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The private legal order, financial intermediation and competition

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Since the 1970s, the relatively new discipline of economic analysis of law has gained a firm foothold in the Anglo-American common-law world, where today it is more or less on a par with other fields of legal scholarship. Since the 1980s, it has obtained less substantial footholds in Latin American countries rooted in civil-law tradition. Accordingly, much of the work done in law and economics to date focuses on the developed world. The work done on the developing world has been more limited.[1] None the less, though it has turned in meagre results to date, the prospects for the success of the field could hardly be brighter. The present state of knowledge is at a sort of 'tipping point.' Law and economics is now in a position to co-opt civilian methodology, where civil-trained legal scholars will be able to undertake a searching inquiry of the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung.)* As a result, the immediate future augurs well for the prospects of the economic analysis of law in developing countries.

Some may see, with critical legal eyes, ulterior motives on the part of industrialised countries in the diagnoses that have originated in the past on what's wrong with the law in developing countries—the law and development movement of the 1970s was undertaken with completely altruistic reasons by North American legal scholars centred in New York University, who aimed to help transfer their knowledge base and experience to the developing world. The new field of law and economics of development—as described by Edgardo Buscaglia[2]—may be just over the horizon. This paper seeks to contribute to this new field. By bringing together work from transaction costs economics, development economics and corporate finance, we will change the focus of the inquiry in the literature on financial intermediation from one of the nature of economic organisation to one of the legal

system. These fields still fail to grasp the nettle. We reexamine the question from a different perspective: how the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) facilitates the channelling of savings into productive investment through financial intermediaries.

Pioneers in the field of law and economics are clearing great paths into understanding and opening up the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) to reveal a wide panorama of just how private property rights and the law of obligations redress informational asymmetries, align incentive effects, reduce monitoring costs, allow for pricing mechanisms, mitigate governance costs and decentralise decision making about resource allocation. Nearly half a century ago, Ronald H. Coase defines transaction costs as all the expenses run up in negotiating and enforcing agreements in the private marketplace.[3] These costs include the amounts expended in identifying the parties with which to transact, carrying out negotiations to come to an understanding, formalising the agreement that will spell out the rights and obligations of the parties concerned, choosing a contractual form that makes the agreement legally binding, measuring and monitoring the performance of the parties under the agreement, and enforcing the contractual obligations entered into by the parties.

By bundling together the different costs run up in negotiating and enforcing transactions, Coase is able to bracket this part of the analysis into one measurable overall ledger and focus on other specific, definable factors—eminently subject to examination and analysis—such as the legal system or the nature of economic organisation in the private marketplace. Twenty years after Coase defines transaction costs, another economist, Robert D. Cooter, improves upon Coase's base analysis.[4] Cooter points out that by bracketing transaction costs, Coase postpones the economic analysis of conflict and cooperation. A new discipline,

game theory, formalises the study of strategic behaviour where people try to affect or anticipate the behaviour of others.[5] Cooter argues that what Coase calls 'transaction costs' turns on strategic behaviour. Game theory focuses on situations of interdependence: where what I do depends on what you do, and what you do depends on what I do. Cooter proposes to analyse Coase's hypothetical world of efficient bargaining through a game-theory lens.

Coase looks mainly at hypothetical situations of interdependence, where external costs are problems of a reciprocal nature.[6] The vibrations from a confectioner's machinery disturb a doctor's work/a doctor's ability to work in peace and quiet would interfere with the operation of a confectioner's machinery. A rancher's straying cattle destroy a neighbouring farmer's crops/a farmer's crops would be in the way of a rancher's straying cattle. The fumes of a manufacturer of ammonia sulphate discolour a neighbouring manufacturer of coir matting's husk fibre/the husk fibre of a manufacturer of coir matting would be in the way of a manufacturer of ammonia sulphate's fumes. A landowner's high adjacent wall partially blocks a neighbour's chimney so that smoke billows into his flat/a neighbour's chimney would blow unhealthy smoke on and grime a landowner's high wall. The stopping up of a well prevents a neighboring pub's brewing operation/the venting of a pub's brewing operations through a well would contaminate a cottage owner's well water. A building blocks air to a whirring windmill/the breezes a windmill is harnessing for wind energy would blow where a building stands. The oily smell of a fried fish shop disturb well-off neighbours/an odour-free environment for the well-off neighbourhood would keep the shop from frying fish. A store addition casts a shadow on a neighbouring hotel's swimming pool/the fun in the sun at the neighbouring hotel's swimming pool would interfere with a store addition. An airport's noise, dust, and low-flying planes disturb a landowner/simple peace and quiet for the landowner is in the way of an airport. The sparks of a railroad

