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The connection between the judiciary and credit as an instrument of national development: the case of Brazil[1]

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The connection between the judiciary and credit as an instrument of national development: the case of Brazil[2]

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Resumo

O crédito no Brasil é pequeno em tamanho, volátil no tempo em sua oferta e caro em sua estrutura. Este artigo trata da relação entre o Poder Judiciário, o Direito e o crédito no Brasil e de sua contraposição com o desenvolvimento econômico. Enquanto a relação entre desenvolvimento econômico e crédito é mais conhecida na literatura acadêmica, a sua abordagem jurídica tem sido sistematicamente desprezada como mera conseqüência das reformas institucionais. Este artigo trata de três aspectos centrais para a discussão da tutela jurídica do crédito no Brasil: as garantias, os juros e a certeza jurisdicional de sua execução, na hipótese de inadimplemento. O trabalho procura responder a duas questões centrais, básicas e precedentes ao debate do crédito: primeiro, por que a oferta de crédito é tão pequena, volátil e cara; segundo, qual é o sistema ideal para que o crédito possa expandir-se e tornar-se mais estável e menos caro?

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Abstract

The credit market in Brazil is small in size, volatile in supply, and expensive in structure. This article examines the relationships among the judicial branch, law, and credit and Brazil, and how these in turn relate to economic development. Although the connection between economic development and credit is well known in the academic literature, the judicial framework has been dismissed as a mere consequence of institutional reforms. This article deals with three central aspects in judicial oversight of the credit market in Brazil: guarantees, interest rates, and jurisdictional certainty with regard to execution of laws, especially in the case of default. The essay seeks to answer two central questions in the debate surrounding the credit market. First, why is the supply of available credit so small, volatile, and expensive? Second, what is the ideal system under which credit might be able to expanded and made both more stable and less costly?

After years of inattention to the connection between the judicial branch and economic development, recent multidisciplinary studies have begun to revive and expand upon this important linkage.[3] There are two premises which should be observed initially before expanding on this theme: first, the most basic guarantee of a market democracy is a strong judiciary which applies the law effectively. Any country with a model positive law, an extraordinary substantive law, but with weak application and enforcement of this law is doomed to backwardness. Respect for the law and its application transcends simple social organization. An institution such as the judiciary – and we will explore this theme further on – which is solid, operational, independent and technical ensures that the law is carried out, and empirically, is a key element for economic development.[4]

A second premise that we will adopt here is that the judiciary is a human institution, not some mythic organization which cannot be transposed and which receives a divine mission to distribute justice. As with any human institution, throughout history it has been influenced by shifting and innumerable social, cultural, political, and economic factors.

The very concept of "institution" is fluid and relatively varied, and there are many different usages of the term.[5] For Hodgson, for example, institution has a generic and generalized element, and although intrinsically economic and dependent upon human behavior and the prevailing thoughts of the day, it cannot be reduced merely to this:

"Institutions are durable systems of established and embedded social rules that structure social interactions. Language, money, systems of weights and measures, table manners, firms (and other organizations) are all institutions. In part, the durability of institutions stems from the fact that they can usefully create stable expectations of the behaviour of others. Generally institutions enable ordered thought, expectation and action, by imposing form and consistency on human activities. They depend upon the thoughts and activities of individuals but are not reducible to them.[6]

[3] In fact interest began to grow at least ten years ago. MAYER, Colin and SUSSMAN, Oren, *The assessment: Finance, law and Growth.* Oxford Review of Economic Policy. vol. 17. n. 4, pg. 459 observe: "Probably the most significant institution that is resurrected from irrelevance is the law."
[4] There are countless studies linking law and economic development which will be cited throughout this paper. For an historic overview of all written articles, see BECK, Thorsten, DEMIRGÜC-KUNT, Asli and LEVINE, Ross, *Law and Finance. Why does legal origin matter?* World Bank Policy Research Paper 2904, Oct. 2002.
[5] CONCEIÇÃO, Octavio A. C. *O conceito de instituição nas modernas abordagens institucionalistas.* Available at www.ie.ufrj.br/revista
[6] HODGSON, G. M. *The approach of institutional economics.* Journal of Economic Literature, v. 36, Mar, 1998. pg. 166-192.

The classic definition of institutions came from Douglas North, Nobel Prize winner in economics and recognized as the leading contemporary theorist of institutions:

"Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g. rules, laws, constitutions), informal constraints (e.g. norms of behaviour, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specially economies. (...) Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying, determinants of economic performance. Time as it relates to economic and societal change is the dimension in which the learning process of human beings shapes the way institutions evolve."[7]

Why then is the judiciary an institution? It seems clear that nature and human activity require a certain degree of cohesiveness, and yet society remains beset by conflict. On the one hand, it is necessary to organise some form of society, and on the other hand, the conflicts which inevitably arise from human relations must be resolved in some fashion. The alternative to justice is revanche or resignation, which clearly would either escalate violence or permit injustice to crystallise. If we accept the premise that law is a sophisticated inducer of conduct, that its application must be observed by all (*erga omnes*), and that non-compliance must be punished, we are implicitly accepting that the judiciary should be a human construct with certain indispensable functions in society.

Thus, it can be affirmed that the judiciary has two basic functions in society: to resolve conflicts and to punish those who violate the law, in the traditional and well known function which is termed legal "sanction".[8]

If this is so, a structure within the overall political and social blueprint of the State must be designed to serve as an appropriate locus for conflict resolution and applying sanctions. There judiciary has an additional preventive function, even for actors who have no conflict whatsoever. A good judicial system functions as a safe haven signaling that if conflicts should arise between economic agents, they will be adequately resolved. The bulk

[7] NORTH. Douglass. *Economic performance through time*. The American Economic Review, v. 84, n. 3, Jun 1994, pg. 359-68.
[8] See REALE. Miguel. *Lições preliminares de Direito.* São Paulo : Saraiva, 1983.

of financial contracts in the 19th century stipulated England as their jurisdiction, more specifically the Court of London, which was renowned for its neutrality.[9]

One of the central elements of a good judiciary, clearly, is its independence. Certain theorists, such as Feld and Voigt, have demonstrated a strict inter-relationship between an independent judiciary (from all players on the economic stage, including the State) and economic growth.[10] Therefore, as a corollary of this observation, the judiciary, an institution essential to social organisation, could well be considered one of the most important institutions in a democracy.

Justice as well is a principle of lasting social order – in a society without justice, as noted above, only revanche would prevail. However, revanche leads only to violence when the defeated party, not accepting the outcome, initiates retaliation. For this reason, justice can often be viewed as a means to ensure societal peace in so far as it determines the veracity of facts and decides what is "just" among private agents and the State. The concept of what is just is extremely elusive, as is well known – but more important than defining what is just, is to be able to achieve by means of these decisions a perception that justice has indeed been rendered. Here the sense is one that the law has been applied independently of the nature of the parties, which also serves as a sign of maturity of a given society's institutions.[11]

According to the World Bank Report *Building Institutions for Markets*, there are two sources of injustice. The first is when decisions are subject to political influence by the State and the courts are powerless to make the Government comply with the law. The second is when pure economic power alone is able to influence judicial rulings.[12]

A better judiciary benefits everyone. It is not only that one or another party wins in a specific case, but that by correct and adequate incentives, a system of conflict resolution emerges in which everyone can place their trust. The argument for the common good that arises from a good judicial system has repercussions in the economic system as well, specifically with regard to protection for creditors in bankruptcy laws. Good legislation works to the advantage not only of the creditor but in fact all potential borrowers, since they will

[9] The observation is described with eloquence by COKE, Edward. *The first part of the institutes of the laws of England.* New York : Garland Publishers, Inc. 1628 (1979 version). For some explanations and justifications, see BURKE, Helen. *The London Merchant and Eighteenth Century British law.* Philological Quartely, 73. 1994

[10] FELS, Lars and VOIGHT, Stefan. *Making judges independent - some proposals regarding the Judiciary*, Working Paper 1260, Munich, Cesifo (April)

[11] GROTE. Rainer, *Rule of law, Rechtsstaat and 'Etat de Droit'* in Christian Stark. (ed). *Constitutionalism, universalism and democracy. A Comparative Analysis.* Baden-Baden: Nomos Verlagsgesellschaft

[12] WORLD BANK. *Building Institutions for Markets. 2002.* pg. 118

benefit, in theory, from a reduction in the risk premium to be paid for their credit. In this sense, it is emblematic that the entire society develops economically at the same time that a strong judiciary takes root.[13]

The independence of the judiciary (and I note that according to Art. II of the 1988 Constitution, all branches of the state should be "harmonious and independent") is not merely a legal concept but above all a political one in the strict sense of the word.[14] It speaks not only to the behaviour of the members of the judiciary, but to its institutional insertion in the social area of a given country. The reason for this is evident when one looks at the judiciary throughout history. First, while the existence of courts and judges is millennial, the institution of the judicial branch as an organized body of the State with its own prerogatives and without any link to the executive branch is a relatively modern institution. For example, in the French Revolution, the courts were an institution of the *Assemblée Nationale*, given that it arose from the assumption that it was the *people* who should judge conflicts and the errors of other citizens — and for this reason it was the National Assembly that was charged with the majority of judicial decisions. Only a small portion, that is the technical and strict application of the laws of the National Assembly, were attributed to the courts for judgment.[15] To this day, in many jurisdictions such as the United States, the same principle applies.

