Part Two

The Challenge of Consolidation

LIBERALIZATION, STABILIZATION, PRIVATIZATION, and poverty relief are intrinsic to transition. But they are not enough to create vibrant market economies. Building on the early gains of transition will require major consolidating reforms, to develop strong market-supporting institutions, a skilled and adaptable work force, and full integration into the global economy.

The many institutions that support market exchange and shape ownership in advanced market economies—both concrete organizations and abstract rules of the game—largely disappeared under central planning. As Part One showed, even in this weak institutional setting, favorable policy reforms have been able to spur economic growth. But a growing body of evidence on market economies suggests that, for the longer term, if transition economies are to join the ranks of the advanced market economies, they will need not just good economic policies but strong and accountable institutions to support and implement them.

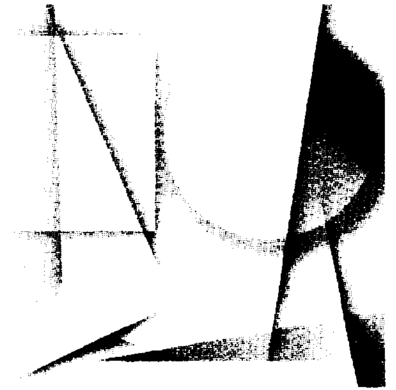
Which institutions are most critical? First are good laws and effective means for their enforcement (Chapter 5). These establish and apply the rules of the game, lower transaction costs, increase commercial certainty, create incentives for efficiency, and control crime and corruption so that businesses can focus on productive activities. Second are strong financial institutions (Chapter 6), to encourage saving and channel it to its most productive uses. Financial institutions also play an important role in corporate governance, complementing that of enterprise owners, by imposing financial discipline and overseeing the activities of borrowers. A third essential institution is government (Chapter 7), but the all-powerful, all-encompassing governments of the planning era need to be completely reoriented toward a smaller, more selective set of activities that support and complement, rather than stifle, private enterprise.

Institutions do not develop in a vacuum. Reformers' top-down efforts to develop strong legal and financial institutions and to change government behavior must be complemented by bottom-up demand for such reform. This demand will not spring up overnight, and it will often require deep changes in incentives, attitudes, and experience. But it will emerge faster if policymakers are vigilant in pursuing macroeconomic stability, open markets, and private sector development.

An extensive body of research shows the importance of human capital for the sustained growth and adaptation of market economies. Many countries enter transition with a strong human capital base, and their rising returns to education already show the importance of skills in the new economy. Nevertheless, thorough reform of education and health systems is needed, both to preserve past achievements and to adapt to the needs of the market (Chapter 8).

Finally, openness to trade and foreign investment has proved an equally robust predictor of strong economic performance across countries. Indeed, both have already had a large positive impact in transition economies. Deeper integration into the institutions of the global economy carries obligations as well as rights, and these can help integration serve a broader purpose: that of locking in reforms against the emergence of pressure groups (Chapter 9).

Legal Institutions and the Rule of Law



Under central planning, law was first and foremost an instrument of state control. Law in market economies is fundamentally different: it defines the rules of the game and gives individuals the rights and tools to enforce them. Where the rule of law is in force, laws are applied fairly, transparently, and evenhandedly to all; individuals can assert and defend their rights; and the state's powers are defined and limited by law. People in countries with a well-established rule of law rarely stop to wonder where it comes from. But transition economies need to start over, to replace arbitrary rule by powerful individuals or institutions with a rule of law that inspires the public trust and respect that will enable it to endure.

Developing the rule of law

The rule of law requires good laws, demand for those laws, and institutions to bring them to life. Good laws are not easy to design or to enact even in the best of circumstances; the task is harder still in transition economies, where policy debates still rage over fundamentals, political pressures are intense, and experience with market mechanisms remains scant. Yet failure to pass good laws imposes costs that go beyond the mistakes in individual laws to the integrity of the legal system itself. Laws passed with major inconsistencies and uncertainties, or with clear avenues for abuse, simply deepen public cynicism and mistrust.

Where do new laws come from? Transition economies can turn to two sources: "home-grown" law, drawn up either from scratch or from legislation enacted before central planning, or law transplanted from established market economies. The CEE and Baltic countries, with their shorter history of central planning, have tended to draw from prewar legislation where possible, but this source is largely unavailable to most of the NIS or to China. The alternative, imported laws, has the advantage of experience, but importing is risky. Differing histories and cultural traditions shape the way legal systems work. If laws do not take local legal culture into account, they may be inappropriate or may not take root. An intermediate approach—borrowing ideas from best-practice models abroad, then adapting them through indigenous legal drafting and political debate—usually works best.

Many countries have good laws that are ignored, but the centrally planned economies brought this dichotomy between law and its application to an extreme. Many laws were put on the books—such as constitutional provisions guaranteeing basic freedoms—that were never meant to be applied in practice. Transition economies thus need to develop effective supporting institutions to move their new laws from theory to practice. One obvious example is the court system. Although, as discussed below, most contract enforcement is and should be informal, countries still need formal enforcement mechanisms at the margin. For these to work, however, litigants must be confident that courts have the power and the capacity to judge objectively and to get their judgments enforced.