engine damage woods and crops along its path/landowners would grow woods and crops along the path of a railroad line. A landowner's rabbits overrun a neighbour's land/a neighbour's land is in the way of the rabbits harboured by a landowner. A farmer's manure pile causes a fly infestation in a neighbour's house/a fly-free environment for a neighbour's house would keep the farmer from engaging in animal husbandry. A factory next door discharges pungent fumes and metal dust/a clean environment would keep the factory from operating and local workers would lose their jobs.

Game theory generalises situations of conflict and coordination. All of the (partially) hypothetical situations Coase discusses are a limited case of bilateral bargaining games, in which the parties possess asymmetric information and an institutional mechanism is necessary to overcome the strategic problems. In Coase's nomenclature, the parties in these hypothetical situations face 'high transaction costs' and the institutional mechanism here is the court system that settles disputes. Coase also conceptualises a situation where bargaining parties face 'low transaction costs,' though he fails to present, de rigueur, paradigmatic examples of such situations. Voluntary exchanges in the private marketplace, which are potentially ubiquitous, and hence barely-noticed, involve multilateral bargaining games, in which the parties possess asymmetric information and an institutional mechanism is also necessary. However, as Cooter makes clear, the institutional mechanism here is the competitive market. Competitive prices in the marketplace simplify the bargaining process for people as a matter of routine. What are the competitive prices in the marketplace? There's only one way to know that, and it's to shop there. These much more mundane situations are not anything more than just that: ordinary occurrences. Perhaps everyday economic life is just too run-of-the-mill for Coase to attempt to illustrate. Cooter's approach generalises Coase's analysis with remarkable elegance and represents a significant analytical advance upon Coase.

Games	Institutional mechanisms
Bilateral bargaining games with asymmetry of information	Legal courts
Multilateral bargaining games with asymmetry of information	Competitive markets

Coase's approach invites us to look upon on how judges or legislators choose rules to govern disputes in tort, contract, or property—where there is a bargaining breakdown—which is just what Guido Calabresi and A. Douglas Melamed do in short order.[7] However, the legal system handles all sorts of everyday situations, not simply those where disagreements result in litigation and disputation in court. Coase deduces that, as long as there is free exchange and transactions costs are zero, efficiency would be achieved irrespective of the initial allocation of legal entitlements. The real world, of course, is rarely so simple. Bargaining is complicated by strategic problems related to market position or to imperfect or asymmetric information. Cooter's approach invites us to look more generally upon the nitty-gritty of ordinary economic life: how a competitive market facilitates voluntary exchange with the private legal system as a background framework. We should note that a game-theoretic approach underlies the development of the economic approach to property rights. As early as 1968, Garrett Hardin applied the prisoner's dilemma to resource depletion problems.[8] An extensive literature in law and economics explores how private property rights and the law of obligations redress informational asymmetries, align incentive effects, reduce monitoring costs, allow for pricing mechanisms, mitigate governance costs and decentralise decision making about resource allocation.[9] The foundation of a private marketplace consists of a private legal system that enforces private contracts and protects private property rights, and that —we will argue— facilitates financial intermediation.

Private ownership, by allowing owners to capture the economic value of their investments, redresses informational asymmetries and aligns economic incentive effects with decisions on resource allocation. At the same time, private rights, which are themselves rights of exclusion, avoid onerous governance structures and decentralise decision making about resource allocation.[10] Where social norms are ineffective, the private law of obligations supports free exchange, monitoring and credible commitments.[11]

A system of private law not *only* prevents strategic behaviour in bargaining games, in which the parties possess asymmetric information, by permitting varying degrees of exclusion to resources,[12] or restricting opportunistic behaviour,[13] or incentivising parties to reveal information,[14] or monitoring the performance of obligations. It is the constant threat of competition that has been long recognised as the key to price restraint in any free-market economy. Since the 1970s, economic theorists have been asserting that competition, rather than government intervention, constitutes the greatest support to economic efficiency, a point that Cooter brings home for us, not R.H. Coase or A.C. Pigou. Now, law and economics is positioned to co-opt civilian methodology and develop a stronger focus on the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung.*)