A second important distinction regarding the judiciary is the difference between administration of the judicial enforcement (that is, the process of declaring and carrying out the laws) and material law itself. The administration of justice is handled by judges (or magistrates of the superior courts) within the scope of an institution, whereas positive law (i.e., legislation, either a parliamentary or normative byproduct) is the objective result not of a monocratic decision but of the will of the people expressed via their representative assembly.[16]

This distinction is of paramount importance since it carries with it the notion that a good judgment is better than a good law, or that substantive and positive law without a good

[13] In the same World Bank report cited above, on p. 117 it notes that in China there were close to 17,000 litigations in 1979. With the growth and opening of the economy, by 2002 there were already 1.5 million new cases.

[14] For a political concept of the Judiciary see SWEET, Alec Stone. *Governing with Judges.* Oxford: Oxford University Press, 2000. Also see ASHENFELTER, Orley, EISENBERG, Theodores and SCHWAB, Stewart. *Politics and the Judiciary: The influence of Judicial Background on case outcomes.* The Journal of Legal Studies. vol. 24, n. 2, (jun. 1995), pg. 257-281

[15] See DAWSON. John P. *The oracles of the law.* University of Michigan law School, 1968.

[16] For the role of Parliament, see OLIVER, Dawn and DREWRY. Gavin. *The law and Parliament.* London: Butterworths, 1998.

judge are of little worth. One judge and scholar of the law and economics movement, Frank Easterbrook, subscribes to the principle that a system should always trust in its courts:

"The United States relies more on courts and less on law. Good thing, too! For judges are just bureaucrats with general portfolios… (Judges) can enforce contracts. For then the investors and managers themselves lay down the rules. Judges serve as neutral umpires, enforcing the contracts without regard to who gains and loses in a particular case. The contents of the contracts, however, come from competition in financial markets, rather than from law."[17]

In the heritage of French law, such a premise is not even considered. The judge should interpret the law in the strictest sense possible, without any margin for doubt, insofar as the law is the result of the people's will. In this sense, little maneuvering room should be given to applying the law. The law is not what the judge says it is; the law is what the legislature voted on and approved, and there is thus no scope whatsoever for interpretation.[18]

It is no trivial matter to determine the degree of judicial independence – obviously a list can be made of certain objective criteria for a neutral analysis (for example, judges' remuneration, criteria for promotion, etc.) and this has already done in fact with results that are well known.[19] The results however cannot be considered conclusive. Austria for example has 21 judges per 100,000 inhabitants while Brazil has only two, and 29,294 court cases distributed per judge whereas Brazil has 2,739.[20] The justification is that more than 85% of the cases reach the Austrian judiciary merely for homologation, and these are known as "summary cases".[21]

To view the judiciary as a bureaucracy is to oversimplify a much more complex problem. The structure of the judiciary as a bureaucratic organisation is extremely sophisticated and was not shaped at a single moment, but in accordance with time and historical moments in culture and society. From its internal administrative organisation to the naming of its judges, the influence within the judicial environment is immense.

[17] EASTERBROOK. Frank H. and FISCHEL. Daniel R. *The Economic structures of Corporate law.* Harvard University Press. 1991.
[18] BERMAN. Harold J. *Law and revolution: the formation of the Western legal tradition*. Cambridge : Harvard University Press, 1983.
[19] Lex Mundi, Harvard University and World Bank. *World Development Report 2002. Background Project.*
[20] CONTINI. Francesco. *European Database on Judicial Systems.* European Network on Judicial Systems, 2000.
[21] Idem, ibidem.

With regard to legislation itself, one of the best known arguments in the debate over the quality and efficiency of the judiciary is that it is not responsible for the creation and the writing of the laws. If the laws are bad to begin with, their application will also be compromised. Armando Castelar Pinheiro in a detailed study of the Brazilian judicial branch suggested that mediocre production of laws and the infinite quantity of veto points which exist in the Brazilian judicial system are responsible for the compromised application of justice.[22] By the same token, studies of the formal structure of the law – especially the widespread criticism as to the procedural rigor of our legal system – depart from a judicial system that is fragmented and hardly systematised at all.[23]

Procedural formalities are considered one of the chief causes of the sluggishness of the judiciary. Without entering into a more profound debate on the reasons and the justifications, it is a fact that efforts to reform parts of Procedural law with the goal of speeding up judicial enforcement. Measures such as the anticipated court ruling *(antecipação de tutela)* (and its generalized use starting in 1994, through law number 8952, of 13 December 1994, specifically art. 273) and the reform of enforcement laws show that it is necessary to advance with new bylaws to attempt to attenuate the grave situation of the sluggishness in the judiciary. On the other hand, new judicial provisions (as well as new executive acts) are constantly being written and continue to cause doubts and uncertainties, as well as natural congestion in the judiciary.

There is as well the suggestion by some observers to attempt to provide incentives for alternate means to mediate conflicts – and to speed up judicial rulings, based in the canard "slow justice is no justice". For example, World Bank suggests it is necessary to think of the judiciary as the principal means to solve its own crises. For this reason, they affirm:

"(....) delegating the mechanisms of procedural reform to the judicial branch can speed up the process of reform. Where procedures are transparent, allowing some degree of innovation and experimentation by judges can help increase judicial efficiency." [24]

To better illustrate the point, some question the formalities of oral procedures in judicial process (such as for example, taking testimony and cross examination of witnesses) *versus* written procedures (legal documents) and the conclusion was that the greater the written procedures, the more restricted justice will be.

[22] See PINHEIRO. Armando Castelar. *Reforma do Judiciário: planos, propostas e perspectivas.* Rio de Janeiro: Booklink Publicações, 2003.
[23] FARIA. José Eduardo. *Direito e Economia na Democratização Brasileira.* São Paulo : Ed. Malheiros, 1993.
[24] BANCO MUNDIAL. *op.cit*. pg. 119

The more independent the judiciary, the more the capital and credit markets will develop, especially for small and medium sized firms. If the laws are good and the judiciary applies them correctly and equitably, there will be a more favorable environment for investment. The impact of a deficient judiciary on the economy is seen as one of the most important factors for blocking development due to the mistrust of economic agents. The well respected daily *Financial Times* openly criticised Brazil for being at the center of doubts about the application of its laws:

"Brazil's dysfunctional judiciary…is increasingly seen as an obstacle to national development. It is a system that allows debtors of all kinds to abscond at will, knowing that none but the most determined of creditors will pursue them through the courts. It forces banks to lend at astronomical rates of interest because they cannot foreclose on debts. More worryingly, it means that vital infrastructure projects are stalled because investors cannot be sure the judiciary will uphold their rights."[25]

The distinction between structural independence and behavioural independent needs to be emphasised. Kenneth Dam defines it this way:

"The former term, as used here, refers to the way in which government is constitutionally structured: does that structure lend itself to independence? The latter concept is more far-reaching. Are individual judges independent—that is, not just dispassionate and free from bias, but willing to take difficult positions, to resist corruption, and to make truly independent decisions?" [26]

Within a structure of pure separation of powers, there is no type of decision that can be altered by another power. It is the concept of checks and balances and this is the way to guarantee an independent judiciary. But, it was the emblematic case *Marbury vs. Madison* in 1803 (5 US 137) that brought judicial review to modern times. In the UK for example, to this day there is still no so-called judicial review, and as Blackstone affirmed, the Parliament can create or undo any law it pleases, and even alter the constitutional norms.[27]

[25] Article in the Financial Times. *Why Brazil's judicial system is driving the country nuts*. Author: Jonathan Wheatley, 24 May 2005.
[26] DAM. Kenneth. *Legal institutions, legal origins and Governance.* (www.ssrn.com)
[27] BLACKSTONE. William. *Commentaries on the laws of England.* London: Cavendish Publishing Limited.