The administrative-command system of central planning marginalized law within the economy, and all formal judicial institutions atrophied in the economic sphere. In most of CEE and the NIS, economic disputes between enterprises were removed from the courts' jurisdiction altogether and instead decided by special arbitration bodies. Even then, if a trading partner reneged, managers would generally turn to ministerial or party officials for redress rather than pursue administrative remedies. Ministries could order delivery of key inputs, whereas administrative bodies might only award money damages or impose fines—cold comfort to enterprise managers seeking to fulfill the plan.

With transition, independent courts and alternative dispute resolution and enforcement mechanisms need to play the remedial role formerly assigned to the bureaucracy. But to say that the state must withdraw from administrative control is not to say it should give up enforcing the law.

Transition economies struggle with a constant tension between, on the one hand, the need for a strong state to enforce laws and impose order and, on the other, the need for constraints on state power to make room for individual rights. Sorting out where state power is legitimate and where it is not is a constant task of governments everywhere. But whereas established market economies argue these questions at the margin, transition governments are completely refiguring the enforcement functions of public institutions.

Formal legal systems place judges, prosecutors, arbitrators, court functionaries (for example, bailiffs and bankruptcy trustees), and the private legal profession in the role of primary interpreters and enforcers of laws. But the full cast of characters underpinning the rule of law in any country runs much longer. Equally important are those who produce and distribute information and monitor market participants: among these "watchdog" institutions are accounting firms, credit rating services, securities regulators, investigators, and other elements of civil society—including a free press. Like the courts themselves, these institutions were neglected under central planning and must now be rebuilt, essentially from the ground up. And of course none of them can work well if people do not know what the law is, because it is constantly changing and they have no definitive and accessible compilation to turn to. Transition governments need to make sure that laws, decrees, and important court decisions are quickly published in an official and widely circulated text.

Finally, the rule of law can take hold only if good laws and competent institutions are supplemented by demand for them. This will vary across countries, depending on their history and culture, but economics also plays a role. Individuals and companies have strong economic incentives to claim their legal rights and abide by legal responsibilities only to the extent that they depend on the market—and their reputation in it. Banks and other creditors, for example, will not take seriously their new rights under collateral, debt collection, and bankruptcy laws unless convinced that state bailouts are unavailable. They have to see that aggressive debt collection is necessary for survival. Similarly, when managers require a law-abiding reputation to purchase supplies or raise capital, they will think twice about violating the sanctity of contract or abusing minority shareholders. If managers can instead turn to the government or the state banking system for subsidies, or if they enjoy a monopoly position, they will have no reason to worry about their market reputation. Market-oriented incentives therefore complement market-oriented laws and institutions. One cannot proceed far without the others, and all three are essential to developing the rule of law.

As noted in Chapter 9, a strong commitment to international integration can also stimulate demand for law and provide market-friendly models of legislation. The desire of many European transition economies to join the European Union has motivated them to adopt economic laws that meet EU requirements in such areas as taxation, trade, and competition policy. Trade agreements with the United States and eventual membership in the WTO and other international bodies can also encourage legal reform, as can a strong commitment to foreign direct investment. The point here is not that integration will push transition countries into precisely replicating foreign laws, but that it will fuel demand for certain types of law and help policymakers design laws that foster links with the outside world.

Creating legal frameworks for private sector development

Economic laws in market economies have at least four functions: defining and protecting property rights; setting rules for exchanging those rights; establishing rules for entry into and exit out of productive activities; and promoting competition by overseeing market structure and behavior and correcting market failures. Many transition economies are well along in drafting and enacting legislation in the fundamental areas of property, contracts, company organization, bankruptcy, and competition, as well as other, more specialized topics. Inconsistencies and omissions remain, however, and many laws are only now beginning to be implemented. Governments are often hesitant to relinquish control, citizens are slow to assert their new rights, judicial and other enforcement institutions are still severely underdeveloped, and a body of legal interpretation to help guide practice in specific areas must be created, largely from scratch.

Property rights

Property rights in successful market economies are complex things. They form a rich, intricately defined array extending from full ownership through partial use rights (such as leaseholds and easements) to rights contingent on specific events (such as inheritance rights and collateral rights to debtors' property). Countless types of property are defined and protected, from real estate and movable property to new ideas and inventions. Under central planning, concepts of property were based not on the scope of individual rights or the nature of the property, but on the identity of the owner. Laws established a hierarchy, with state property at the top, cooperative property in the middle, and individual property (generally restricted to housing and personal items) at the bottom.

At the start of transition most of the NIS and the CEE countries moved to expand the scope for private property

and to put it on an equal footing with state property. China and Vietnam still hold to the supremacy of state ownership, but they do allow private property and have provided wide scope for long-term leases of property by individuals and small businesses. Chinese farmers, for example, typically lease their land for twenty to seventy years. Most transition economies, including those in Asia, have also adopted intellectual property laws, often at the urging of trading partners, although these laws are proving notoriously difficult to enforce.

Yet many of these new rights are limited by heavy restrictions on use, pledge, and ownership. Land use is often subject to strict controls, with prohibitions or high fees for the conversion of agricultural land to industrial use or of housing to commercial use. Both domestic and foreign lessees of state-owned commercial property may be subjected to arbitrary changes in lease terms or rental rates; rent controls often prevent owners from covering even maintenance costs. Although the letter of the law may permit the pledging of assets, the lack of a third-party notice system and of simple foreclosure procedures may preclude it in practice (Box 5.1). In sum, although property rights are now recognized on paper and to a growing extent in practice, they are still not free from extensive arbitrary interference. All societies preserve some role for government regulation over the use of private property (for example, through environmental or nuisance laws), but many transition economies still go well beyond what is normal in market settings.