Surely, antitrust law by *directly* preventing monopolies and duopolies from forming is vital to spreading proper competition throughout the economy and has long been regarded the traditional turf of the economic analysis of the law. Weak antitrust enforcement allows competition to be stifled as economic actors collude, fix prices or otherwise limit competition. Furthermore, a failure to enforce antitrust laws vigorously may lead to counterproductive new regulations. Effective antitrust law enforcement is thus compelled by sound economics.[15]

Yet even zealous, champions of antitrust enforcement must understand: a precondition for healthy competition remains sufficient access to capital for business start-ups and businesses to expand. Without economies of scale, one cannot compete in the modern global economy—and even with relatively low entry costs, people (with wealth constraints) will be unable to start up businesses without access to capital. Accordingly, financial intermediation opens up access to capital and opportunity to thousands and thousands of people. Many, if not most, economists agree that it is market discipline imposed by competition that is pivotal in encouraging innovation, promoting efficiency, and optimising the investment of scarce societal resources.

Tax law is *directly* pertinent to financial intermediation—although it might be better for tax rules simply not to determine whether people decide to save or invest. Taxing income from savings creates a disparity between the treatment of current consumption and deferred consumption. The tax structure may penalise capital investment and discourage it. Some headway has been made in comprehensive tax reform in Latin America. New revenue-raising measures have shifted from reliance on asset-based taxes, such as those on net worth, business real estate or business inventory, in favour of a consumption-based tax system along the lines of the value-added tax so familiar to Europeans. Another consumption-based tax, the cash flow tax, represents a significant new concept for most people, although it has been well known to economists familiar with the economics of taxation for decades. A cash-flow tax is based on 'cash in' and 'cash out' of a business, and it makes real investment, such as the purchase of capital goods, tax deductible.[16]

Our point is that the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) also *indirectly* supports competition and averts unilateral market dominance by facilitating efficient financial intermediation. Economists seek to differentiate

between ‘positive economics’ and ‘normative economics.’ Positive economics says ‘what is’; normative economics says ‘what ought to be.’ Our analysis is ‘normative’ in that we point to the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) as embodied in the accumulated wisdom and experience of the Roman people for over a thousand years as a model private law system.[17] Our analysis is ‘positive’ in that we point to specific aspects of particular civilian legal systems, which are at odds with the establishment of more efficient rules by private law. In particular, we will ask how the idea of *fides* in Roman law, and the ex post oversight of the *ius honorarium* of Roman praetors and aediles, should provide a model for reform of civil-law systems of today.

In this paper let us look at both bank-based and non-bank-based systems of financial intermediation—both debt and equity. In the past, public policy in Latin America has been overly concerned with putting in place investor-friendly laws, tailoring a more investor-friendly legal regime, or creating the most investor-friendly legal environment. Latin American countries have opened up their economies to global financial markets, and sought to attract foreign direct investment in order to drive economic growth. An unintended consequence of these policies is a lingering vulnerability of our economies to global capital markets and financial ‘contagion’ as financial crises spread from one developing country to another. Another unintended consequence is that many Latin Americans have come to see ‘privatisation’ as handing sovereignty over national assets to foreigners. Latin American countries have surprisingly paid less attention to building robust legal infrastructure to facilitate effective *domestic* financial intermediation, which would limit the contagion effect of financial crises and make the population a participant in making the region’s economy grow.

