



Reforming Legal Systems in Developing and Transition Countries

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A weak legal system can undercut efforts to develop a modern, market-oriented economy. What is the relationship between legal reform and economic reform, and what specific steps can countries take to encourage the former?

IN COUNTRIES where formal legal systems are weak—for example, in some developing countries and countries in transition from central planning—laws may exist only on paper, and may not be known or respected by the public or enforced by the state. Both violent crime and white-collar crime may be prevalent. Corruption in citizens' dealings with government may be widespread. Judicial institutions may be slow or unpredictable, with few links to the real world. As a result, there may be an enormous gap between what is written in law and what happens in practice.

The reasons for such weakness are complex. One cannot separate legal processes from the broader historical, political, cultural, and economic settings in which they function. British and American common law and Continental civil law, for example, grew out of different histories and traditions, as did indigenous legal processes in Asia and Africa. The weak legitimacy

of legal institutions in many transition economies today is, in part, an outgrowth of their compromised position under communism. Furthermore, inadequate legal processes and widespread corruption in poor countries may be as much a *result* of their underdeveloped physical and educational infrastructure as a cause of underdevelopment. Yet government leaders and policymakers should not be complacent. Improving the functioning of legal institutions is an essential component of economic development.

Informal legal processes may fill some gaps and permit some markets to function. Both parties to a contract fulfill their legal obligations because they benefit from the transaction or because neither party is willing to risk its reputation or family ties by renegeing. There is a growing literature on informal product and credit markets in developing and transition countries that shows the importance of reputation and family or ethnic networks as screening devices in selecting reliable partners in the absence of formal contract-enforcement institutions. African businessmen of Asian descent interact primarily with others from the same ethnic background (Biggs and others, 1996), and Russian managers deal primarily with commercial partners who are familiar from central planning days (Hendley and others, 1997).

This same literature, however, points to the limits of informal mechanisms. Complex or long-term contracts are likely to be relatively scarce in this environment, and new firms without family or ethnic connections may find it impossible to break into the

contracting network. In Bulgaria, for example, private firms have little trust in formal enforcement mechanisms, and they hesitate to deal with strangers (and often require payment up front if they do); new firms find it difficult to enter the market, and long-term contracts between firms are rare. These legal shortcomings have economic costs. A shortage of new firms and new people can mean a dearth of new ideas and entrepreneurship, and an inability to enter into long-term contracts can inhibit the adoption and development of complex technologies. The need to find reliable trading partners can also impose high search costs on transactions. Finally, illegal (often violent) enforcement mechanisms may substitute for legal ones, as is commonplace in the former Soviet Union, encouraging corruption and organized crime.

Surveys of private businesses around the world confirm that an unreliable judiciary is a significant hindrance to private sector development (World Bank, 1997). If a dense and efficient network of commercial relationships is to flourish in an economy, it needs a credible and low-cost formal legal process to which aggrieved parties can turn when all else fails.

Requirements for legal reform

How can developing and transition countries reform both the content and processes of their legal systems (see box) and move toward the rule of law? Three ingredients appear to be essential to a well-functioning legal system in a market economy—a supply of market-friendly laws, adequate institutions to implement and enforce them, and

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a demand for those laws from market participants. In some circles, legal reform—or, indeed, institutional reform more generally—is viewed as a prerequisite for successful economic change, but, in fact, the two are inextricably linked. The demand for legal and institutional reform that arises from economic liberalization is as critical to legal reform as the supply of good laws and functioning legal institutions.

Supply of market-friendly laws.

The first necessary (but not sufficient) step toward the development of a well-functioning legal system for a market economy is preparation of a set of written laws that clearly delineate individuals' rights and responsibilities and that embody market-friendly economic policies. Getting the economic signals "right" is itself an enormous challenge, given the wide scope of the policy debate, the intense political pressures, the shortage of experience with market mechanisms, and the limited economic analytical skills often found in developing and transition economies. Unfortunately, the failure of this first step may have systemic costs that go beyond the direct consequences of mistakes included in individual laws. When laws are passed that incorporate major inconsistencies, uncertainties, or economic flaws, this can deepen public mistrust in the law in general.

Perhaps even more difficult than getting the economic signals right is developing

principles of individual responsibility, particularly for those acting in a fiduciary capacity. In transition economies, the socialist system undermined the mutual trust that is so essential for decentralized markets to function, and the state and civil society must together begin to rebuild it. "Spontaneous privatization" of state enterprise assets in Bulgaria and Ukraine; investment fund pyramid schemes or other alleged misdeeds in Albania, the Czech Republic, and Russia; and asset diversion by liquidators in Hungary and Poland are just a few examples of weaknesses in these countries' fiduciary accountability. White-collar crime is widespread even in mature market economies, where the public and private sectors spend enormous resources to deal with it, so it should not be surprising that meeting this challenge is extremely difficult in transition countries.

There are two possible sources of substantive law: "home-grown" law (formulated either from "first principles" or prior legislation) or legislation transplanted, in whole or in part, from advanced market economies. Although imported laws have the benefit of supplying "pre-tested" models, they are inherently risky, because they do not grow out of local legal culture and may not take root when transplanted. For example, Portugal gave Brazil an idealistic and rigid Roman system of laws with few links to local custom and experience, producing a wide gap between law and prac-

tice, and considerable cynicism among Brazilians (Rosenn, 1984). Countries in Central and Eastern Europe have often gone back to their pre World War II heritage to resurrect old laws. Unfortunately, these laws do not reflect legal developments of the last half century and may no longer be adequate for a modern economy. An intermediate model—borrowing general ideas from "best practice" models abroad but then adapting and internalizing them through a thorough process of indigenous legal drafting and political debate—is probably optimal in most cases. Sometimes the choice of best practice model is influenced by regional ties. For example, the desire of many Central European transition economies to join the European Union has influenced the design of their taxation, trade, and competition laws.