Box 5.1 No loans for movable property?

Businesses in established market economies rely on movable capital: it accounts for about half of the private nonresidential capital stock and about three-quarters of corresponding gross investment. Yet private lenders in most transition economies are reluctant to make loans when the only collateral offered is movable property held by the borrower—tractors, livestock, inventory, machinery, or, in extreme cases, cars and trucks. Rather, lenders require that the movable properties be placed under their direct control—as if they were valuables in a bank vault or goods in a bonded warehouse—or that the borrower offer other types of collateral, such as real estate. This difficulty in using movable property as collateral results in much presumably desirable investment going unfinanced. Capital formation is slowed, resulting in lower output and growth. Why is real estate or merchandise in a vault acceptable as collateral, but not livestock, machinery, and inventories? The answer lies in the process of creating, prioritizing, and enforcing security interests in movable property—the underlying contracts necessary for loans and credit sales to work.

Creation. Legal systems should ideally permit the inexpensive creation of security interests for any person over any thing. Yet many transition economies restrict the development of such interests. Bulgaria and Estonia forbid the pledging of goods not currently held by the borrower, making it difficult to finance crops and livestock. In Hungary and Poland only banks may formally lend for property that remains in the borrower's hands; this limits development of nonbank lending. Vietnam forbids the sale of pledge items, making it difficult to finance inventory.

Determining priority. For pledging to work, lenders need a cheap and easy way to determine whether a prior security interest exists against the property offered as collateral. Some advanced legal systems do this by maintaining a publicly accessible registry; others do it less formally. Lenders in transition economies, however, cannot easily determine whether such security interests exist. In Bulgaria the priority of a security interest is determined by the date it is agreed to; without a central registry, this can only be uncovered by searching through hundreds of scattered notarial records. The pledge registry in Poland is open only to banks. In China and Lithuania a security interest in movable property can only be registered if the underlying asset requires registration—fine for cars, trucks, ships, and airplanes but useless for tractors, drill presses, and grain silos. In Latvia and Poland state taxes take automatic priority over secured private claims, so private lenders without intimate knowledge of the status of a borrower's tax payments cannot know if a loan is safe.

Enforcement. In the event of nonpayment, lenders also need a quick and inexpensive way to recover and sell pledged and mortgaged assets. In transition economies the time required for repossession and sale of a pledged asset ranges from six months to three years and can extend even longer. This is too long for most collateral to retain its economic value. Inventories of food, clothing, and even machinery will depreciate so much during this period that they cannot effectively guarantee a loan. Recent Russian and Chinese laws take some promising steps to address this problem, but it is too early to tell how well they are working.

Contracts

Freedom of contract is one of the great virtues of market-oriented legal systems, providing a decentralized way of allocating resources to their best uses. Parties are free to negotiate performance requirements and prices, to allocate risks of loss if conditions change, and to specify how disputes will be handled. And during the course of the contract, if the bargain ceases to make economic sense to one party, contract law generally allows that party to withdraw and pay monetary compensation rather than continue to perform under the contract.

In centrally planned systems, by contrast, parties had no freedom either to enter into or to exit from commercial contracts. Interenterprise contracts were mere instruments of the plan, and full performance was generally required. The collapse of central planning put an end to these notions of contract, to be replaced by new, amended, or revived civil and commercial codes. Although these codes generally follow Western European norms, tendencies toward control and paternalism sometimes remain. The new Russian civil code, for example, contains several provisions aimed at controlling the activities of firms perceived as economically strong. Many of the controls arise from a legitimate desire to protect consumers and debtors who are unfamiliar with markets, in situations of unequal bargaining power and inadequate judicial protection. But they can also reflect an older tradition of trying to dictate economic relations and outcomes. In a market setting some of these controls could end up hurting the very people they are meant to protect, by constraining their freedom to allocate risk or by preventing some transactions altogether.

The impact of these new contract laws will depend on their enforcement. Most day-to-day contracts in market economies do not require formal enforcement. Both parties fulfill their legal obligations because they benefit from the transaction or because neither party is willing to risk its reputation by reneging. But an economy still needs credible, low-cost formal enforcement mechanisms to which aggrieved parties can turn when all else fails.

The shortage of institutions to enforce contracts limits the scope of transactions, makes contracting more costly, and prohibits some contracts altogether. A recent study of contracting in Bulgaria, for example, found that private firms have little confidence in the courts (although they still use them from time to time) and instead rely heavily on trust when choosing business partners. They find suppliers who ship quickly and customers who pay quickly, and work with them on a continuing basis. They are suspicious of new customers, who are carefully screened and often required to pay up front. Lack of confidence in formal enforcement mechanisms, and thus in dealings with strangers, limits firms' activities and hinders new firms from entering the market. Long-term interfirm contracts are almost nonexistent, because such contracts are particularly difficult to police and maintain. Limits on the scope of contracting are only some of the costs of inadequate formal enforcement. A more menacing cost is the vacuum opened for more violent enforcement mechanisms—such as the mafia—that corrode trust even further, as discussed below.

Company and foreign investment law

Well-designed and well-enforced company law is essential if private companies want to tap into capital markets. In 1995 financial markets valued a typical Russian firm at only about one-twentieth of its likely value in a mature market economy. This low valuation all but prevents firms from raising new capital by issuing shares. Why are share prices so low? A survey of foreign investors suggests that one important reason is the weakness of company law as an instrument for overseeing managers and protecting shareholders, particularly minority ones.