A contribution to the new field of the law and economics of development has been made by the Peruvian economist Hernando de Soto, who has argued that the lack of formal titles to land and other property prevents the poor in the developing world from posting collateral to secure loans[18] and that excessive red tape and administrative costs prevents them from obtaining formal recognition as legal entities in order to gain access to the domestic lending market.[19] He makes a crucial point. The poor in the developing world own assets worth far more than the money their countries receive in foreign direct investment.[20] Because of antiquated property laws and the high administrative costs of a suffocating bureaucracy, the poor in the developing world are unable to freely own, resell and mortgage the real estate on which they live and have no way to lever their hard-won assets into liquid capital for new enterprises. Moreover, nobody really knows who is accountable for the performance of obligations, who is responsible for losses and fraud, and what mechanisms are available to enforce payment for services and goods delivered. Unfortunately, de Soto refuses to see his own 'backyard' research as law and economics. His work falls within development economics. As result, with an unsurprising lack of legal insight, he is unable to see —beyond the narrow categories of clearly defined property rights and enforceable contracts— that a vast body of law and tradition, the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung,*) stands behind everyday economic transactions. It's a well-worn truism to say that clearly defined property rights and enforceable contracts are critical to successful capitalism. Yet more is needed in Latin America than a re-run of the property-title revolutions that enriched Western Europe and America in the 18th and 19th centuries, or General Douglas Mac Arthur's "magnificent" property-titling programme in post-War Japan. We may also choose to draw attention to another well-established truth: the legal system must ensure public order in accordance with law and implement procedural protections aimed at limiting the abuse of state power. The rule of law is sacrosanct and law and order should prevail. Yet more is needed.

Savings (defined as 'deferred consumption,' meaning we choose to miss out on something today to have more in the future,) are basically the engine room of wealth. More wealth means more choices. Savings allow us to invest or start up a business. Yet investments need time in the market to realise their full performance potential. The demand for capital tends to be at a fixed- or long-term basis. Life for flesh-and-blood human beings, on the other hand, is full of imponderables. The supply of capital tends to be at a withdraw-on-demand- or short-term basis. A broad range of bank and non-bank forms of financial intermediation effectively match withdraw-on-demand- or short-term capital supply and fixed- or long-term capital demand.

Non-bank-based	Market makers	Capitalisation	Private and decentralised markets	Voluntary
Bank-based	Reserves	Leverage	Private and centralised firms	Voluntary
Government	Taxes	Public spending	Public and centralised state	Forced

At the most basic (and oversimplified) level, banks accept deposits that the depositor has a legal right to withdraw on demand or after a short term. Banks pay interest on money deposited, and also make fixed- and long-term secured commercial loans until the terms end, or reach maturity, and charge interest for the money lent. Banks hold a reserve of available funds to reimburse depositors on demand. That's an important duty, and one that provides much-needed liquidity to capital markets. Banking laws and regulations provide a

legal platform to facilitate financial intermediation through debt, by imposing reasonable reserve requirements and regulating the use of commercial paper.

Despite wide financial sector reform since the early 1990s, the region has 'a deeply dysfunctional banking system.' Though banks in the region provide a host of other financial services, they falter or fail as financial intermediaries. Banking regulation in Latin America is rarely characterised by a light touch. Commercial banks in developing countries are frequently subject to regulatory interest-rate caps on savings deposits, even in times of hyperinflation. As a result, private banks—looking for alternative survival strategies—have merged with holding companies and engage in the practice of lending to their non-bank affiliates without adequate security. Most governments in Latin America have successfully pursued cautious monetary and fiscal policies in order to limit upward pressure on prices and quash the persistent inflation that was so destabilising in the 1980s. However, the fall in the growth of personal bank deposits remains, as rising risk premiums push against caps on interest rates, and real interest rates move into negative territory. The level of financial intermediation in Latin America is extremely low. Some governments in the region have even imposed freezes on bank savings accounts without much impact on the broader economy. Caps on interest rates may have to be lifted, but the solution lies deeper in the fine-tuning of the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung.*) In addition to de Soto's property-titling programs, an overall reform in the area of secured transactions in Latin American civil and commercial codes is advisable to ensure that people can freely pledge their chattels. To achieve this reform we need to work within a framework of Roman law—not with a legislative framework resembling Article 9 as it has been achieved in the U.S.[21] Roman law is a useful model in another way. Land or chattels, as forms of real security, are the most sought after by banks, finance companies, and other lenders. Their values, and the acceptable margins of risk which form the basis of

loans, can be easily calculated. However, civil and commercial law could take inspiration from Roman law, where *adpromissiones* were preferred forms of personal security. The practice of micro-lending began in the early 1980's and grew slowly, but from the experience to date, most economists agree that it works. Micro-credits target the working poor who have good ideas for starting businesses, but lack collateral to apply for traditional bank loans. Micro-credits are backed by 'solidarity' groups of co-guarantors. However, it is worth noting that micro-lending is not a form of financial intermediation but a form of state aid or private philanthropic economic assistance, and may for this reason take place on too small a scale to promote economic growth.

