore, even benevolent rulemakers may systematically rule against efficiency because their instincts predispose them to solutions which were adaptive in our evolutionary past but are no longer adaptive in our current environment.

In particular, given that, in the evolutionary time scale, market relations are very new, they tend to be systematically misunderstood by poorly-cultured judges, leading to misguided justice.

¹⁰ The importance of biases documented by experimental psychology and economics has been questioned because experiments may fail to face decision-makers with relevant situations, oversimplifying the informational structure of real problems. See Cosmides and Tooby (1996), Gigerenzer and Goldstein (1996), Koehler (1996) and the works in Gigerenzer *et al.* (1999). The usefulness of evolutionary psychology in legal analysis has also been criticized by Rachlinski (2001), Ulen (2001) and Korobkin (2001), the main point being its inability to produce univocal predictions. See Jones (2001) for a defense of evolutionary psychology, as well as Korobkin (2001) for a much-needed integrative view that defends combining rational choice and evolutionary psychology with empirical analysis in a multi-disciplinary enterprise.

Findings in evolutionary psychology support that these failures may respond to instinctive human traits being applied out of context.¹¹

In particular, judicial proclivity to redistributive justice and to balanced compensation fits in neatly with the prevalent role that sharing, authority and reciprocity have arguably played in most human interaction during our ancestral environment (Fiske, 1991; Cosmides and Tooby, 1992). The apparent disregard that some judges show for the effect of their rulings on later trade seems also adapted to the ancestral environment in which trade was only made on the basis of reciprocity and most interactions took place among relatives and personal contacts. This probably causes a bias in favor of identifiable individuals and against anonymous parties,¹² a bias which is also likely to be damaging to judicial rulings. Such biases are more serious when an element of abstraction is present in the transaction because human brains, in contrast to their more intuitive understanding of barter of physical goods, show intuitive resistance to grasping the value added by providers in abstract transactions, mainly those which involve intangible

¹¹ See Fiske (1991) and Cosmides and Tooby (1992). These findings provide a common and more solid ground to the pioneering and rival arguments by Polanyi (1944) on the limits of market-type relations and the resistance of societies to the dominance of such relations; and, mainly, Hayek (1944, 1960, 1973-1976, 1988) on the opposing rules of the “extended order of cooperation through markets” and the more intimate and personal order. The evolutionary argument helps in explaining both the difficulties for “disembedding” the economy, in Polanyi’s terms, and the tendency to apply personal rules to the market order, in those of Hayek. The danger that the primitive collectivistic leanings of human beings pose to the market has also been stressed by Smith (2003) from the perspective of experimental economics.

¹² Favoring people we know is consistent with findings that people faced with cooperation games cooperate more when they are allowed to communicate than when they play against anonymous parties (Dawes, McTavish and Shaklee, 1977; Isaac, McCue and Plott, 1985; Isaac and Walker, 1988; Valley *et al.*, 2002), even for one-shot interactions and especially as communication opportunities increase (Ostrom, Walker, and Gardner, 1992). In addition to this bias, probably rooted in mental mechanisms which evolved to facilitate cooperation, human beings have been shown to find it very difficult to make more than a few cycles of mental inferences in experimental settings (Nagel, 1995; Camerer, Ho and Chong, 2003). This difficulty could hinder the full evaluation of rulings that affect market transactions, given that markets act through long series of overlapping effects.

services and inter-temporal exchange, such as the use of capital and payment of interest; elusive services such as mediation and arbitrage; and also services provided by human capital that has been created through previous and therefore now invisible investments, like professional services. Not by chance, all these trades have historically been among the first to be restricted or forbidden. More recently, the judicial apprehension against adhesion contracts can be traced to the same cause, if we think of the different treatment that courts give to such contracts and to physical products, even though both are complex designs produced by competitive firms. As Manne (1997: 34) pointed out, judges are willing to void a clause because the buyer does not understand it but they do not cease enforcing the purchase of a car because the buyer does not understand its engineering.