The need for comprehensive company law emerges in full force only when large-scale private activities are fully legalized. Transition economies have typically emulated the models in established market economies, particularly the company forms and related rules found in Western Europe. Most new company codes in transition economies provide for joint-stock companies, limited-liability companies (smaller entities often limited to fifty or so investors), and limited and general partnerships. The most popular form among smaller new firms has been the simpler and more flexible limited-liability company. The more formal joint-stock company predominates among large privatized firms and publicly traded companies.

Like most of the important legal changes discussed in this chapter, the move to modern forms of company law represents a radical shift for transition country governments, from controlling to merely facilitating economic activity. Company law has to walk a fine line between two often-conflicting goals: flexibility and protection. Company owners and managers need to be as free as possible to arrange their own activities, yet the public, including investors, employees, and other stakeholders, also needs protection from insider fraud and mismanagement. Western rules regarding joint-stock companies may not give adequate protection to investors in transition economies, which lack the highly developed market, legal, and government institutions on which such rules depend (Box 5.2).

The tension between flexibility and protection is particularly problematic in transition economies. In the name of protecting investors, creditors, or the public, many countries have erected high-cost barriers to entry. Two of the most conspicuous are high minimum capital require-

ments and complex registration requirements. Minimum capital requirements for joint-stock companies, for example, typically range from $20,000 to $40,000 and sometimes (as in Hungary) exceed $100,000. And in Moscow, for example, it takes an average of six to eight weeks to fulfill the ten steps typically required to register a new company (not including the additional licenses required for many activities). Supposedly designed to protect the public, these requirements are burdensome for new entrants—particularly small entrepreneurs who may therefore choose to remain in the informal sector—and are obvious sources of corruption. Many could be reduced or eliminated. Fraud is indeed a crucial issue in transition environments, but these are inefficient tools to combat it. Countries should work to develop more sophisticated legal devices, such as criminal prosecutions, class action suits for aggrieved shareholders, and doctrines that look behind the corporate veil to make individuals personally liable in cases of fraud.

Bankruptcy law

A well-designed bankruptcy law—generally including procedures for both liquidation and reorganization of problem firms—plays several important roles in market economies. It provides failing firms with an orderly means of exit. It spurs ailing but potentially viable firms to restructure. And it promotes the flow of credit by protecting creditors. Ideally, bankruptcy shifts control over financially distressed firms to their creditors before all the assets have been misused or dissipated, and it gives creditors the information and power to direct the use of the remaining assets to recover debts. Without this safeguard, creditors

Box 5.2 Protecting investors: Corporate law from scratch

Transition economies have weak and sometimes corrupt courts and regulators, undeveloped capital markets, and a shortage of trained lawyers and accountants. It is difficult for potential investors to get information on companies and to enforce laws against managers, who may also be large shareholders. Hence the risk of insider opportunism is high, which discourages much-needed outside investment. Transition economies need a corporate law that can work even in this setting.

Two broad Western models for protecting investors through corporate law are available. So-called prohibitive corporate laws bar many kinds of behavior that are open to abuse, such as self-dealing transactions and cash mergers. This model was followed in nineteenth-century U.S. and British codes and is to some extent followed in European codes today. By contrast, the so-called enabling corporate laws that prevail in the United Kingdom and the United States today allow companies greater freedom and depend more on market constraints and other civil and criminal laws (such as antifraud statutes) to discipline managers and protect investors. The enabling model is almost certainly unsuitable for transition economies because of the weakness of these other constraints on insider opportunism. But the prohibitive model also has its costs. Not only can its inflexibility inhibit legitimate business behavior, but strong courts or administrative agencies are needed to enforce its many rules.

An alternative approach, followed to a large extent in the new Russian companies law, is a self-enforcing corporate law. This model focuses on structural and procedural rather than substantive requirements. Its goal is to give significant minority shareholders the power to protect themselves against opportunism by controlling insiders. At the shareholder level the model focuses on voting rules. For example, it puts more types of decisions up for shareholder approval, and it requires supermajority approval for important business decisions such as mergers or major sales of assets. At the governing level the model requires that a certain proportion of directors be independent, and it gives "disinterested" directors (those without a direct stake) sole power to approve certain types of transactions, such as those between related parties. It mandates "cumulative voting" for directors, a rule that ensures that large minority shareholders are represented on the board. By imposing these and other procedural requirements, the self-enforcing model tries to create self-policing mechanisms and to reduce reliance on courts and administrative agencies for enforcement.

Of course, the self-enforcing model also works better when judicial enforcement mechanisms can serve as a backdrop. But even without official enforcement, the introduction of procedural safeguards may slowly change norms of behavior as more and more companies adopt them to develop a good reputation for honest behavior, to emulate their peers, or simply because they are available and reasonable. No one knows whether this model will succeed in Russia or elsewhere, but it stands out as a pragmatic attempt to tailor long-term institutional reforms to the limitations of the transition environment.

will either refuse to make loans or turn to the state for support when loans turn bad. Bankruptcy is an important complement to—not a substitute for—disciplined macroeconomic policies and privatization.