The behavioural nature of a judge's independence is in his or her capacity to judge without any interference by any other societal player, whether it be from the public or private sector. Hamilton understood that the life-long tenure of the judge was a very important institution which permitted the independence of the judiciary.[28]

In the Brazilian judicial order, besides the prerogatives that a judge serves for life, there are also basic prerogatives for a magistrate such as the institution of specific guarantees for salaries. In fact, these are guarantees foreseen in article 95 of the Federal Constitution of 1988 as a means to ensure the unfettered performance of a judge's duties. It appears clear that the Judge cannot be removed, save for motives of the public interest, as per article 93, VIII of the Charter ("the act of removal, availability, and retirement of the Judge in the public interest, will be based on a decision by a vote of two thirds of the respective court, ensuring ample defense"). The prohibition against reducing a Judge's salary is to guarantee that her or she will not be economically penalized in his or functions.[29] Finally, as to life tenure, article 95, I, of the Constitution of 1988 says tenure will be awarded after two years of service. If the job is lost in this period, it will be through strict deliberation of the court to which the judge is attached, and in all other cases, by a sentence handed down by the court. The independence of the judiciary is in fact translated not as independence of a Power (branch) of the state, but according to article 99 of the same Brazilian Federal Constitution of 1988 as a requisite for autonomy (from the Greek *auto*, or self, and *nomos*, meaning rules): "Unto the Judicial Power is assured administrative and financial autonomy."

Good laws do not compensate for weak institutions

For a long time it has been believed that merely a good legislative product would be sufficient to protect rights. Or in other words, the institutions are more important than good legal texts. In an extensive study of socialist countries which transformed into a capitalist system, Piston, Raiser and Gelfer concluded that despite the well done reforms of bankruptcy laws in each country between 1992 and 1998, the impact felt by the financial markets occurred only when those legal institutions became more effective.[30] Additionally, the conclusions about the capitalization of the capital markets or even the increase in

[28] Hamilton, Federalist Papers 79: "Nothing can contribute so much to firmness and independence as permanency in office."

[29] There was a heated debate when the Special Commission set up to give its opinion on Constitutional amendment 96-A of 1992, which intended to include in the language of article 95, III (non-reduction in subsidy) the condition according to the following text: "... and the suspension in the case of unjustified non-compliance with the procedural time limits specified by law".

[30] PISTOR, Katharina, RAISER, Martin and GELFER, Stainslaw. 2000. *Law and Finance in transition economies. Economics of Transition* 8 (2) 325-68.

domestic credit only came about when the institutions began to function. With this in mind, one of the initial premises (and justifications) of the Bankruptcy law was precisely the reduction of the banking spread, which effectively did not occur, at least in the first year of the law. This serves to confirm the argument that more is needed beyond favoring the creditor with real guarantees to allow credit to expand.[31]

In a resounding way, Pistor (*et al.*) affirmed:

"our regression analysis shows that legal effectiveness has overall much higher explanatory power for the level of equity and credit market development than the quality of law on the books… Good laws cannot substitute weak institutions."[32]

Obviously, every comparative study is intrinsically subjective – for example to measure the efficacy of a legal system is not an easy task and it is clear that much is open to interpretation. But in any case there is a strong indication that a good law does not always cause the market to progress. The good intentions of lawmakers are miniscule compared to the efficacy of the institutions, especially that of the judiciary.

The World Bank in its extensive report in 2002, analysing the existing judicial systems - the *World Development Report 2002* – attempts to measure the efficacy of 109 countries with two recurring examples which are faced by any judiciary: eviction and recovering a check. Their analysts use two arguments in a comparative manner: the first is that the degree of formality in a judicial system is relevant to final decision. The second argument is about regarding the procedures adopted by the courts. The conclusions – and these are based on two kinds of suits, an eviction suit and a suit to enforce a credit security – indicate that the more specialised courts, judges with greater technical know-how, greater and better use of informal procedures and less necessity for justification for their dispatches end up determining the effectiveness of the judicial system. And the objective manner of defining this effectiveness is measured with a single criterion: time. The results of these two claims considers how much time it takes to evict a renter for lack of payment or to collect payment from a bounced check.[33]

[31] See Public Debate no. 8 of 2006 – *Primeiro Ano da Lei de Falências.*
[32] PISTOR, Katharina, RAISER, Martin and GELFER, Stainslaw. *op. cit*
[33] The study was criticised by Kevin Davis in *What can the rule of law variable tell us about the rule of law reforms. Michigan Journal of International Law* (26) I, 141-61

While we will not argue judicially either for nor against the study (after all, the formality of legal proceedings are amply justified by the comprehensiveness the system must possess in order to reduce the margin of error and incorrect rulings), one point must be brought into the debate regarding *efficiency vs. justice*: the precision of judicial enforcement, *lato sensu*, is not necessary inversely proportional to its agility. The faster a final ruling is reached without the possibility of appeal, the greater the statistical probability that ample arguments to the contrary cannot be made. Or, as argued by Kenneth Dam: if the disputes are smaller, the greatest value to keep in mind is to reach a conclusion, for good or ill, in order that the demand is finished. Even so, if a complex case (for example requires a forensic study) is hastily judged, there is a good chance it will not be just. And such observation could be complemented by the popular American expression, here slightly modified: *bad justice is no justice.*[34]

By the way, in other research by the World Bank, 76% of those interviewed understood that a delay in judicial enforcement (for good or ill) constitutes the greatest problem facing the judiciary. At a general level, a good judicial system depends on a good judge and correctly applied law. And it is on this judicial certainty that the credit market is based. The Minister of Finance of Mexico made a poignant analysis of the countries of Latin America regarding this close relationship:

"Judicial processes [in Latin America] are unpredictable, riddled with corruption, long, and expensive. Their costs are reflected, among other effects, in high bank intermediation margins. Excessively high credit rates discourage demand for credit, and poor credit demand is, in turn, reflected in a scant supply of deposits and of other banking services. Intermediation margins are, after all, the "price" or cost of the financial sector which, when expensive, result in a flabby banking sector. Such immature and insufficient financial sectors often mean insuperable entry barriers for small firms and a dearth of housing mortgages."

The impact of the judiciary in the credit market is evident. The creditor, just as Shylock in the *Merchant of Venice*, seeks to recover his credit above any other consideration.[35] A limit on allowable interest is relevant to the development of credit but does

[34] A recent note in the magazine *Exame* (20-12-2006) showed that the controversy continues. The Appeals Court Judge Carlos Teixeira Leite Filho stated "Brazil needs to decide if it wants better justice or cheaper justice," as though they were mutually exclusive. The affirmation essentially questions the debate of *efficiency* versus *equity*.

[35] Jappelli, Pagano and Bianco justified it thusly: "The key function of courts in credit relationships is to force solvent borrowers to repay when they fail to do so spontaneously. Hence poor judicial enforcement will increase opportunistic behavior on the part of borrowers: anticipating that creditors will be unable to recover their loans easily and cheaply via the courts, borrowers will be tempted to default. Lenders respond by reducing the

not define its existence. The could well be those who lend under a limit on interest or even an absolute prohibition (e.g. the Islamic system of *Sharia*), but if the credit is free – or in other words, the hypothesis of recovery is too remote or nebulous — there will never be a market for it.[36] The market is guided by the expectation of increase, just as any other economic activity.

It is evident that for the credit market, to reform the delays of the law is fundamental. But this depends intrinsically on encompassing functioning mechanisms and an incentive structure, as well as on generalized levels of efficiency.

The concept of efficiency has already been broached in other works, but even so a few quick observations are in order. What is an efficient judicial system?

One way to measure efficiency is the result of given process, having in sight its means. In this sense, an efficient law is that which permits the greater allocation of resources if there were no transactional costs (in the Coasian sense). Louis De Alessi and Robert J. Staaf define it better:

"Within this framework, a new rule is more efficient than the one it replaces if it allows an allocation of resources closer to the allocation that would have been observed in a world of fully defined, allocated, and enforced private property fights exchanged at zero transaction (including litigation) costs. Thus, property fights flow to their highest valued use (for example, liability is assigned to the least-cost avoider) as the result of litigation bids in a process similar to a pseudo market rather than as the result of individuals contracting around existing rules." [37]

Thus, if an efficient system has a direct relationship to the allocation of resources in a given economy, it is clear that a system which most protects property rights tends to be seen as the most efficient. And this has much to do not only with the process itself, but as the law is applied, and this extends, in large part, to individual action.[38] This being so, it is important not only to establish that the system should be efficient, but that it seek to align the important

availability of credit." JAPPELI, Tullio. PAGANO, Marco and BIANCO, Magda. *Courts and Banks: Effects of Judicial enforcement on credit markets.* CSEF Working Paper 58.