This argument fits in well with some tendencies in judicial rulings. A common consequence of instinct are rulings, believed to be “fair” for an individual case, which favor the weaker party to a contract but, as a result, harm all weak parties to future contracts, who will end up paying higher prices or will be unable to contract. If, for example, a ruling in an insolvency case considers the debtor’s poverty, it might resolve an individual problem but, to the extent that it prevents creditors from collecting their debts, it hinders all loans that might be subject to similar rulings in the future. As a result, the ruling also harms anonymous potential debtors of a similar type to the beneficiary of the judgment, who are deprived of access to credit or will have to pay additional interest. In a similar vein, the substitution of the employment at will doctrine for unjust dismissal doctrines in several US states has been found to have damaged new workers in those states causing, among other consequences, significant increases in temporary aid (Miles, 2000; Autor, 2003). The argument is also applicable to courts’ bias against the exercise of quasi-judicial decision rights by the parties, even when the parties themselves have explicitly

contracted for these quasi-judicial rights ex ante. Such an arrangement is often efficient when one of the parties has the best information and incentives to carry out such a judicial task because of its central position and reputation.¹³ This quasi-judicial activity, crucial when controlling a network of producers, is undermined in court when judges interpret the subject matter of litigation as deriving from greater bargaining power on the part of the larger party and not from the ex post exercise of judicial functions that were contractually allocated ex ante by the parties. Such ex post contractual asymmetry tends to be perceived by judges in different countries as unfair and they therefore tend to correct it, thus inefficiently restricting the quasi-judicial powers which the private contract itself allocates to one of the parties and leading the parties to introduce additional clauses with the purpose of avoiding judicial intervention (Masten and Snyder, 1993).

In sum, when insufficiently *cultured about the market*,¹⁴ judges keep sentencing as if they were living in a non-market economy in which transactions are relatively unique, concrete and reciprocal events, in which no credit element is involved.¹⁵ Do legislators also suffer this anti-market bias to a similar extent? For some issues, like those related to identification of

¹³ This explains why car manufacturers are assigned rights in relation to their dealers to define their obligations, assess their performance and punish or reward them accordingly (Arruñada, Garicano and Vázquez, 2001). Many retailers carry out similar quasi-judicial functions with respect to their suppliers (Arruñada, 2000).

¹⁴ Two remarks are in order. First, the “culturalization” that we are referring to is linked to an understanding of how the market works and has no necessary connection to the amount of formal training. Second, judges are influenced by cultural factors, such as their education and religion, but these cultural influences always operate on a biological basis, which is constrained by our ancestral environment. See Barkow, Cosmides and Tooby (1992), and, for introduction and updated references, Cosmides and Tooby (1994) and Pinker (1997, 2000).

¹⁵ Our emphasis on judicial biases complements recent applications of evolutionary psychology to legal theory, most of which focus on how the law interacts with evolved minds considered as, for instance, citizens, holders of liability, contractual parties or criminals (see, for example, Jones [1997] and, for extensive references, Jones [2001: 209]).

individuals, it is clear they do not, because the legislature generally rules in more abstract terms and for anonymous parties, at least in private law, and not with respect to specific cases, while judges have personal contact with the parties. However, this supposed advantage would affect all legal systems equally and cannot therefore explain the discrepancy in judicial discretion between the common and the civil law.

Furthermore, for most issues, legislatures are quite willing to follow redistributive policies, abrogating contracts if necessary, as occurred often in history with debt contracts.¹⁶ In general, the existence of a cognitive gap in favor of the legislature hinges on the structure of the political system. We maintain that legislators did not suffer a similar anti-market bias in Continental Europe in the 19th century, opening a cognitive gap between legislators and judges, because the political system left the government in the hands of intellectual elites, who had market experience and could also contemplate the profit opportunities brought about by economic change, while the continental judiciary was still staffed by a sort of nobility raised and anchored in the Ancient Regime. This is highly visible in the function of parliaments which, at the time, were considered the finders of the true and rational solution—the “law”. The intention was that the law should endure and be applied universally. In contrast, parliaments evolved in the 20th century as weighing machines or battle grounds that establish equilibriums amongst private interests, and produce mere “rules” according to the momentary will of the prevailing consensus,

¹⁶ An example is the farm foreclosure moratorium legislated in the USA in the 1930s, upheld by the Supreme Court in 1934 (Alston, 1984).

with no pretence of permanence and often in violation of freedom and equality as both concepts were previously understood.¹⁷

2.2. Hypothesis: The pro-market orientation of the Western legal system

The assumptions behind our cost and benefit analysis of judicial rulemaking discretion—in particular, the insignificance of self interest—are equivalent to assuming a benevolent legislator who wants to create a market economy. Historically, market institutions were created in a more spontaneous manner in common law, while in civil law they were subject to a greater degree of intervention by the builders of the liberal state in the 19th century. In analyzing civil law, we can therefore personalize these state builders who wanted to create a market economy, whereas in common law we have to assume a fictional social planner. The difference is not substantive, however.