Many transition economies have adopted new bankruptcy laws. Those in Bulgaria, Estonia, Hungary, and Slovenia are among the best designed. They provide, for example, clear criteria for determining insolvency and delineating claims, efficiency-enhancing priority rules (most important, giving preference to secured creditors over government claims), broad scope for debt forgiveness and workable voting rules (generally requiring one-half to two-thirds majorities to bind dissenting minorities) if creditors want to reorganize the firm, and flexibility as to the method of asset sale in cases of liquidation.

Design is only half the issue, however; bankruptcy laws are not yet effectively enforced in any transition economy. Hungary perhaps comes the closest (see Box 3.1), although creditor involvement remains inadequate to ensure efficient economic outcomes and guard against fraud. In some countries, such as the Czech and Slovak Republics, the government has deliberately slowed the implementation of bankruptcy law, and the number of cases (although increasing rapidly) is still relatively small. In others, such as Albania, Bulgaria, and Romania, laws are of recent vintage, and it remains uncertain whether creditors will have the incentive to use them effectively. Finally, China and most NIS (other than the Baltics) have not yet implemented a package of reforms, including subsidy reductions, privatization, and banking reforms, that will force hard budget constraints on creditors (whether banks or firms) and thereby create the widespread demand that brings bankruptcy laws to life.

Competition law

As discussed in Chapter 3, transition economies, particularly in CEE and the NIS, inherited an industrial structure with many monopolistic or oligopolistic firms, dominant state ownership, and a strong tradition of state control. Many governments continue to erect barriers to trade, whether through tariffs and quotas on imports, taxes on exports, or local government curbs on products entering other provinces. These anticompetitive legacies and practices need to be dismantled if markets are to function effectively. Experience in CEE confirms that reducing tariffs and removing other trade barriers can go a long way toward promoting competition, particularly in small countries, by imposing world prices (adjusted for transport costs) as an effective ceiling on domestic prices. Improving market infrastructure, both physical facilities and services, is also critical.

But these efforts need to be complemented by regulation of natural monopolies and by antimonopoly law to ensure efficiency and protect the public from the abuse of monopoly power. Both are difficult areas and further examples of the tension between the need for a strong state and the need for constraints on state power. Some transition economies, in their push to free up markets, have underestimated the need for active government involvement. Others have maintained overzealous and anticompetitive controls.

The case for regulation is not always clear-cut; electric power generation, for example, and natural gas production are potentially competitive, although the distribution side of both industries is a true natural monopoly (in which a single firm most efficiently supplies the market). In cases of natural monopoly, governments need to develop clear and effective regulation that is stable over time. This is especially important when countries want to exploit new opportunities for private sector involvement in infrastructure industries (see Box 3.6). To be credible, natural monopoly regulators must be independent, operating at arm's length from the regulated firm, other government agencies, and other vested interests. They must guard against both "capture" by the regulated firm and popular and political pressures to let prices fall below cost. Some transition economies, such as Ukraine and Albania, are already setting up autonomous regulatory bodies (in electric power and other industries) similar to models in the United States, the United Kingdom, and Latin America. Central European regulators in telecommunications—another industry that tends toward monopoly—are less independent, and formal tariff authority and other regulatory powers remain largely with ministers.

The CEE and Baltic countries, Kazakstan, Mongolia, and Russia have adopted antimonopoly laws that generally follow Western European models (in most cases to reflect the harmonization requirements of the European Union). These laws typically restrict horizontal and vertical restraints on trade and the abuse of a "dominant" market position (usually defined as 30 to 40 percent of the relevant market and the unilateral ability to restrict competition). Horizontal restraints are agreements among competitors to fix prices or divide markets; vertical restraints include a wide range of restrictive agreements between producers and distributors. These laws also empower the government to block anticompetitive mergers and in some cases to break up monopolies.

The European Union and several member and nonmember countries (particularly Germany, the United Kingdom, and the United States) have played important roles in helping design these competition laws, pushing for their adoption, and training staff for and otherwise assisting antimonopoly offices. Because transition economies inherited such a legacy of state dominance and are short on administrative capacity, however, antimonopoly offices face somewhat different priorities than their EU and U.S. counterparts. They must focus their scarce re-

sources on big issues and big problems, becoming first and foremost strong and vocal advocates of competition and free trade. Of the offices established so far, those in Central Europe (most notably Poland and the Czech and Slovak Republics) have been among the most forceful and effective, although even their voices are sometimes difficult to hear. Offices also need to concentrate on dismantling regulatory and other barriers to the entry of new firms, because entry is a key source of competition in these economies. For example, exclusive supply or distribution agreements imposed by dominant firms may act as barriers to entry and may be challenged under competition laws. The Ukrainian antimonopoly office, established in 1994, has devoted much attention to preserving a level playing field for new firms by combating discrimination against them, particularly by state actors. With regard to horizontal restraints, offices should combat overt price fixing (and similar cartel agreements) among big producers and address structural concerns by maintaining veto power over anticompetitive mergers and by breaking up the most egregious state-owned monopolies before or during privatization. The Czech and Slovak antimonopoly offices, for example, have focused on dismantling monopolies prior to privatization. Russia could be more aggressive in confronting monopolistic structures, including some of the emerging financial-industrial groups.