In some areas, best practice models may provide only limited guidance. An example is the new Russian company law, which was adopted in late 1995. Western European or North American company laws may well be inappropriate in an environment with weak institutions; and the new Russian law, which is designed to promote "self-enforcement" through enhanced procedures for shareholder monitoring of managers, represents a significant shift away from Western models in order to meet the needs of the Russian environment (Black and others, 1996). Among other differences between the Russian company law and its Western counterparts are the following: it calls for submitting more types of decisions for shareholder approval, requires supermajority approval of more consequential business decisions (such as mergers or sales of assets), and gives "disinterested" directors—those without a direct stake in the firm—sole authority to approve certain types of transactions. The goal of such provisions is to give significant minority shareholders the power to protect themselves against opportunism by dominant insiders in an environment where judicial safeguards are weak.

Supportive institutions. A second necessary (but still insufficient) step toward development of a well-functioning legal system in a market economy is establishing a broad set of supporting institutions. Well-designed laws may lie dormant without institutional support. Formal legal institutions such as judges, prosecutors, arbitrators, and court functionaries (including, for example, bailiffs and bankruptcy trustees) are the primary interpreters and enforcers of laws. If the rule of law is to prevail, they must be competent, honest, and generally

What is legal reform?

Legal reform is a confusing term. Because it can encompass so much, it can mean very little. There is a common tendency to divide public policy work into legal reform on the one hand and economic reform on the other. But this is a false dichotomy. From a substantive perspective, legal reform is often synonymous with economic reform. Most economic policies are implemented through laws and regulations, and economic analysis helps guide policymakers as they design such laws and regulations. Although the drafting of laws to fit the local legal culture and constitutional requirements is a specialized legal skill, designing market-friendly legislation is more a task of economic policy analysis.

From a broader perspective, legal reform deals with process as well as substance, and in this sense it diverges from economic policy. The legal process has several key functions in any market economy: to set legal standards (primarily through laws and regulations), to implement and enforce these standards, to resolve disputes, and to limit the power of the state vis-à-vis the private sector. The best formal legal systems operate only at the margin, leaving most standards in a society to be internalized and "self-enforced" by society itself.

Different legal systems accomplish these core functions in various ways. Standards can be set, for example, through laws approved by a country's parliament or decrees adopted unilaterally by its president. They can be enforced by the police and judiciary or by specialized agencies such as a regulatory body or an antimonopoly office. Disputes can be solved by courts or private arbitration, and each of these can be organized, staffed, and run in a myriad of ways. Legal systems in democratic societies attempt to limit state power by many means—including court review of the constitutionality of laws, complex notice and hearing proceedings prior to the adoption of regulations, and the ability of private parties to sue government. Although the economic impacts of alternative substantive legal provisions are commonly studied, we know far less about the economic impacts of alternative legal processes.

autonomous with respect to the state. Although reaching that goal is inevitably a long and deeply political process, it can be facilitated by well-designed enabling legislation and adequate financial support, training, and technical assistance. Institutional development is self-reinforcing, as each successful case of law enforcement and dispute resolution creates a demonstration effect that builds overall trust in the legal process.

The list of institutions needed to undergird the rule of law in any country goes well beyond these formal legal ones, however. For decentralized norms to be usable by market participants in everyday commerce, perhaps the most important institutions are those that produce and distribute information and monitor those participants—that is, the “watchdog” institutions such as accountants, appraisers, credit rating services, securities regulators, company and property registries, the private bar, private investigators, and the press. These institutions provide the information that is absolutely critical in ensuring that laws are enforced (whether “self-enforced” by the participants themselves or enforced by formal institutions) and that economic policies have their intended effects. When they work well, as in mature market economies, these institutions tend to be taken for granted. When they do not, they are sorely missed. The state’s role in creating and supporting these watchdog institutions varies and in many cases is rather limited. If private sector watchdog institutions are to be

successful, they need to arise in large part to meet societal demand rather than being imposed from above by bureaucrats.

Demand for laws. Finally, a third step toward development of a well-functioning legal system is the creation of a set of incentives for individual market participants that motivates them to take full advantage both of their legal rights and of the information and enforcement capacity provided by supporting institutions. Once again, the role of the state is critical. As noted earlier, parties will have strong incentives to take advantage of their legal rights and shoulder their legal responsibilities *only to the extent they depend on the market—and their reputation in it*—for survival. For example, banks and other creditors will not use the rights provided under collateral and bankruptcy laws unless they are convinced that state bailouts will not be available to them and, thus, that aggressive debt collection is necessary for their survival. For example, the recurrent recapitalization of Hungarian banks between 1991 and 1994 undercut their incentives to pursue aggressive debt-collection actions against nonpaying customers. (See Cheryl W. Gray, “Creditors’ Crucial Role in Corporate Governance,” *Finance & Development*, June 1997.) Similarly, managers in private firms will be tempted to ignore shareholder protections and other checks and balances laid out under corporate law unless their access to inputs and their ability to sell products and raise capital depends on a law-abiding reputation. If their firms can raise capital by turning to

the government or state banking system for subsidies, or if they have a monopoly position in the market (either as output seller or as input purchaser), why should they worry about their reputations in private markets?

In sum, economic liberalization and stabilization—and the market-oriented incentives they create—complement market-oriented laws and institutions. All three are inextricably linked, and each is an essential element in efforts to achieve fundamental legal reform. [F&D]

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