This benevolent legislator will allocate rulemaking discretion to the judiciary considering the specific circumstances in each country. In particular, legislators creating market institutions may restrain judicial rulemaking to avoid judges' opposition to freedom of contract and market exchange. From this perspective, both Western legal systems might therefore be understood as adaptations to specific conditions that allow the development of effective market-supporting institutions in different historical circumstances.

¹⁷ A process described, if not explained, by Schmitt (1936), which is now often seen as an exaggeration of democracy to the detriment of liberty (for instance, Zakaria, 2003). In particular, see also how, for England, law was something to be “deduced”, not to be “created” before the Reform Act of 1832 (Pipes, 1999: 127).

In essence, market relations were introduced sooner in England, as many feudal constraints were abrogated earlier and the industrial revolution also took hold earlier. These changes also took place more slowly, without such drastic changes in property rights as on the Continent. This creeping evolutionary process, together with a generalized respect of private property, gave time for judges and the public to be cultured in an intellectual tradition more propitious to the free market. In most of Continental Europe, however, most of the constraints that the Ancient Regime imposed on trade and movement of land and people were suppressed later and more abruptly, often together with substantial redistribution of property. Most judges were then still the intellectual product of the Ancient Regime, in addition to forming part of the former ruling elite. Their lack of understanding of the market and disrespect for property rights explain why the defenders of contractual freedom responsible for designing the institutions for continental markets opted for constraining judicial discretion.¹⁸ From this perspective, we explain the restrictions imposed on judges in the civil law tradition, whereby they had to subject their rulings to contractual terms (whether defined explicitly by the parties or tacitly by default through statute law and jurisprudence) as an institutional control designed to protect an unnatural creation—market contracting—from our ancestral collectivistic, reciprocal and redistributive instincts.

¹⁸ It is possible that judicial discretion was to a certain extent already limited in the Roman law tradition from the 12th century but this did not prevent later evolution from *additionally* constraining judges' discretion.

3. A historical overview

Our argument is broadly consistent with the history of both legal traditions. We will, first, confirm that institutional checks and balances and judicial training shaped the common tendency towards market-based relationships in England and on the Continent in very different ways. Second, we will conceive the convergence of Western legal traditions during the 20th century as a restoration of instinctive social patterns, made possible by the democratization of the political system, which removed the cognitive advantage of parliaments and political leaders.

3.1. The evolution of common law and its judiciary

The evolution of common law was shaped by the judges who coined most of its rules. The appointment of English judgeships was dependant to a much greater extent than elsewhere in Europe on professional practice, as English judges were chosen from among barristers. As such, they had seen the world from the perspective of the parties they had represented and were therefore more familiar and educated about the intricacies of the incipient market economy (Duman, 1982: 29; Abbott and Pendlebury, 1993). The understanding by English judges of the fundamentals of the market economy also benefited from the early checks imposed on royal authority which, by limiting the ability of the Crown to sell new public offices (Swart, 1980), gave judges the ownership of secure investments (the judgeships), in addition to creating an environment of general respect for private property (North, 1981; North and Weingast, 1989)¹⁹.

¹⁹ For some historians, this view exaggerates the role of the English Parliament in creating a market-friendly institutional environment (for example, Carruthers, 1990; Clark, 1996; Epstein, 2000). This

As a result, the transformation of the feudal economy spurred on by Parliament received an early ally in the English judiciary which, by making incremental changes in long-standing customs, supported the evolutionary development of common law toward the new market order.