Judicial institutions

As this chapter has stressed throughout, laws are only as good as the institutions that enforce them. And it is competent and reliable courts and specialized enforcement agencies such as securities commissions and antimonopoly offices that provide the foundation on which all enforcement activity—formal or informal—ultimately depends. Courts not only enforce laws and resolve disputes; their interpretations also fill in the many inevitable gaps in legislation. CEE and the NIS have followed different paths in re-creating judicial institutions for dispute resolution and enforcement. In most of the NIS the state arbitration system that used to mediate disputes between state enterprises was transformed into a formal court system—the *arbitrazh* courts—to supplement existing civil courts. In CEE, by contrast, the arbitration system was abolished, and civil courts were expanded to include separate commercial sections. Although the latter might be the better approach if it fosters more unified standards and a more professional judiciary, either route can work given the right incentives, training, and experience. The notorious powers of the pretransition "procuracy" to supervise courts and intervene in individual decisions has been reduced, and in CEE the procuracy has been transformed into an institution more akin to a Western public prosecutor's office. Most transition economies have also tried to reform appointment and oversight mechanisms and give courts more independence by appointing judges for life. China, the Kyrgyz Republic, and Ukraine are among the few countries that maintain elections and shorter terms for judges. Private arbitration, always used in international trade disputes, is now also allowed for domestic disputes in most transition economies. This is extremely important because it can save scarce judicial resources by privatizing dispute resolution and can provide helpful competition to spur court reform.

Despite these important reforms, courts in transition economies will need time to overcome the legacies of the past and regain public confidence. Judges, particularly in the NIS, have limited experience with markets, earn low salaries, and as a profession enjoy little prestige or public trust. Clear notions of professional ethics are not yet well developed. Court fees are high and waits can be long. The newness and lack of clarity of many laws make for unpredictable decisions. And even when judgments have been reached, the winners can find them difficult to enforce. In Vietnam, for example, fewer than 40 percent of court rulings in 1993 and 1994 were actually enforced, and up to half the judgments of Russian courts go unenforced. These factors, combined with engrained cultural attitudes toward the law, help to explain why so few private businesses want to use the courts to settle disputes, particularly in the NIS and East Asia.

The private legal profession is another institution that must develop if people are to become familiar with the law and use it effectively. As markets grow and law becomes more complex, societies need independent lawyers to counsel clients, structure and formalize transactions, and help resolve disputes. In centrally planned economies lawyers were employees of the state. Their role in the commercial sphere was primarily administrative, and they had little independence and few of the skills needed in a market economy. Transition has brought a dramatic rise in the number of lawyers and the training opportunities open to them. In China, for example, the number of licensed lawyers rose from only 3,000 over the entire 1957–80 period to more than 60,000 in 1995. Law school enrollments today exceed 30,000, and the government has announced a target of 150,000 lawyers by 2000. But standards of competence and professional ethics will take longer to develop and enforce. Many transition economies are beginning to require bar examinations, but the recognition of conflicts of interest—and other ethical dilemmas—is still in its infancy.

Increasing the level of trust in the state

Defining and enforcing the laws governing private sector activity require a strong and competent state. Yet well-functioning markets also need a clear sense of where the state's role ends. The government must itself be ruled by law and trusted by private entities not to intervene arbitrarily in

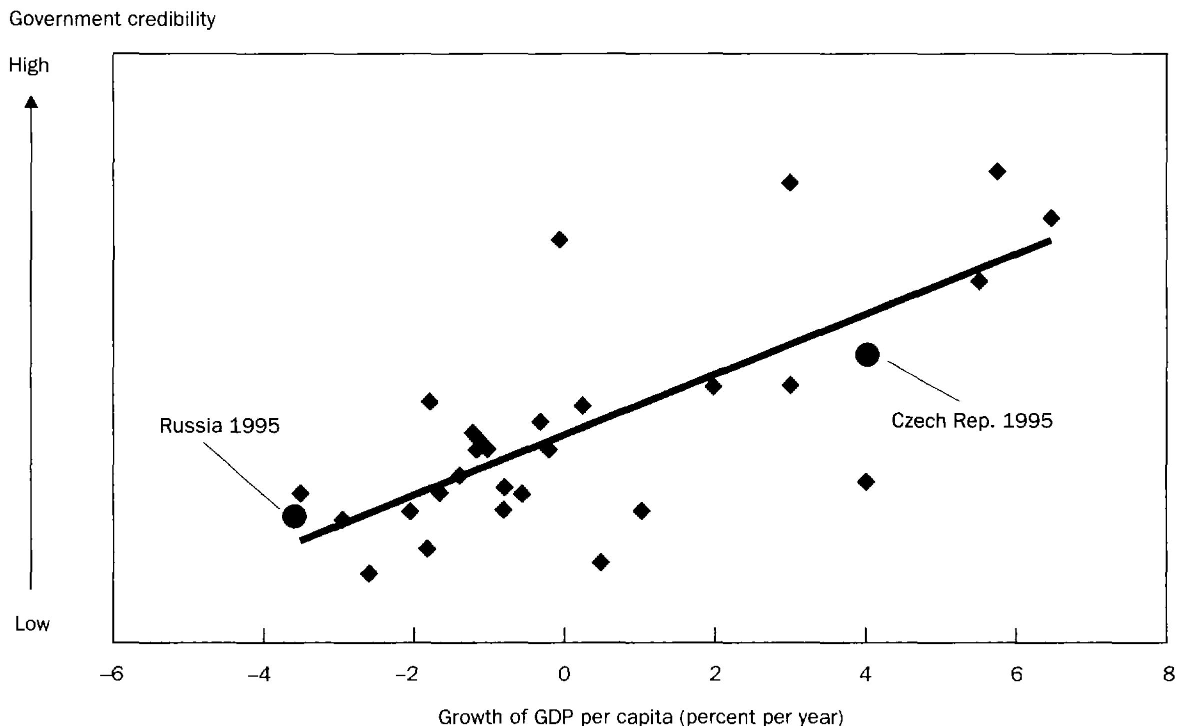
their affairs, to follow its announced policy statements, and to deliver on its obligations. Recent cross-country research suggests that citizens' level of trust in government to carry out its declared policies and to meet its obligations is positively associated with long-term economic growth (Figure 5.1). Separate surveys of private firms in 1995 suggest that the Czech Republic has achieved a high level of government credibility, whereas in Russia credibility is much lower. Countries with levels of credibility as different as in these two countries typically have widely differing economic growth rates. Trust in government depends partly on citizens knowing that they can seek recourse against arbitrary or illegal state acts, on limits on official corruption, and on the state's ability to control crime.