[36] For an analysis of the Islamic system of interest rates (*riba*) in Sharia, see ZAHER, Tarek S. and HASSAN, M. Kabir. *A comparative literature survey of Islamic finance and banking.* Financial Markets, Institutions and Instruments. Vol. 10, n. 4 page 155, Nov. 2001,

[37] DE ALESSI. Louis E STAAF Robert J. *The common law process: Efficiency or order.* Constitutional Political Economy Springer NetherlandsVolume 2, Number 1 / December, 1991

[38] Idem, ibidem.

indicators or criteria of a good judicial system. In the opinion of many theorists, the question can be boiled down to four necessary basic and necessary preconditions:

a) Agility: A good system should be capably or resolving the demands which are placed upon it in a reasonable period of time. There is no empirical evidence that a judicial sentence which takes more time is technically superior to one which takes less time to reach.[39] What is a reasonable period of time for a lawsuit? Clearly this varies from case to case, and from jurisdiction to jurisdiction, but it is evident that a period of ten years to enforce repayment of a debt cannot be considered adequate. Agility depends as well on the expectations of the economic agents. For example, in trivial operations it is expected that the solution be more expeditions than in great demands, where there are for example, more subjective themes, doubts about the amount of debt, monetary correction, or any other punitive clause in the original contract.

b) Cost of Access: a good system should have a low cost. If litigation or demanding payment in escrow is too expensive (in Peru, for example, the cost of enforcing a simple check with judicial expenses and lawyers fees can reach 35% of the face value of the check) there will be very little disposition to carry on, especially if this implies a risk of not receiving anything.[40] In other words, enforcing a debt cannot be a burden; and clearly there are explicit transactional costs (contracting lawyer, paying judicial fees, etc), but the value to be 'invested' in the enforcement of the debt should be reasonable to the point of offering an incentive to the creditor to exercise his right to recover what he is due.

c) Predictability (or *calculability*) is a notion under which current behaviour can be put in order facing an expected standard of sanction. Every economic agent is capable of weighing actions against the impact they might have in the future. A good judicial system should be consistent and coherent in its time frame as well as predictable. If a case is judged in one way and very a similar case in another way, the predictability of the system is reduced and comes to center upon the judge (therefore, on an entirely personal basis) to whom the suit is distributed.

e) Neutrality It appears evident that any judicial system, in declaring and carrying out its laws, must be just in the sense of impartial or neutral. Neutrality, when referring to

[39] CASTELAR PINHEIRO, Armando. *op.cit.* pg. 44
[40] WORLD BANK. *op. cit.* pg. 22

> the independence of the judiciary, signifies the capacity of any other party to influence its final decisions or even the Judge to base his or her decisions not on the law but rather in any other exigency or conviction that seems better to him or her.

Legal scholars try to feed their models with data about the judicial system – numbers of judges, budgets, numbers of people engaged in administrative support – and even the productivity of any given judge. Other studies focus not on the administrative or operational structure of the judiciary, but in the quantity of demands for judicial services – and in their capacity to be attended to depending on their availability. In both types of studies, the results are not entirely conclusive.

It is not easy to make comparisons among systems of different countries, even though it has already been tried – and this will be the object of the following discussion. But even so, the criticism which is made by any comparative model must analyse elements and situations which depend on culture, on the system of values, on the mores and ethics of each of these countries, and in every case these factors can be very different when considered individually. For example, the very concept of a judge is extremely different from one country to another. In one jurisdiction he or she may be a technical professional, while in another, a public servant in a qualified career, and in another merely a mediator. The same indicator can be used for his or her productivity. For example, in Germany, the Judge is completely removed from any and all bureaucratic activity not related to the judgment itself. In Argentina, at the other end of the extreme, he or she spends more than 70% of his or her time on administrative activities.

There are, however, some universal indicators. One of these is the volume of funds which is spent on the judicial branch as a percentage of GDP or even as a *per capita* indicator. Another index is the quantity of judges in a given society. In Peru for example, there is one judge for every 100,000 inhabitants, while in Brazil there are two, in Austria 21 and in Germany 27. How can it be shown that each country has a degree of respective development based on the efficiency of the judiciary? Even more so, if there exists a correlation between development and law, can it be that these indicators serve for a critical analysis of the functioning of the judiciary?

Clearly there are no evident responses. But one of the most intriguing debates carried out in recent years tried to bear fruit and explain some of these justifications: the origin of the institutional nature of Roman law *versus* Anglo-Saxon law.

Is there a better judicial system ?

It is evident that there is no better or worse judicial system, even of the debate has been heating up around this question in recent years. And curiously, the discussion did not begin with law, but with the discipline of Finance. Four economists, Rafael La Porta, Florêncio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (almost universally known as LLSV) studied a sample of forty-nine countries in an attempt to investigate the relationship between the norms of the financial system and the origin of the judicial system. The conclusion of the study is, at the very least, controversial: countries with consuetudinary law have stronger legal systems and therefore are better for the financial system than countries with a tradition of Roman civil law. And LLSV concluded that independent of the colonization or its past history, on average, countries with common law, grow more as a result of the origin of their legal system.[41]

To complicate the situation regarding the origin of modern civil law – French law with its proclaimed superiority due to the process of codification – countries which are based on the French legal system found themselves among the worst legal systems.

A digression is necessary to explain the study, and later to better discuss it. LLSV used certain variables and subjective criteria to measure the performance of each country – themes like the application of the law, efficiency of the legal system, the state of law, etc as well as norms from material law, especially laws referring to protection of minority parties and creditors, including in bankruptcy proceedings. Directed toward the analysis of various financial systems, the conclusions reached by LLSV, that countries with common law favored greater economic growth (followed by the Roman judicial systems of Germany and Scandinavia), sparked rumors among academic and even journalistic circles. Could it be possible to explain economic growth based only on the origins of a country's laws?

A second conclusion that the authors reached is that the financial structure of a country is a consequence, not a cause, of the legal structure. The distinction may appear merely a question of semantics but it most certainly is not. To mitigate the example of a majority stake, they claimed that a country (by means of its financial structure, a key element in development) which has a legal system that affords minimal protection to the investor forces the investor to seek a controlling stake, and thus a judicial regime to protect minority

[41] La Porta, Raphael, and others (Florencio López-de-Silanes, Andrew Shleifer, and Robert Vishny).1998. *law and Finance.* Journal of Political Economy 106 (6): 1113–55. And by the same authors, 2000. *Investor Protection and Corporate Governance*. Journal of Financial Economics. 58: 3–27.

shareholders is unnecessary since all the firms have a majority stake concentrated among few shareholder. The conclusion of this rationale is that as a result of this kind of institutional arrangement (that is, as a product of a legal system) the country will have weak finance structures and consequently lower levels of socioeconomic development.[42]

The argument is unconvincing. First, because there are any number of exceptions, as shown by the *Lex Mundi* study which researched the time necessary to collect on a bad check. For example, in Canada, a country with a common law system, collection takes up to 421 days, while it take only 60 days in Belize, and even a mere 40 days in Swaziland, both countries with origins in Roman law. Secondly, in terms of creditor protection, bankruptcy and even minority shareholder rights, throughout most of the world such matters are laid down also in statues and codes and not in precedent leading cases.

The argument therefore leans toward a certain historic determinism: only those countries born under the aegis of common law shall experience development by virtue of having a legal system which does not stand in the way. Perhaps the fact that France was the greatest victim of the study – especially at a moment when its institutional structures were frankly showing themselves incapable of attending to a the demands of a unified Europe – there was such a stir over the issue, especially in the confusion (perhaps deliberate) between the political channels of the institutions (such as democratic voting mechanisms, the system of constitutional protections of liberty, etc) and defending the property right system. The idea that France does protect the rights of creditors **equally** as England did, seems strange and anachronistic, having been based only on certain provisions of the French Bankruptcy law which was, of course, being reformed at the time.[43] A second consideration raised by Merryman is that LLSV viewed the system of Roman law almost exclusively as the Napoleonic Code, and this ignores all the jurisprudence and discretionary judicial rulings that exist in various countries.[44]

In a subsequent article two years later, the tone changed but conclusions of the LLSV quartet remained the same.[45] In general the study was directed toward the controlling shareholder structures of publicly traded companies – and less about the financial structure.