The Industrial Revolution brought about larger potential markets, which required more developed and uniform rules. Common law satisfied these demands during the 19th century, mainly by introducing some well-tested, Roman law solutions and strengthening the doctrine of binding precedent, by which courts are reluctant to interfere with principles established in previous decisions (*stare decisis*). Despite these changes, however, the development of common law towards more market-oriented institutions remained evolutionary in nature because, first, the introduction of Roman law took place mainly at the level of concepts, as codification attempts did not succeed, arguably because they were less necessary than on the Continent.²⁰ Moreover, the legal development of common law, which supported the huge economic development of the 19th century, remained almost exclusively the work of courts, with few legislative initiatives. Second, the strengthening of the doctrine of binding precedent did not divert common law from its evolutionary path, as precedents could still be overturned with relative ease by distinguishing

criticism, however, does not question the fundamental point that the English Parliament exerted much greater control over the Crown. In a similar vein, there were also some well-developed markets on the Continent, specifically credit markets (for instance, Hoffman, Postel-Vinay and Rosenthal, 2001). When considering these markets, the dominance of agriculture in the economies of the 16th to 18th centuries should be kept in mind, however, as well as the likely fact that market relations for trade in goods had been well-established in some areas of the Continent earlier than in England, as shown by the history of Italian cities in the Middle Ages, the Hanseatic League or the Champagne fairs. This also applies, in particular, for ascertaining the importance of merchant law. The challenge for those creating the institutions of the modern market was to develop institutions not only for trade but, perhaps, mainly for transactions among non-merchants.

²⁰ This divergence in codification is consistent with the argument that Continental codification was driven by the need to constrain judges, rather than to systematize the law, which probably was as unsystematic in England as on the Continent.

the case at hand from the one in the precedent.²¹ Together with the right of appeal, it was, however, important in ensuring consistency and equality across increasingly wider markets (Manne, 1997: 13-19).

3.2. The conscious design of modern civil law

The development of the law on the Continent followed a different path, largely because of the way judges were selected and trained. Not only were they appointed without previous practice (Doyle, 1996) but their training was based on the university study of *ius commune*, a doctrinal system developed mainly by scholars proficient in Roman and Canon law, and only secondarily affected by statutes and judicial rule-making. It has been claimed that both the lack of practice and these doctrinal influences made Continental judges more resistant to capitalist wealth accumulation and hindered their understanding of market transactions (Taylor, 1967). Judicial respect for property rights also probably suffered because judgeships were often expropriated by kings who were free to sell new judicial offices (Doyle, 1996; Swart, 1980) and interfere with private property (North and Thomas, 1988; Pipes, 1999), hampering the secure development of property rights. Thus, the judiciary on the Continent did not gradually erode the constraints of the Ancient Regime. On the contrary, civil law judges hindered the development of new market order, for both political and cognitive reasons. A radical change in both the law and the administration of justice was therefore necessary.

²¹ The demand for more binding precedents during the 19th century is understandable, because of the greater geographical scope of the market, triggered by better transportation technologies (canals, rail, steamships) which probably required faster adoption of legal standards over a wider area.

Consequently, the new legal order was implemented in a top-down fashion even if it was essentially a liberal (that is, free-market-enhancing) initiative. Legislators issuing Civil and Commercial Codes in the 19th century aimed at both systematizing custom and case law, mainly through default rules, and mandatorily regulating what we would now call externalities. Their reliance on case law led to the codification of well-tried default rules, when available, allowing parties to adapt contracts freely to their circumstances by writing specific clauses into them. As a result, 19th century codified law was mainly the distillation of customary law, and codes represented a combination of local customs, local laws and subsidiary Roman law (Sirks, 1998).²²

In addition, most mandatory rules enacted at the time had a clear function in grounding the market economy. Some of the most important of these mandatory rules are a direct consequence of the political principles of freedom and equality, which have contractual correlates in terms of mandatory freedom of contract and mandatory equality of all contractual parties. In contrast, previous law often granted higher probative status to the word of employers than to that of employees. Market support was also behind the emphasis of liberal reforms in precluding the future entail of property, thus facilitating the emergence of a proper market for land.²³ Property law provides another interesting case in its treatment of a particular kind of externalities, those caused in the Ancient Regime by the proliferation of property rights and their enforcement as

²² In particular, codifiers of commercial law, from the Code Savary in 1673 to the Uniform Commercial Code of 1970, relied heavily on the *lex mercatoria*, developed by merchant courts (Benson, 1998).