The relationship of the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) to bank-based systems of financial intermediation is well-understood.[22] What is invariably underconsidered in the relevant literature is the relationship of the private legal order *(el ordenamiento juridico, l'ordre juridique, die Rechtsordnung*) to non-bank-based systems of financial intermediation.

Corporate finance has focused on the nature of economic organisation to the detriment of the legal system. Franco Modigliani & Merton H. Miller established, in the late 1950s, that under certain restrictive assumptions the cost of capital to a company—and its market value—would be independent of both its debt-equity ratio and its dividend payout ratio.[23] The (admittedly unrealistic) assumptions that shape Modigliani and Miller's capital structure irrelevance proposition are: that there be no taxes and no costs of bankruptcy; that the cash flows of a company be determined exclusively by the assets of the company; that there be no asymmetry of information between managers and investors; and that there be no agency problems between managers and their company's existing shareholders. Modigliani and Miller's proposition serves to identify the sources of the importance of capital structure

in economic organisation. Various scholars in corporate finance and law and economics have followed this line of inquiry by relaxing the various assumptions that lead to situations in which capital structure matters.[24] However, the inquiry in the literature on financial intermediation has been on the nature of economic organisation generally—as has much literature in transaction costs economics,[25] as well as in law and economics.[26] With Cooter´s expanded lens view, we intend to move this inquiry on financial intermediation to the legal system now.

At the most basic (and oversimplified) level, passive investors buy shares issued by a company. Shares, also known as equity, are freely transferable and represent ownership of part of a company. Shares provide passive investors both capital growth as their prices rise and regular income through the payment of dividends. Companies receive investments in exchange for an equity stake at par value. The stakeholders are passive because they remain rationally ignorant about the details of the business. In order to invest, accordingly, they need the protection of limited liability (Otherwise, the collapse of a company may bring ruin to passive investors faced with unlimited liability.) The limited liability means that their losses as owners of the company will be limited to their investment in the company. To obtain such limited liability, companies must do more than simply incorporate. The business must be run as a corporation. All payments must be to or from the corporation, and all documents must be in its name. Regular meetings of the board of directors and of the shareholders (with minutes) must also be held. Companies receive investments on a permanent- or until-they-buy-back-shares- basis. The stakeholders are able to recover their investments on a withdraw-on-demand- or short-term basis by selling their shares to other passive investors in a stock exchange. A stock exchange is a facility for buying and selling shares. Broker-dealers act as 'market-makers' in a company's shares after it goes public, by matching buyers and sellers. They generally keep an inventory of those shares in their own

account and stand ready to trade it at virtually any time of the ordinary trading day. That's an important role, and one that provides much-needed liquidity to capital markets. Commercial and securities laws and regulations provide a legal platform to facilitate financial intermediation through equity, by offering a range of protections, including limited liability, regulating restrictions on transferability of shares (which would hurt the liquidity and value of shares) as well as protecting market makers from insider trading,[27] requiring full public disclosure of all material information by a publicly-traded company and protecting the interests of minority shareholders from asset-shifting.

Despite the expansion of market capitalisation that has occurred since the early 1990s, stock markets in Latin America are not yet 'mature.' Though stock markets tap flows of capital from foreign investors seeking high returns in emerging markets, they falter or fail as domestic financial intermediaries. The majority of passive investors are located outside emerging market countries. Typically trading occurs on fixed-income securities, mostly bonds, asset-based securities, securitised debt instruments, and a few stocks, which account for a considerable part of total market capitalisation. Stock markets are riddled with labyrinthine regulations that make it hard to buy or sell securities. Many so-called privatisations so far have simply parcelled out dominant shareholdings to different arms of government, leaving only minority stakes for private investors. A lot of companies have very concentrated ownership structures and sell only a small part of their shares in public offerings. Moreover, the controlling shareholders of publicly-listed companies and other enterprises with concentrated ownership abuse their control to exploit other shareholders. Latin American commercial law provides weak legal protections for minority shareholders, which include supermajority voting rules and allocating directors to large-block minority shareholders. Beyond these basic measures, the law allows for the rights of inspection, proposal and withdrawal.[28] Latin American commercial law also establishes 'personal

liability' for company directors and officers. However, these rules are ambiguous, general and abstract. They cannot really be enforced except in exceptional circumstances, which makes them illusory and theoretical. Lastly, the lack of liquidity and the shortage of market makers mean it is difficult for shareholders to exit a corporation, which is scarcely effective in imposing market discipline on managers.[29]