[42] The analysis in MAYER. Colin and SUSSMAN. Oren. *The assessment: Finance, law and Growth.* Oxford Review of Economic Policy. vol. 17. n. 4, pg. 462.
[43] See BRUNET, Andrée. *Propos critiques sur le projet de réforme du droit français de la faillite*. mimeo.
[44] MERRYMAN. J. H. *The French deviation.* American Journal of Comparative law. 44, pp. 109-119.
[45] "An exogenous component of financial market development, obtained by using a legal origin as as instrument, predicts economic growth".La Porta et al.. *Investor protection and corporate governance.* Journal of Financial Economics 58: 3-27

The important conclusion of these new findings was that laws are indeed relative to the economic system, but are not endogenous to the other variables in the economy.

Lamoreaux and Rosenthal, in turn show in a comparison of shareholder legislation between France and the United States in the 19th Century, that the French legal system is much more effective in response to changing economic conditions than the American system. France's legal and institutional environment for mergers and acquisitions was by far superior to that of the United States.[46]

A similar study, developed by Paul Mahoney, demonstrated the correlation between the origin of the legal system and economic development, but through the role and the size of the State. Its conclusions were in the same direction, that countries with common law grew at least 0.7% more.[47]

Finally, there is a great difference between how the law is applied in a federation and a non-federated state. Countries such as the United States have evolved in a very different way than other federations, such as Germany for example, even for the simple reason that there are a variety of state legal systems and they contradict one another on many points. Seeking to explain federative systems under a single banner at the very least, ignores the wide range and diversity which exists even under the designation "common law".[48]

The differences are infinitely greater than the similarities. Even the creation of indices, which is very much in fashion and relatively useless to compare countries, takes into consideration markedly distinct criteria and methods. There are some truly distinct aspects in every part of this debate, such as for example, the role of the Judge in the process. The Encyclopaedia of Comparative law affirms:

"In civil law … nations the ratio of judges to attorneys tends to be greater than in common law countries. Civilian judges are more actively involved in both civil and criminal proceedings with the goal of reaching the correct result than common law judges with their more privatized judicial procedure that delegates most evidence gathering to the parties' attorneys…. The role of judging in civil law nations involves much more responsibility for gathering evidence and moving the process forward…. Civil law judges also take on more of

[46] LAMOREAUX, Naomi and ROSENTHAL. Jean-Laurent. *Organizational choice and economic development: a comparison of France and the United States during the Mid 19th Century.* University of California, mimeo.
[47] MAHONEY, Paul. G. *The common law and economic growth: Hayek might be right.* Journal of Legal Studies, 30 (2) pg. 503-25
[48] BECK, Thorsten (et al.). *law and Finance. op.cit*.

the effort of analyzing law … while common law judges rely on the attorneys to brief them on the legal issues." [49]

Regarding the debate over legal origins, there are still two other facts which jump into view for any analyst who is attentive. The first is that in the great majority of cases which have been studied, a comparison exists between the themes of private law – the rights of creditors and non-controlling shareholders – yet it is just as clear that there are themes of Constitutional and Administrative law, among others, which have an equal impact on development.[50]

In the tradition of the French and German codification – from which many countries take their inspiration – the objective was Private law, not Public law. Clearly this is not to say that Private law is not important for economic growth, but it remains evident that there are innumerable other aspects – without considering the fact that the protection of rights and property is in the field of Public law. The second point regards the simplification of the criteria for the sample. As the large part of the Roman law countries took their inspiration from the 19th century French law, there is clearly a deviation in the sample. And, for example, the country which is growing the most – Spain – is a country with Roman law and not common law system. And there are as well innumerable influences from German, Italian and even Swiss law in all of this legislation.

Moreover it appears evident that in countries based on Roman law, jurisprudence has shaped court rulings in a pronounced way. And jurisprudence, in a certain sense is germane to common law, in spite of the non-obligation of the Court Judge to apply it, it shapes the judicial system, since it concerns the analysis of precedent cases.[51]

Brazil's legacy from the Luso-Iberian tradition was not a ready and finished judicial system, but instead certain historical characteristics in the way operations and transactions in a given economy that influenced our judicial order in a decisive way. First, in the 18th Century, the environment forced courts to operate in a political manner with a clear 'social network' and family prestige to gain privileges. Second, because of uncertainty, reliance on other ways of solving conflicts became much more effective.

[49] E. U. Pertersman, *International Encyclopaedia of Comparative law,* 1981, p. 21.
[50] SCHLESINGER. Rudolf (et al.). *Comparative law : Cases, Text, Materials.* 6th Ed. New York : Foundation Press. They stated: "The economic and social changes which have taken place during the 20th Century… mostly are reflected in the growth of such public law fields as administrative law, labour law, social securities, taxation, nationalizations and public corporations. Many of these changes, are only faintly reflected on the face of the modern private law codes."
[51] Vide JOLOWICZ. J. A. *Development of Common and Civil law – The contrasts.* Lloyds Maritime and Commercial law Quarterly 1982 (1) : 87-95.

From the point of view of the respect for property and its origins, it becomes clear that this has little to do with the origin of law, and much more with the development of its key institutions.[52] The same study in Finland, where the rights of non-controlling shareholders were greatly amplified – while those of creditors were reduced – shows the duality of results.[53]

Other arguments strongly criticise the LLSV study, claiming, for example, that there are many questions which were poorly thought out or intended solely to generate expected results.[54]

Kaufmann for example, indicates that when the indices of governance of a determined country are compared – such as the volume of foreign investment – the differences between countries of one or another system simply disappear. He suggests that it would be better to research six distinct dimensions to explain economic development that are not merely quantitative:

a) Accountability overseas and the capacity to influence
b) Political stability and the absence of domestic violence, crime and terrorism
c) Governmental efficiency
d) Absence of a regulatory burden (or regulatory quality)
e) The rule of law
f) Control over corruption

Perhaps a comparative study with such characteristics could better indicate whether or not the judicial system is central to economic development and especially, for credit. [55]

Independent of the criticisms over the impact of the origin of legal systems and development, and the ingenuousness of the empirical results as this text seeks to demonstrate, it is important to note that the debate opened very much in function of these

[52] The same explanation is found in Douglass NORTH. *op. cit*.
[53] HYYTINEN, Ari, KUOSA Iikka and TAKALO. Thomas. *law or Finance : Evidence from Finland.* Bank of Finland, Discussion Papers 8, 2002.
[54] DAM, Kenneth. *op. cit.* gives an example: "In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with influencing laws and policies, regulations, or decrees to favor selected business interests?" (with seven possible answers ranging from "common" to "never occurs").
[55] KAUFMANN. Daniel. *Governance redux: The empirical challenge.* In: The Global Competitiveness Report, Ed. Xavier Saka-i-Martin, pp. 137-64, Oxford University Press

studies. In this regard, the direct causes of a system functioning properly or not, demonstrating the dysfunctions and inefficiencies, could be better understood.

It is evident that legal institutions influence development, and especially financial development and the credit market. While there is general consensus as to this idea, there is not over the other aspects of the role of the state, as a formulator of law (be it by means of the executive branch, or by means of the Legislature).

For liberals, for example, the system should simply enforce the private contracts, as well as help to resolve problems of the Theory of the Agent.[56] For so-called developmentalists, the State should go beyond this point and guarantee a strong and capable legal system. Glaeser *et al.* agrees, but affirms that for this to be true and attainable, the judiciary must have the technical capacity and institutional will to understand the complexity of the demand, and to remain neutral and impartial in its conclusions.[57] How this can be done depends entirely on the existing judicial regime. It is that which we will now analyse.

Economic Growth and the Judicial Regime

The best explanation for the role of law in development concerns the historical conditions which helped to shape the formation of a legal tradition, and this has to do with the logical sequence of a single, basic qualifier.

a) The social environment, due to historical, cultural, geographic, and even political questions, favors (or not) the emergence of strong institutions which endure over time;

b) If among these legal institutions exists the legal tradition of protection for property and the respect for contracts between private agents and between private agents and the State;

In this regard, it is important to infer how it is that the protection of property rights stimulates growth and what is its impact on the credit system.

[56] COASE. Ronald. *The problem of social cost.* The Journal of law and Economics. 3, pg. 1-44. 1960, STIGLER. George J. *Public regulation of the securities market.* Journal of Business 37, pg. 117-142, 1964

[57] GLAESER, Edward and SHLEIFER. Andrei. *Legal origins*. Quarterly Journal of Economics. 117, pg. 1193-1230.