²³ Notice that, by the 17th century, common law had already developed the Rule Against Perpetuities, which enabled a court to declare void future or postponed interests in property that might possibly vest outside a certain perpetuity period. The goal seemingly was also to prevent land being tied up and to protect free markets.

rights *in rem* even when they remained hidden to third parties. During the 19th century, land law reform and the creation of land registers led to a stricter policy of *numerus clausus* in most European countries—that is, the legal system reduced the number of rights that could be enforced *in rem*, enforcing the rest as mere personal (in other words, contractual) rights. In parallel, publicity was increasingly required to produce rights enforceable *in rem*. Both of these constraints seem to diminish parties' freedom to produce rights *in rem* but in fact are essential for making some of them possible, reducing transaction costs in land and, in particular, making it possible to use land as collateral for credit (Arruñada, 2003), precisely the declared purpose of the reforms in this area.

Furthermore, operationally, civil law bound the judge to the law. This has often been seen only as a tool to enforce state law, disregarding that, when the law sets default rules, it protects freedom of contract, because it makes sure that the judge is constrained by the will of the parties. Therefore, the law protected the private legal order freely created by the parties, whereas under a system of greater judicial discretion this private legal order remains in danger.²⁴ This fear drives the efforts of 19th century legislators to purge many dogmatic rules from received law, often rooted in Canon law, that were contrary to freedom of contract. A prominent example is the liberalization of credit transactions, which were still subject to substantial constraints, including

²⁴ We pay no attention to private legal order solutions (of the type analyzed, for instance in Benson, 1989; Ellickson, 1991; Milgrom, North and Weingast, 1990; Bernstein, 1992, 1996, 2001; Greif, Milgrom and Weingast, 1994; Shavell, 1995), as we think they involve intrinsic difficulties for becoming the legal order for a modern capitalist economy. First, because the reliance of private enforcement on group membership limits its effectiveness to intra-industry trade, often on a personal level. Second, because they are only effective when state judges abstain from acting as appellate courts and they are permanently threatened by this possibility. Otherwise, private enforcement is only based on informal social sanctions, increasing its personal nature. This happened in particular with merchant courts, which,

the prohibition of interest and foreclosure.²⁵ Similarly, reformers often prohibited the judge from reducing the amount of penal clauses contractually established to punish a debtor in default (Danet, 2002: 218). Most codes also derogated rules that had allowed courts to disregard some “unequal” contractual clauses on the basis of scholastic “just price” arguments, such as the doctrine of “lesion.”²⁶ More importantly, the scope of “cause” as a necessary element of any enforceable contract was considerably reduced (by reversing the burden of proof, for instance), and even fully eliminated in the “abstract” transaction of the German civil code, as well as, more generally, in the laws of mortgages and bills of exchange. This pruning of the concept of cause curtailed notably the possibilities of constraining contractual freedom with moral principles that the canonist interpretation of the original Roman concept had previously offered.

Understandably, reformers also sheltered legal reform from any judicial reaction, including the possibility that judges would exert their discretion to issue sentences on the basis of abstract principles and against the new rules,²⁷ thus rendering the reform ineffective and hindering

by being subordinated to royal courts in terms of appeals and enforcement, can be seen as mere local courts with an additional functional specialization.

²⁵ Until the 18th century, for example, French laws against usury outlawed short-term credits that were indispensable for commerce, industry and banking. Borrowers and debtors therefore had to spend substantially on circumventing the prohibition, which hindered the development of the financial market (Taylor, 1967: 480). Understandably, one of the main goals of the Napoleonic Code was to empower contractual parties to act on their own behalf, protecting them from anybody, including judges, who could alter the terms of their agreement (Mattei, 1997).

²⁶ Ascribing the doctrine of lesion to “the civil law,” without warning of its removal or reduction by 19th century codifiers (as made, for example, by Cooter and Ulen, 1997: 191, 253), exemplifies the ambiguities that complicate comparisons between legal systems. See, for a detailed analysis, Abril Campoy (2003: 42-70).

²⁷ For example, Hayek (1960), among many others, emphasizes that the revolutionaries distrusted judges and their desire to control judicial discretion led them both to issue codes and to adopt more formalized legal procedures. This is consistent with recent empirical evidence showing that civil law countries regulate the judicial process more thoroughly (Djankov *et al.*, 2003).

development towards the market order. Legislators therefore subordinated the judiciary to the law and to jurisprudence, and restructured the professional career of judges.