We rely on *fides* in civil and commercial relationships and in investor relations. *Fides* may be of a contractual- and quasi-contractual nature as in *communio*. Courts in Latin America should exercise wide latitude in protecting the interests of minority shareholders in private companies as well as in a wide assortment of other relationships that involve Roman law *fides*. Basically, courts must have the power in the spirit of the *ius honorarium* to order whatever ex post just relief they deem necessary. In a civil society, *fides* as a legal concept should be both essential and seen as an entry point for efficient social norms into civil and commercial law. Legal doctrine may examine in what relationships *fides* exists, exactly what constitutes a betrayal of *fides* and the legal consequences generated by such a violation. *Fides* will probably be found to exist in *fiduciarius*/*fidiecommissarius*, *mandatarius*/*mandator*, *tutor*/ward, corporate director/officer-corporation and shareholders, *socius*/*societas*, and major shareholders/minority shareholders relationships (These categories are not exclusive.) When the incentive structure is efficient, courts should uphold *fides* to mitigate the rigours of civil and commercial law in accordance with underlying social norms.[30] It cannot be denied that conducting business with and on behalf of other people involves a great deal of responsibility, and can also involve uncertainty, not to mention risk. Who knows what the future might bring? This is why the Roman consensual contracts of *societas* and *mandatum* are frequently open-ended and rife with gaps (incomplete contracts.) It is difficult to specify all the possible outcomes ex ante, or to know which details will be important ex ante. In civil and commercial life, we are called

upon to act with *diligentia*. However, monitoring and evaluating the performance of people we rely on is costly. For all we know, they may shirk their responsibilities or misappropriate our assets. Accordingly, courts may be called on to make ex post determinations regarding whether people have acted with *fides*, which are necessarily context-dependent. In cases of apparent conflicts of interest, self-dealing and misappropriation, people may have to prove that they acted with loyalty. In cases of inferior results, people may be called on to prove that they acted within the standards of care required. Or they may be shielded from such inquiry. Different levels of risk are appropriate in different relationships. For example, a *tutor* often is required to act with *diligentia quam in suis* in managing the assets of his ward, whereas the officer of a corporation may only be liable for *culpa lata*.[31] Courts in Latin America must create incentives to abide by Roman law *fides* (the *ius honorarium* was perennially relevant to Rome's increasingly complex, commercial life) in order to support civil and commercial relationships and investor relations in the region.

Financial intermediation occurs between withdraw-on-demand-/short-term capital supply and fixed-/long-term capital demand both through debt and equity markets. A lack of access to capital as a result of dysfunctional financial intermediaries means that even low entry costs to much economic activity become prohibitive for people with wealth constraints, and there is less shadow competition around the entire economy. Economics textbooks all suggest that a lack of competitive market discipline ultimately leads to higher prices and lower quality, and generates net social losses. The lack of shadow competition also hobbles Latin American countries with inefficiency, listlessness, underemployment, lack of discipline in the workplace, an informal economy, lost economic opportunities, lack of global competitiveness, nepotism, cronyism, promotions and rewards based on 'know-who' rather than 'know-how,' unnecessarily high staff levels, and rent seeking behaviour, all leading to a lack of real choice in products and services and low national job-creation

figures.

Ineffectively, governments in Latin America —saturated with statist culture— step in as financial intermediaries to fill the void, channelling domestic saving away from taxpayers and to a compendium of government waste, mismanagement and pilfering of the public purse, on an exceptional scale. High deficit financing requirements further crowd out credit to the private sector and lead to the unfortunate practices that permeate the economy: uncontrolled tax evasion, standard double accounting, a habit of under-reporting payrolls and understating revenues and profits. Investors are denied transparent, consistent and reliable financial information and valuation and pricing of the assets and liabilities of companies becomes highly sensitive and potentially problematic for passive investors.