For some analysts, even the geographic pattern of disease during colonization had a decisive influence over the area that would be settled. Factors such as the mortality rate were decisive elements in the choice of regions to be colonized.[58]

Clearly the English immigrants in the 17th Century who came to America brought with them the rigid Calvinist doctrine of the work ethic and respect for laws, and this in large part permeated the entire New World. Much more than any other country, England already had a stable base for its regime and was much less fragmented than France. It is attributed to Voltaire the phrase about law applicable to France of the day: when one travels through France, one changes legal systems as one changes horses.[59]

Though to what extent the fragmentation of a judicial system interferes with private property may be open to debate, it is certain that the New World institutions were born with a central concern over the protection of private property.[60]

The evolution of English law itself was based on secure protection for rural property rights. Since William I, land owners were not royal tenants but indeed had true claim to the land. For this reason, 17th century English law is considered a law of property rights. When James I set out to impose his royal prerogatives over the common law, stating that the law could be changed according to the whims of the King ("*Lex, Rex"* – The law is the King) he, and the Stuart dynasty along with him, ended up being deposed in 1688.[61] The regime of protection for property rights can be considered one of the factors which adequately define the development of modern society.

Much later, the judicial system for property rights was also central to the development of a free and open market. Historically, the concept of property was based on the idea that a tradesman would face a free market to extract value from his right to property, or in other words, he would be able to find a market open for all to come and go, as convenient, in order to trade their goods. Meanwhile, the crack-down on monopolies (in the 20th century) never represented a restriction on property rights, but instead an incentive toward the adequate conduct of economic agents.

[58] See BECK, Thorsten, KUNT, Demirgüc, Asli and LEVINE, Ross. *Law, Endowments, and Finance.*
[59] ZWEIGERT K. e KOTZ H. *Introduction to Comparative law.* Oxford University Press, 1988, p. 80).
[60] The argument is found in NORTH. Douglass. *Structure and Change in Economic History.* New York : New York, WW Norton, 1981.
[61] BECK, Thorsten and LEVINE. Ross. *Legal institutions and financial development.* Working Paper 10417. www.nber.com

The importance of a judicial system is in the capacity to protect contracts and to guarantee the rights of property, over which all financial and credit products are presumed, based on a system of coherent norms which are tied umbilically to justice and economic development. Douglass North, the Nobel laureate in economics, best captured this connection. He summarises:

"In fact, the difficulty with creating a judicial system gifted with relative impartiality, which guarantees the compliance with agreements, has shown itself a critical impediment on the path to economic development. In the Western world, the evolution of the courts, legal systems and a relatively impartial judicial system performs a preponderous role in the development of a complex system of contracts capable of extending through time and space, an essential requisite for economic specialisation".[62]

To comprehend the relationship between law and development, it is therefore necessary to search for responses to the following lines of inquiry: what are the merits and the faults of a judicial system and a legal system in a given economy? How do they contribute to the credit system?[63] How are their impacts distributed? How does one reform a judicial system in a developing country in order to attain greater economic growth?

In order to find appropriate responses to these questions it is first important to decipher their meaning. For Haussman, "there is an ever-growing consensus as to the connection between justice and economic development".[64] Hay, Shleifer and Vishny, in the same vein, said that

"the primacy of the law means in part that people use the legal system to structure their economic activities and resolve their contentions. This means, among other things, that individuals should learn what the legal rules proscribe, and structure the respective economic transactions by using them, seeking to punish or obtain compensation from those who break them and turning to the public entities such as the courts or the police, seeking to apply them".[65]

We can summarise thus far that from the point of view of economic development, judicial systems perform four central functions:

1) They protect the rights to private property;

[62] Douglass NORTH. *Structure and Change in Economic History.* New York: New York, WW Norton, 1981.
[63] George STIGLER. *Law or Economics?* The Journal of Law and Economics. Vol. 35, n. 2, oct. 1992. pg. 462-3.
[64] Ricardo HAUSMANN. *La politica de la reforma juidicial en America Latina.* Mimeo, 1966, p. 41.
[65] Jonathan HAY, Andrei SHLEIFER, Robert VISHNY. "Toward a theory of legal reform", *European_Economic Review*, vol. 40, n. 3-5, Apr. 1996. p. 559.

2) They establish rules for negotiating and selling these rights among private parties themselves and the State;

3) They define rules for market access and departure;

4) They promote competition and regulate conduct in the sectors where there is a monopoly or little competition.

In synthesis, the law dramatically affects the economy in determining property rights and contractual rights, and also by correct application of the law by the judicial branch. It is law which best explains the difference between developed and developing countries, while the respect for contracts and private property is of great benefit in an economy with a credible legal system. A legal system with a properly functioning judiciary is a pre-condition for the credit market.[66]

A credit market requires from its most basic conception an equally efficient judiciary. This is because the greater the confidence in the judicial system, the higher the chances that the credit system can develop adequately.

There has been an equally ferocious debate over judicial efficiency. Dakolias stated that judicial efficiency can be measured, which is not the case with its other intrinsic characteristics such as the quality of rulings, or even on how judges are trained.[67] Here one discusses the time it takes to reach a ruling. Apparently the evidence that the origin of the legal system is not so relevant – there is not a single model – is that Pakistan, Nigeria and Thailand are all consuetudinary law countries and take up to 630 days to reach a conclusion in enforcing a check. Also, a country's level of socioeconomic development is not relevant – Canada takes on average 421 days while Belize takes 60 and Swaziland takes only 40 days.[68]

The conclusion of the Dakolias study is that morosity implies that economic agents will completely avoid the judiciary. Complex shareholder cases, for example, end up migrating to other arenas for resolving conflicts, such as mediation or arbitration. Buscaglia and Domingo summarizes the general sentiment of businesspeople who bring their conflicts

[66] MAYER. Colin and SUSSMAN. Oren. *The assessment: Finance, Law and Growth.* Oxford Review of Economic Policy. vol. 17. n. 4

[67] The book by Maria DAKOLIAS published by the World Bank, *Court Performance Around the World*, 1999, is obligatory reading to understand comparative jurisdictional systems.

[68] Idem, ibidem.

to the judiciary: the majority of market participants are simply are not inclined to have their conflicts resolved by the courts, because they perceive the system as slow, uncertain, expensive and of poor quality.[69]

The best explanation for efficiency – if we employ here the term as a synonym for speed – is not necessarily time, but the number of judges in a given country per lawsuit. If we use this scale objectively to compare various legal systems there are some surprises. For example, Germany has 27 judges for every 100,000 inhabitants, France has ten, Ecuador and Peru have only one, and Brazil has five.[70] A second analysis is the percentage of GDP spent on the judiciary: here, Brazil has a relatively comfortable position and is more or less average. Despite the general criticism that the Brazilian judiciary does not have budgetary resources, the reality is quite different. The judiciary does indeed spend close to 1% of the GDP, which is in line with other emerging market countries, but the problem is that it spends its funds poorly.[71]

Another criterion is to consider the problem through the viewpoint of the backlog of suits or by the demand on the judiciary. With the promulgation of the Constitution in 1988, a new generation of rights came to the fore – such as for example, all the material related to consumers' rights, environmental law, etc. Access to the judiciary – both ample and unrestricted – has ended up causing an extraordinary burden, and even Brazil's highest judicial authority, the Federal Supreme Court, has among its jurisdiction rulings on *habeas corpus* in petty criminal cases.

According to some analysts (and the article in the *Financial Times* reveals this) the overwhelming criticism of the Brazilian system pertains to a persistent conviction that each case should be judged on individual merits, case by case, in a justice model carried forward from the 19th century. The statistical data for the filing of claims per year (and we will be doubling the number of suits at this rate in only 10 years) added with our anachronistic procedural system causes an extraordinary delay, even in situations where the final result should be exhaustively well known.

The critique is a simplification of the discussion of Constitutional Amendment no. 40 of 2006, which approved the *Súmula Impeditiva de Recursos* and the *Súmula Vinculante* (*stare decisis* in Anglo-Saxon common law, which obliges lower courts to uphold precedent

[69] BUSCAGLIA, Edgardo and DOMINGO, Pilar. *Impediments to Judicial Reform in Latin America.* 1997. Centro de Investigación y Docencia Econômica, Mexico.
[70] Idem. ibidem.
[71] World Bank. (2006). *op. cit.*

of the higher courts). Afterwards came the infra-constitutional legislation, that is Bill 6636 of 2006, which regulates the use of *Súmula Vinculante* by the Federal Supreme Court (STF), a mechanism which obliges the lower instances of the judiciary to follow the orientations adopted by the STF and sanctioned by the Chief Executive. Others sanctioned include Bill 5828, which concerns the use of data technology for the judicial process, and Bill 6648 of 2006, which limits the analysis of extraordinary suits by the STF to questions with general repercussions, considered relevant to society as a whole. Meanwhile Bill 6636, which was ratified into Law 11276 of 19 December 2006, created the *Súmula Impeditiva de Recursos*, a law which determines that the Judge in the first instance shall not accept an appeal of any sentence which is grounded in precedents set by the STF or the Superior Court of Justice (STJ).