Not only were codes and statutes given priority as a source of law, but the production of binding precedents was allocated to the higher court of appeals, which was conceived, at least originally, more as a court-controlling body than as a proper court. Its function was to supervise the legal interpretations given by lower courts, guaranteeing uniformity, making sentences predictable and enhancing legal security. Furthermore, no court had powers to question the constitutionality of legislation. In the French model, even controlling the executive power was assigned to a quasi-governmental judicial body, the Conseil d'État.

In parallel, the practice of purchasing judicial offices was abolished and judges were converted into civil servants. They started their judicial career young and inexperienced, by passing specific exams after law school. Even today their promotions and salaries increase with seniority and sometimes with discretionary governmental appointments to the higher courts and other public offices. This meant that judges could lose substantial quasi-rents if they opposed the government or, even worse, were expelled from their positions. Compliance was further enhanced in some countries by modifying judicial liability, making judges personally liable if they issued sentences contrary, not to dominant doctrinal opinion, as before, but to the statute law and formally established jurisprudence.

Summing up, our interpretation as to why reformers in civil law countries reduced the discretion of the judiciary lies in the fact that, in such countries, the transition to market economies was relatively more revolutionary and was generally not supported by Ancient Regime judges. Institutional change in England followed a relatively smooth, evolutionary process, which started much earlier and developed over a considerable time span, giving time

and occasion for the judiciary to become cultured in the market order. In contrast, judiciaries in Continental Europe were structured with greater central control with a view to achieving and enforcing an intended change, for which judges were largely unprepared.

3.3. Current anti-market trends in the Western legal system

Both common and civil law suffered substantial transformations during the 20th century, such that jurisdictions pertaining to different legal traditions now show remarkable similarities in areas in which they are often supposed to differ. Considerable convergence has also taken place in fields in which legislation is more recent, such as consumer protection or financial regulation. These changes have been interpreted as consequences of a general social shift from a more individualistic economic and social order to a new kind of collectivism (Berman, 1983: 34; Merryman, 1985: 14). This shift is consistent with an interpretation based on our hypothesis because the political structure required in both systems experienced radical changes.

As we will see, changes in the structure of the political system at the end of the 19th century and the beginning of the 20th, like the introduction of universal suffrage and the development of organized interest groups—from big firms to unions, moved most countries away from an elitist model of democracy, thus introducing cognitive biases into the rulemaking institutions, which previous governing elites had learned to suppress. Whatever the direction of causality, however, the cognitive gap between legislators and judges with respect to anti-market biases was likely to diminish substantially or even disappear as a consequence of the change in the political system

that transformed political leaders into political agents.²⁸ Political systems became, as a consequence, willing to supply a certain amount of “sharing” solutions, even if they were contrary to freedom of contract, the market order and long-term economic prosperity.

In addition, changes in the legal system might have satisfied an instinctive demand for insurance at a time when the political system was more willing to supply it. From the perspective of evolutionary psychology, the high level of insecurity and, mainly, the exogenous risks generated by the two World Wars and the Great Depression, activated demand for “sharing” solutions, introducing all sorts of welfare mechanisms and creating the mixed-economy systems that have characterized Western societies since the second part of the 20th century. (Even if the antecedents of the welfare state go back to the fourth quarter of the 19th century, they did not reach a substantial share of GDP until well into the 20th century. The weight of the state in the economy also differs substantially across countries but these current cross-country differences are much smaller than historical differences between the present and the 19th century). Evolutionary anthropology tell us that ancestral human beings relied on social sharing structures for coping with exogenous risks.²⁹ Understandably, the World Wars and the Great Depression might have triggered a backlash against the free functioning of the market and the introduction of all sorts of state controls and social insurance, and this conjecture finds some support in the parallel events that took place almost simultaneously in countries under civil and common law,

²⁸ For an account that considers the potential influence of evolutionary maladaptation in politics, see Rubin (2001a; 2001b; 2002, 153-181).

²⁹ See Cashdan (1980, 1989), Kaplan and Hill (1985), Kaplan, Hill and Hurtado (1990), Cosmides and Tooby (1992).

as interventionist rules have since then substantially constrained freedom of contract in both systems.³⁰

3.3.1. Changes in common law

We argue that these processes are behind the changes in the fabric of American common law, which was substantially altered by decisions taken by both legislators and judges.