We need to address the inefficiencies caused by the lack of competitive pressures in the economy by focusing on domestic financial intermediation instead of looking to foreign investment or global capital markets. All of the above point to the biggest myths there are—namely, that functional debt or equity intermediation exists at all in many Latin American countries or that a privatised system of Social Security may create them. The full scope of financial intermediation is path dependent on our venerable legal system, which is a product of sixteen centuries of Western life and experience and legal history. We may expect to fill in a very big hole in our understanding of how the legal system and financial intermediation fit together, only through the study of the law and economics of the legal order.

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[1]Robert D. Cooter & Hans-Bernd Schäfer pose the 'novel' question—How would the economic analysis of law in the developing world differ? See Cooter, Innovation, Information, and the Poverty of Nations: (April 17, 2005). Berkeley Program in Law & Economics. Latin American and Caribbean Law and Economics Association (ALACDE) Annual Papers. Paper 15. http://repositories.cdlib.org/bple/alacde/15

[2]The Law of Economics and Development (1997).

[3] The Firm, the Market, and the Law 33 (1988).

[4] The Cost of Coase, 11 J. Leg. Stud. 1, 23 (1982).

[5] See generally John Von Neumann & Oskar Morgenstern, Theory of Games and Economic Behavior (1944).

[6] Coase's examples include some actual English nuisance cases: Sturges v. Bridgman, 11 Ch. D. 852 (Ch. App. 1879). Cooke v. Forbes, 5 L.R.-Eq. 166 (V.C. 1867). Bryant v. Lefever, 4 C.P.D. 172 (Ch. App. 1879). Bass v. Gregory, 25 Q.B.D. 481 (Q.B. 1890).

[7] Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972). Louis Kaplow & Steven Shavell, Property Rules Versus Liability Rules: An Economic Analysis, 109 Harv. L. Rev. 713 (1996).

[8] The Tragedy of the Commons, 162 Science 1243, 1244-45 (1968). Hardin's analysis is very old in the *ius commune*. See Juan Javier del Granado, Controversia de imperio legis et emblemata de origine iuris. Bolivia: Editorial Javeriana 88 (2003).

[9] Running a private market economy is a matter of getting the road rules right, not directing all the economic traffic.

[10] See Henry E. Smith, Exclusion Versus Governance: Two Strategies for Delineating

Property Rights, 31 J. Legal Stud. 453, 457-58 (2002).

[11] See Avery Wiener Katz, An Economic Analysis of the Guaranty Contract, 66 U. Chi. L. Rev. 47 (1999).

[12] See Thomas W. Merrill & Henry E. Smith, What Happened to Property in Law and Economics?, 111 Yale L.J. 357, 387 (2001). The Property/Contract Interface, 101 Colum. L. Rev. 773 (2001). Optimal Standardization in the Law of Property: The Numerus Clausus Principle, 110 Yale L.J. 1 (2000).

[13] See Patricia Munch, An Economic Analysis of Eminent Domain, 84 J. Pol. Econ. 473 (1976).

[14] Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 Yale L.J. 1027 (1995).

[15]Antitrust enforcement in developed countries has become more lax as competition becomes global, and competitive markets instead of government intervention are seen as breaking monopoly power. Latin America has long been a safe haven for monopolies and duopolies of all kinds. The government's control of natural resources and its tight control of most other economic activities enables politicians to dispense all kinds of favours: monopoly rents, licenses, tax exemptions, exemption from costly regulations, and privileged access to moneymaking activities, while entry barriers and high duties protect political favourites from competition.

[16] It should be noted that integrating a cash-flow tax into a world where the United States is subject to an income tax poses strategic difficulties. A race-to-the-bottom here spells the end of any efficient Tiebout-type competition.

[17] In Roman law, what today is a penal system administered by a state bureaucracy was subject to forms of private redress. In legal history, we start with what is knowable and verifiable, and only then, and most carefully, look for patterns in what we find.

[18] To lever capital, these assets must be formalised so that ownership can be traced and validated.

[19] The Other Path: The Invisible Revolution in the Third World (1989). The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else (2000).

[20] De Soto calls such underutilised property 'dead capital.' He claims that in some nations the value of dead capital is many times greater than that of the country's active assets. If this capital were brought to life, the economies of such countries could be transformed.

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