Constraining state power

Formal constraints on arbitrary state power in established market economies derive partly from constitutional and administrative law. These bodies of law ensure that all legislation is consistent with the national constitution and that regulations, in turn, are consistent with the law. They delineate the rulemaking authority of various state bodies, lay out the procedures for enacting laws and promulgating regulations, and provide individuals recourse against unlawful or capricious state action. Of course, these formal constraints are not created in a vacuum but are spurred by deep historical, cultural, and political forces. Unsurprisingly, there were very few legal or social constraints on state power in centrally planned systems. Sev-

Government credibility and faster growth usually go together.

Figure 5.1 Economic growth per capita and government credibility



Note: The sample consists of twenty-eight economies plus Czech Republic and Russia. Growth data are annual averages for 1981–90, and data on government credibility are based on public opinion surveys taken in late 1992 (which included retrospective questions), except that data for Czech Republic and Russia are for 1995 on both measures. Source: Borner, Brunetti, and Weder 1994; World Bank data.

eral planned economies did establish administrative courts or empower regular courts with administrative oversight, beginning with Yugoslavia in 1952 and followed by other CEE countries in the 1960s and 1970s and eventually the Soviet Union (1987) and China (1989). But their power was tightly circumscribed, and the reforms had little practical impact.

Democratic reforms have led many transition economies to broaden the scope of judicial review to cover all administrative acts and to give civil or commercial courts clear oversight jurisdiction. In addition, all CEE countries and some NIS have established constitutional courts with the power to overturn laws and regulations that they find unconstitutional. Thus, the procedural means to oversee state actions is beginning to emerge. There is still, however, profound confusion about the division of authority among various state actors, particularly in the NIS. The distinction between the legislative authority of the parliament and the rulemaking authority of the executive is vague at best, as is the allocation of authority among national, provincial, and local governments. Different state bodies often issue laws or regulations on the same topics, producing a quagmire of conflicting rules. This struggle for rulemaking power often reflects a deep struggle over the speed and direction of reform. For example, reform-minded executives or ministries often try to push through reforms against defensive or undecided parliaments or local governments. Although this may speed reform in the short run, in the long run it could undermine the rule of law.

The emerging role of constitutional courts in transition economies offers an interesting example of the struggle to establish checks and balances in government and their interaction with economic reform. Hungary's and Poland's constitutional courts have been active in overturning economic reform initiatives. In Poland, for example, the court invalidated most of the government's efforts to cut public spending on pensions. The Hungarian court struck down provisions of the government's March 1995 stabilization package aimed at cutting spending on family allowances and education. This tension between competing authorities may slow some necessary economic adjustment, but it is a healthy indicator of democracy and is likely to ease through continued political debate and legal development.

Controlling corruption

The use of public office for private gain is hardly new to transition economies. Before reform, items as important as housing and as trivial as choice cuts of meat were often allocated through the back door in exchange for favors or bribes. Transition-style corruption, however, is different: it is more visible and more money-based. Corruption has emerged as a major concern in China. And most businesses in Lithuania, Russia, and Ukraine (to cite just three examples) acknowledge paying fees to various officials as well as to organized crime. These bribes are large by international standards: in Ukraine, for example, they can represent up to two months' gross sales per year. Some officials have used their positions to give special privileges to private businesses in which they have personal stakes. In many transition economies the public's perception of widespread corruption—including the misappropriation of public property—is undermining support for governments and for reform.

Why is corruption thriving? Evidence from other countries shows that corruption thrives when both public officials and private agents have much to gain and little to lose, precisely the situation in most transition settings. Traditional controls weaken before new legal restraints—not least, rules regarding conflicts of interest—become effective. In addition, the state retains enormous wealth—enterprises, properties, natural resources—and regulatory power, even as private property, business, and wealth are being legitimized. Uncertain rules, heavy regulation, and pervasive controls give officials exceptional power, many opportunities to seek bribes, and wide scope for appropriating public wealth. The weakness of civil society—political parties, interest groups, social organizations, and the like—in some transition environments means that this important countervailing force is largely absent.

The low official pay of public servants makes corruption particularly enticing. Indeed, in some countries it now represents the main incentive to remain in public service. Despite periodic anticorruption efforts, the risks of engaging in corrupt behavior have fallen dramatically. Not only is government oversight weak, but the legacy of personalized economic relationships and more recently of financial scandals undermine standards for official and private conduct alike. It is hard to punish one person for misconduct if the public perceives that everyone else—including high officials—is doing the same thing. This raises the danger that transition economies may experience an extended period of pervasive corruption.