At the legislative level, the “New Deal” of the 1930s marked a radical turning point (Calabresi, 1982; Sunstein, 1989; Manne, 1997; Glaeser and Shleifer, 2001), moving away from the principles of freedom of contract, introducing wide-ranging regulation and administrative oversight of many private economic activities, affecting contractual and property rights, and developing an enormous body of administrative law. It brought extensive mandatory legislation in fields of law that had hardly existed before, like labor relations, securities, public housing, social security and environmental protection (Berman, 1983: 34).

The New Deal was also a defining moment for the United States’ Supreme Court, whose will was twisted to endorse the constitutionality of the New Deal package. Crucial elements of the Constitution were reinterpreted, reducing individuals’ freedom of contract in many areas, from labor relations to the issuance of financial securities.³¹ Consequently, it lost some of its authority

³⁰ This does not imply that the 20th century solution, characterized by constrained freedom and redistribution, is poorly adapted. On the contrary, these economies have been successful in terms of sustained growth rates and social stability. Furthermore, some experimental works support the claim that competitive interaction among humans requires some degree of redistribution to be stable.

³¹ Even though the Supreme Court had always reinterpreted constitutional provisions in the context of contemporary society and authors disagree on the degree of discontinuity caused by the New Deal legislation on constitutional jurisprudence (Epstein, 1985; Cushman, 1998), sentences on New Deal legislation marked a turning point for key dimensions of the market legal order, such as the debasement

as a guardian of the Constitution together with much of its capacity to override the interpretation of regulations issued by governmental agencies. Courts were able to impose procedural restrictions on administrative agencies but were prevented from achieving substantive results (Manne, 1997: 24).

In addition, judicial interpretation, which for centuries had been supportive of freedom of contract, started to constrain it.³² This happened, for example, with respect to product liability in the US after *MacPherson v. Buick Motor Co.* in 1916 and *Henningsen v. Bloomfield Motors, Inc.* in 1960 (Benson, 1998: 92), and the application of so-called “enterprise liability,” making manufacturers absolutely liable for all accidents arising from the use of their products (Priest, 1985), a practice that allegedly motivates carelessness by consumers. With similar dubious arguments of market power, inequality and unfairness, since the *Williams v. Walker-Thomas Furniture Co.* case of 1965 some US courts have also been applying the doctrine of “unconscionability,” refusing to enforce clauses that offend the courts’ conscience and coming, in the broadest interpretation of the doctrine, amazingly close to using raw versions of the scholastic arguments of Canon law. Something similar is happening in labor law with the tendency of common law courts to require employers to show “just cause” when terminating a contract that includes the default clause of termination at will (Schanzenbach, 2003).

of freedom of contract, the subordination of private property and the expansion of government regulatory authority.

³² Manne (1997: 20-29) summarizes it as parallel change in legal doctrine and education, with the breakdown of the Austinian model, which is extremely respectful of precedent, and its substitution for Legal Realism in the first part of the 20th century.

3.3.2. *Changes in civil law*

Civil law experienced similar changes with only minor differences in timing and intensity. In the legislative area, changes abounded mainly as from the 1920s,³³ when corporatism with diverse political agendas but a common anti-market flavor gained power in several European countries and, with it, state intervention grew in all kinds of private activities. Parliaments, transformed from discoverers of permanent law into representations of heterogeneous private interests (Schmitt, 1936), now enacted plenty of transient and mandatory rules in new legislation, in fields similar to those of the New Deal, a process only reinforced after World War II with the extension of welfare states. Mandatory legislative intervention in old codified law, in the fields of contracts and property, was initially limited, exploding only in the 1960s and 1970s. This greater legislative activity converted what was once thought to be a coherent whole into a mass of ad hoc, and frequently contradictory, rules (Berman, 1983: 35-38).

It might be argued that changes against freedom of contract in civil law countries were made easier because these countries entered the 20th century with more powerful legislatures, unconstrained by the rulemaking capacity of the common law judiciary. Comparing end results in Europe and the US seems to confirm this interpretation, because interventionism grew more in Europe. The British case, however, casts doubts by illustrating that, first, common law is not sheltered against heavy socialization and, second, that a strong legislative power may be the right tool for reinvigorating the market, more so than the relatively discretionary but unsophisticated

³³ The second wave of codification, which started with the 20th century, is also often considered much less pro-market than the first wave—for instance, in the treatment of “lesion” (Abril Campoy, 2003: 48-53).

judiciary that contributed to rule out freedom of contract in common law countries by means of judicial activism.