The proposal in theory should reduce the amount of litigation in the courts without harming the autonomy of the magistrates, who will be free to decide differently from that foreseen by precedent in the higher courts.

As such the efficiency of a system cannot be the only measure as it also varies from country to country. For example, in Argentina, a judge spends almost 70% of his time in activities besides hearing and ruling on cases. There are no similar time budget data for the Brazilian judiciary, but it could be estimated that a judge spends more than half of his time in other activities (administrative or notary functions, interlocutory dispatches, etc.)

Finally there are other aspects besides the sluggishness of the system to be considered. For example in a recent study by IUPERJ, it was shown that 80% of judges believed it was their role to produce the law by means of decisions which they believed to be just. While we will discuss "judicial activism" when we refer to the anomalies in the credit system, the data are surprising in that for a system such as ours, the judge can only declare (or carry out in the case of enforcement) the law. This perhaps is a very clear sign of the crisis facing the Brazilian judicial system.

Judicial Certainty

In a society without a properly functioning judicial system, there is no judicial certainty and the judiciary therefore cannot hope to make any sense or any difference at all. Judicial security is a principle upheld by law as fundamental to reduce uncertainty, since without this

security, economic agents are not able to resolve their conflicts or simply do not know how to go about it.

One strong argument that arises from the economic analysis of law is that private parties continue to create contracts among themselves, as well as with the public sector. The economy is contractual, except for consumer purchases (which are often of a trivial nature such as buying a soft drink at a local market) in which the tradition of delivering the good is involved, the bulk of transactions imply term payments, and therefore obviously require contracts.[72] And we have already referred to extensively in other works, the contracts are incomplete, that is, despite there being a mechanism to mitigate risk, it is impossible to predict all that might occur in the course of fulfilling a contract.[73] Thus, when contracts are incomplete, enforcing rights – in the hypothesis of non-compliance or if the contract did not foresee something – the only recourse is to turn to judicial security, the standard by which to evaluate conduct. If for example, the judicial system does not offer a degree of security recognized by market participants as such, they begin to predict and contemplate an entire series of events which might go wrong – or in other words, if the contract serves to mitigate risks, predicting and detailing and putting into the contract everything that might transpire becomes a way to do so.

It goes without saying that this type of posture has serious implications for the costs of a transaction. Secondly, in attempting to fill all the holes in a contract, permitting negotiations and accommodation *ex post*, the contract loses its original value. If it is known that the contract cannot be enforced, why have a contract? Judicial security is primordial for any judicial system simply because it provides guarantees in a coherent, consistent, and continuous way that the contract will be enforced.[74]

[72] The argument of the Economy of Contracts is quantified in SALANIÉ. Bernard. *The economics of contracts.* Cambridge : The MIT Press, 1997.
[73] See CASTELAR PINHEIRO and SADDI. *Direito, Economia e Mercados*. São Paulo : Campus, 2005.
[74] Spontaneous informal contracts for petty transactions still require the overall rule of law if they are to remain efficient, even without the Judiciary itself as a central presence. Goods can be easily compared against a reasonable and fair standard of quality and price, as a function of market competition, yet as expressed by the age-old market canard *caveat emptor*, the system requires that consumers discern for themselves whether or not a transaction is secure since they may not have the immediate protection of the Judiciary. In a broader sense though, judicial security is necessary to ensure the medium of exchange itself is secure and reliable, and that there is some recourse to establish and maintain the propering functioning of the marketplace at large. Without market confidence in judicial security, even the most trivial consumer transaction becomes a complex matter, as seen during the procyclic crises in Brazil when the prices for consumer goods were "indexed" for inflation periodically throughout the day. The fact that such a system typically works well, without judicial recourse, may suggest a compelling argument for the complementary relationship between the free market system and judicial security. Notably, however, when credit comes into play, even on a small scale such as offering a cheque for a minor consumer purchase, the system is apt to break down for the very same reasons as discussed here.

Without judicial security, there are no rights. As Siches put it, there is neither good nor bad law, nor of any other class.[75] More than understand that the law is indispensable to modern society, it is necessary to loosen the concept of judicial security and how it can be translated in positive law.

For Giambiagi and Castelar Pinheiro, judicial security translates into stable, certain, predictable and calculable norms. They write:

"In positive law, judicial security is sustained by an ample set of principles. Of these, several revolve around ensuring the continuity of judicial norms and the stability of situations involved, guided by the rule that new laws are made to govern the future and not prior situations. The certainty of judicial relations is another important objective sought by the principle of judicial security. This includes the fictitious principle of obligatory knowledge of the law, which means that it is up to people to know the rules, identify what is obligatory, prohibited, and permitted, and based on this understanding, define their behaviour and structure their relations. Otherwise, judicial relations based on the law should be protected by the public authorities. Judicial security also seeks to allow individuals to plan based on reasonable and foreseeable expectations in relation to the future implications of their judicial action. Regarding judicial relations within the economic sphere, especially, the rules should provide the individual with the possibility of calculating with a certain degree of predictability, the consequences of his actions."[76]

The authors also infer that judicial insecurity makes property rights uncertain, since market participants dedicate their time and resources to protecting themselves against the risk of expropriation (remitting funds to other jurisdictions, for example), saving less (if the future is uncertain, it is better to consume right away...), exchanges become riskier (there is no certainty of receiving the agreed-to amount) as well as the low potential put assets to work in gainful activities (for example, assets may not be accepted as guarantees).[77]

There are many concepts which must be discussed here. If the law is through its own excellence, an inducer of behaviour, it is evident that there must be, above all else, a system of incentives for desired behaviours while maintaining certain controls for undesirable behaviour.[78] For example, in order for traffic to move flow more efficiently in any large urban center, there are restrictions on parking. There is clear and evident command which seeks to

[75] Luis Recasens SICHES. *Tratado general de filosofia del derecho.* México, Porruá, 1986, pg. 224
[76] CASTELAR PINHEIRO, Armando and GIAMBIAGI, Fábio. *Rompendo o marasmo. A retomada do desenvolvimento no Brasil.* Rio de Janeiro : Elsevier, 2006. pg. 192
[77] Idem, ibidem. pg. 193
[78] The notion is from BOBBIO, Norberto in his *Teoria do ordenamento jurídico.* Ediouro, 1992.

encourage a clear and evident behaviour: parking in a prohibited spot will result in a penalty (a monetary fine), thus, to avoid the penalty it is better to find an alternative. Let us imagine for a moment that the value of the fine is R$10.00, and the cost of the parking fee in the same location, also R$ 10.00. The rational decision – without any other consideration involved – is to go right ahead and park in a prohibited area and take one's chances with the fine since in the worst case the penalty will not cost more than the parking fee. The law, as can be seen, can stimulate a certain behaviour – right or wrong, depending on the legislative option and of the socially desirable choices – by means of a specific sanction which follows non-compliance with its intent.

If we suppose in this example that the fine was not R$ 10.00 but R$ 100.00, the legislative command clearly discourages opportunism. Not only does it indicate what is permitted or prohibited, but it also leads to, in a certain sense, the choice of behaviour which is socially correct and desirable. The same holds true for the market participant, who calculates his or her actions according to the risk implied in non-compliance. Taking this to the level of the absurd, imagine if the penalty were not a fine but instead the death penalty. In this case, the market participant would be unlikely to exit the parking garage because clearly the risk of the sanction is so severe that it is safer to simply stay at home.

In this singular example, consider as well that the command "no parking" is written into law as "under the criteria of the government, it may be prohibited to park". Another degree of complexity goes beyond the sanction established in the bylaws, which is the degree of authority. In other words, the degree of clarity over what is and what is not prohibited. And, if it is prohibited today, but not tomorrow, and if next week nobody knows if it will be prohibited or not to park in a given spot, the market participant cannot possibly plan whether to stay in the car or not.

Beyond the challenge of clarity and stability in the rules, there is also the question of predictability. This implies evidently that the rules will be applied correctly, with prudence and equity – and accordingly it is correct to infer the maxim attributed to then Minister Hélio Beltrão: the problem is not the magistrate or the legislator, it is the guard on the corner who will enforce the law.[79]

[79] DUARTE, Antônio Carlos. *O guarda da esquina.* Folha de São Paulo, 29 July 1999. Minister Hélio Beltrão, while voting "yes" to the adoption of AI-5, had reservations against its execution. "The problem is the guard on the corner," not rarely unprepared, who would come to possess so much power. "Many will be able to make arrests, but few will be able to free prisoners" he said. Thus the drama of draconian laws: their execution.

Another delicate problem of opportunism is the factor caused by externality. Externality is used here in the sense that it is a negative factor caused by one market participant on another, affecting his or her well-being, in the absence of a direct economic transaction between them. Externality is caused by someone who has to bear costs without consent. For example, when an individual opts for common personal credit, even if he has a perfect and punctual credit history, there is a good chance that he will have to pay a 'premium' because of the bad debt of third parties and deadbeats who increase the margin of risk.[80]

Finally, the uniformity of interpretation of the law, the very stability of its existence, and the predictability of sanctionable conduct are other factors of extreme importance. In the securitised credit industry, which is highly specialised and sophisticated when involving a project with term payments, the only property rights which can remunerate the invested capital over time are the contracted receivables. If a federal ministry, the Central Bank, or any other body such as in the past, can change the original covenants – such as for example, via a table or other unilateral decision to modify the regulations which were in force at the start of the project – the rational structure for deciding upon an investment is entirely compromised. The same can occur with a different interpretation of jurisprudence over the issue. In so far as the judge is free to decide and form an opinion, he or she is not free to judge beyond the law or even contrary to it. Even the hint of a contrary ruling against a payroll-discount loan caused the interest rates to go up.[81]

Judicial security does not imply only making changes in legal texts. laws which are ambiguous, ample, vague and internally inconsistent result in an equally irregular application. Former STF justice Nelson Jobim stated that there exists a "judicialisation" of politics, given that the Legislature, with its fragmented political base and unable to reach a consensus any other way, ends up remitting normative bylaws to the judiciary to reconcile later facing conflicting material.[82]

[80] See the concept of externality in NUSDEO, Fábio. *Curso de Direito Econômico.* and CASTELAR and SADDI. *op.cit*.
[81] See COSTA, Ana Carla and MELLO João M. P. *Judicial Risk creditor expropriations: micro evidence from Brasilian Payroll Loans.* www.nber.com
[82] Presentation by Justice Nelson JOBIM. *Reforma do Judiciário.* 22/08/2006. Secretary of Judicial Reform.

The concept of 'jurisdictional risk'

Based on the observation that the domestic long term credit market in Brazil is basically sustained by the state bank BNDES, there is no other option except long term foreign debt. Arida, (*et al.*) made two important inferences: first, in the majority of long term credit contracts between private parties and the State which tap international markets, the jurisdiction is always foreign and the contracts are expressed in foreign currency. [83] They argue that it is not the domicile of the creditor which explains these observations, but rather the risk that the judiciary may rule with an anti-creditor bias. This combination of risk they define with the phrase *jurisdictional risk* in the following terms:

"Jurisdictional uncertainty may thus be decomposed, in its anti-creditor bias, as the risk of acts of the Prince changing the value of contracts before or at the moment of their execution, and as the risk of a unfavorable interpretation of the contract in case of a court ruling. For our purposes, jurisdiction matters as the power of the State consequent upon its sovereignty to issue laws and administer Justice, and is not restricted to the territorial dimension of the contract. A long-term domestic market does not exist because there are no long-term financial savings available under Brazilian jurisdiction. [84]

While the expression became quite well known – even if the other arguments in the paper did not – and many have contested them, it is interesting to understand a bit more the justification that Arida gives to the existence of jurisdictional risk and why he understood that because of this uncertainty the long term domestic credit market no longer exists.

For Arida *et al.* it is not a question of confidence in the currency, even if according to the authors that the risk inherent in the value of the currency can be mitigated with financial instruments such as derivatives. And it is not exactly a problem of pricing those risks, nor of credit, nor of the price of assets with a foreign exchange clause or even country risk. And

[83] ARIDA, Pérsio. BACHA Edmar Lisboa. RESENDE André Lara. *Credit, Interest, and Jurisdictional Uncertainty: Conjectures on the Case of Brazil*. Instituto de Estudos de Política Econômica, Casa das Garças Rio de Janeiro. 2004. Published in F. Giavazzi and I. Goldfajn (eds), *Inflation Targeting and Debt: the Case of Brazil*, MIT Press. They stated: "There is however a large long-term credit market to Brazilian debtors when the jurisdiction is foreign. Access to this market is restricted to the government, large companies and large banks – firms the size of which justifies the cost of verification of credit quality. The credit risk is, thus, Brazilian, but these same firms that obtain long-term credit outside the country are by and large unable to obtain financing with equivalent maturity in the domestic market. The existence of a long-term credit offshore but not on-shore is not explained by the location of the creditors' decision-making center. There are resident creditors with decision centers offshore, and non-resident creditors with decision centers in the country. The same creditors act on both markets, but they are only willing to lend long-term offshore. The inexistence of a local long-term credit market is also not explained by the currency of denomination of contracts. Despite the legal restrictions for the local issuance of dollar-indexed private debt, not even Brazil's Treasury is able to finance itself locally with long-term dollar-linked bonds. There is no long-term credit market on-shore, either in *Reais* or in foreign currency."

[84] Idem, ibidem

finally according to the authors, it cannot be confused with the risk of doing business in Brazil, which is sometimes called "Brazil cost", or in other words the various transactional costs of any new operation in Brazil. The jurisdictional risk is based on an anti-creditor bias due to negative experiences and a certain judicial activism, as follows:

"Jurisdictional uncertainty reduces the overall availability of credit in the economy and precludes the existence of a large long-term financial market. Secured debt contracts are not sufficient to stimulate credit supply where the judicial system renders difficult the right of creditors to repossess the collateral. The quality of enforcement of guarantees is poor as both laws and jurisprudence are biased towards the debtor. Even if the creditor has sufficient knowledge of the debtor and feels comfortable to lend him for a longer period, jurisdiction uncertainty will make his credit illiquid. If the original creditor needed the resources and had to sell its credit instrument, nobody would be willing to buy it at a fair price. The credit cannot be fairly priced by someone who does not share the same knowledge of the debtor as the original creditor. Every long-term credit instrument is therefore illiquid. Bilateral relationships might work, but jurisdictional uncertainty precludes the possibility of multilateral impersonal transactions that involve credit over longer time periods."

The study is widely contested for various reasons. The central argument of Fernando Gonçalves, Márcio Holland and Andrei Spacov, for example is that a deficient jurisdictional system does not explain the high interest rates and that the empirical results tested furthermore demonstrate that "traditional factors" of monetary policy are "definitely more relevant" to justify the absence of a long term credit market in Brazil.[85]

Ivan Ribeiro suggest in another study that for in-court contractual discussions, where there are a larger number of *normas cogentes*, or a kind of *hard law* which cannot be revoked in part, "variations in the results of judicial decisions between those in which the judge observes the strict terms of the contract and those in which he or she supposedly is carrying out social justice, can be explained by the fact that these contracts go against the law".[86] In other words, the judge is not "carrying out social justice", because the contracts that he or she disrespects "go against the law". As there is still no other objective or independent evaluation of whether or not the contracts contradict the law, the study did not conclude with arguments against Arida *et al*. In refuting "social justice" and "ruling against

[85] GONÇALVES. Fernando M., HOLLAND, Márcio and SPACOV, Andrei. *Can jurisdictional uncertainty and capital controls explain the high level of interest rates in Brazil ? Evidence from panel data.*
[86] RIBEIRO, Ivan. *Robin Hood vs. King John Redistribution. How do local judges decide cases in Brazil ?* mimeo.

the law", and from there to conclude that certain judges do not search for social justice is a syllogism to be criticised.

Perhaps the argument is more valid than it is equivocated, and the works which contest it do not quite present sufficient proof that there is any difference between an elastic interpretation of the law (for example, for a social reason) – and simple disrespect for contracts, nor is there robust evidence that judicial uncertainty is irrelevant.

There are altogether three aspects which are worth considering and serve as final thoughts for this paper. First is the very nature of our fragmented judicial system. While the Napoleonic Code was intended simply to be a direct and objective compilation of the entire private law system, the writing of other normative bylaws in countries which adopted the system of codification only shows the immensity of conflicts which have come about in our judicial organisation. Viewed in this way, there is not a single law but myriad laws, including some on top of others.

Secondly, the system of the code attributed to the Judge reduced importance. Minimizing the role of the judge as interpreter of the law, the Napoleonic objective was simply to have a clear and objective law which could be applied by the Judge. Clearly with the expansion of the judicial functions, this intended objectivity simply ceased to exist.

Finally, while the judicial system was created to insulate the judges from influence, permitting more precise technical decisions with the revision of the double degree of the jurisdiction, what was observed in practice was the absence of positive incentives. For example, if on one side the life-long tenure of a judge permits decisions greater freedom from influence, it also puts an end to the incentives and the motivation for a career judge to do the same thing over many years. And the double degree of jurisdiction has the effect of procrastinating what is done for many long years.