In addition, in many civil law jurisdictions, changes in the position of judges have increased their rule- making powers. First, control on civil law judges has been relaxed and they now enjoy more freedom. Some of the constraints still active in the 19th century, among them personal liability, have also been lifted. Moreover, judicial congestion frees them partly from the implicit control of appeals, which have become much more costly because delays have increased in parallel with a growing opportunity cost of time. Lastly, the above-mentioned change in the nature of parliament has explicitly enhanced the position of judges, especially when constitutions safeguard the positive rights of some groups (civil servants, churches, unions, etc.), constraining legislative discretion (Schmitt, 1936).³⁴ This is clearer with respect to constitutional courts, which were designed to control the legislature and whose powers were reinforced after the second World War.³⁵ But lower-level courts now also enjoy greater discretion in some jurisdictions, in which they can now start proceedings at the constitutional court by questioning the constitutionality of legislation. Similarly, within the European Union, lower courts can also initiate a similar proceeding at the European Court of Justice when they understand that national law contradicts EU law. If our cognitive argument on judicial failure is correct, this greater discretion of civil law courts will probably be used to constrain freedom of contract, unless judges gain a better understanding of market mechanisms.

³⁴ It also modifies the function of “judicial review” (the power of courts to declare legislation void because it violates the constitution), which, instead of being a safeguard of freedom, ends up constraining it.

4. Final remarks

We end by summarizing our analysis and presenting some policy considerations, which are pertinent for the unsolved problem of how to build market institutions in transition and developing economies.

So far, we have argued that the initial evolution of both common and civil law was instrumental in protecting freedom of contract and developing market economies. We also explained the different degrees of discretion granted to courts in both systems as optimal adaptations to particular circumstances, especially to the availability of judges favorable to the market in England and the lack of such judges on the Continent. In our analysis, greater judicial discretion in classic common law courts therefore emerges more as a historical and possibly unique exception than as a replicable solution.

From this perspective, recent studies comparing the performance of common law and civil law traditions (La Porta *et al.*, 1997, 1998, 1999; Mahoney, 2001; Djankov *et al.*, 2002, 2003) seem to focus on relevant, but relatively minor, issues. They fail to distinguish causalities from correlations or to recognize the fact that performances are observed only for those choices that were effectively taken, while the relevant comparison would be between the chosen option and its unobserved alternative. Such comparative analyses therefore provide shaky grounds for policy recommendations. This may explain the recurrent paradox that, even though these empirical comparisons support the claim that common law is superior to civil law for the development of

³⁵ See Alexy (1993) for a theory about the role of the constitutional court in controlling legislation that might reduce the protection of rights by the state.

financial markets (e.g., La Porta *et al.*, 1998: 1148) and economic growth (Mahoney, 2001), both transition and emerging economies opt for statute law for creating the legal basis of such markets, following to some extent the model of developed economies, which for many decades has been based on statutes.

In line with this interpretation, our analysis does not advise any specific reform agenda for transition and developing economies in general but instead suggests that institutional development and academic research should aim at identifying the contextual circumstances which affect the costs and benefits of the different solutions. In some cases, the problems of these economies may be more similar to those faced on the Continent at the demise of the Ancient Regime than to those enjoyed by England more or less at the same time. If so, restraining judicial discretion may be now necessary in developing economies in order to guarantee freedom of contract.

In addition to the obvious need for adaptation, our work suggests that the creation of market-friendly institutions in transition and developing economies would benefit from examining the presence or absence of a cognitive gap similar to the one alleged between European legislators and judges in the 19th century. The lack of market-wise judges can be safely assumed in many transition and developing economies. The existence of elites having a clear idea of the market probably does not vary substantially among countries. However, the role of these elites in government differs with the nature of the political system. Such elites may be allowed to lead the transition (as in some cases in Asia) or, on the contrary, they might be sidestepped by governments acting as mere political agents of ill-informed voters (as, for instance, in much of Latin America).

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