Corruption is by no means costless. Recent cross-country analysis suggests a significant association with both lower private investment and slower economic growth. Bribes may help businesses avoid burdensome regulations, but they also create incentives to make regulations even more complex and costly. Officials may block further reforms to entrench their power and maintain their illicit income. State enterprise managers may realize that they can purchase or divert enterprise assets cheaply if they delay privatization and make their companies underperform. Corruption can divert public resources away from vital areas, such as education, where the potential for bribes is smaller. It also undercuts governments'

ability to enforce legitimate regulations and collect public revenues, as activities shift into the shadow economy to avoid government altogether. Equally serious, corruption weakens public confidence in government and can help extremist politicians who promise order.

What can governments do to combat corruption? Having made the move to the market, they cannot turn back the clock and resurrect the old constraints. Instead, they must both reduce the opportunities for corruption and raise the attendant risks. Rapid and transparent privatization, liberalization, and demonopolization of the economy can do much to reduce the scope for corruption and restructure incentives. Higher salaries for public officials reduce the attraction of bribes and raise the cost of dismissal. Simplifying taxes and regulations—the most important concern, for example, of businesses surveyed in Lithuania—and clarifying property rights reduce opportunities for bribery and help firms survive without resorting to corruption. Where regulations are still needed, governments must strengthen oversight and appeal mechanisms and, where possible, provide alternative procedures so as to reduce the monopoly power of officials in granting approvals. Finally, public education campaigns and serious attempts to publicize and punish high-level corruption can send a message that the rules of the game are changing. These approaches reinforce one another, as many countries, including the United States (Box 5.3), have found.

Stopping organized crime

Private organized crime antedated transition but has grown dramatically in recent years. It has become both more visible and, especially in Russia (where it ranks as a main concern in both household and business surveys), more violent. Crime is closely intertwined with corruption. With a private economy opening new avenues for private criminality, current and former public officials (including police officers and former secret police agents) often facilitate or participate in organized crime. Private security groups—including groups that are themselves criminal—have arisen in part to fill the void left by corrupt police or courts that are unable or unwilling to pro-

Box 5.3 Controlling corruption through overlapping jurisdictions: Examples from the United States

Corruption exists in all countries, albeit to different extents. How governments organize their activities affects the opportunities and incentives for corruption. One way to reduce the monopoly power of public officials is to give them overlapping domains. Corruption in passport issuance is kept low in the United States, for example, by letting people apply at any of numerous passport offices. (A national system of records prevents repeat issuance.) To avoid the payment of bribes for expedited service, the passport agency itself sells such a service. For tasks that impose costs instead of benefits, overlapping jurisdictions can reduce the gains from bribing any one official. For example, some observers claim that the coexistence of federal, state, and local narcotics enforcement authorities in the United States has reduced the level of official corruption.

Where possible, it helps to decriminalize or deregulate an activity that is a major source of crime and corruption. The Eighteenth Amendment to the U.S. Constitution, ratified in 1919, prohibited the manufacture and sale of alcohol. The amendment was repealed in 1933 after a period of widespread illegal activity and corruption of law enforcement officials. The U.S. experiment with prohibition is a case study of the risks and costs of introducing regulatory and legal regimes that lack legitimacy in the eyes of a large segment of the public.

Even after all feasible structural and regulatory reforms have been implemented, strong leadership and law enforcement capacity are needed to fight corruption. The experience with reform in major U.S. cities as diverse as Toledo, Ohio, in 1900 and New York City in the 1980s shows the importance of a committed leader at the top, strong independent inspectors to pursue investigations and prosecutions, and grassroots citizen involvement. In New York, for example, widespread corruption and racketeering in the construction industry imposed billions of dollars in costs on the school system through waste and poor-quality construction and maintenance. In 1988 the city created an Office of Inspector General as a quasi-independent body within the school district with the power to pursue criminal investigations, civil prosecutions, administrative sanctions, and institutional reform. The office put heavy emphasis on prequalifying bidders and refused to do business with any company that lacked a reputation for honesty and integrity. In its first five years the office conducted more than 3,500 investigations, debarred 180 firms, and generated more than $20 million in savings, paying for itself and reducing corruption at the same time.

tect public safety and enforce contracts. Like corruption, economic crime thrives when property rights are poorly defined, when monopolies exist that mafias can tap, and when legal procedures are ineffective and thus the risk of punishment is low. It also thrives when widespread poverty and lack of economic opportunity leave potential young recruits susceptible to the lure of mafia wealth. New financial sectors offer a fruitful arena for crime, and in many NIS and CEE countries crime has been further spurred by the lucrative rewards of drug trafficking. The region is well located to be a conduit for drug transport between poppy-growing regions in South Asia (particularly Afghanistan) and markets in Western Europe.

Russia's mafia is not a single organization but a collection of perhaps 3,000 to 4,000 groups employing more than 25,000 people; several hundred of these groups now span the NIS and CEE and sometimes reach into the West. Some fill market gaps created by inadequate government institutions, providing security services for new private businesses or helping to enforce contracts (for example by collecting debts for banks, a significant number of which maintain close links with organized crime). But the value of these services is dwarfed by the sums these powerful criminal groups extort from private businesses. They force "loans" out of banks, demand protection money from new firms, and use banks and other businesses to gain access to wealthy clients. They disseminate counterfeit money and launder illicit income. Like their Sicilian namesakes, they adopt ruthless enforcement methods, as shown by the numerous murders of leading Russian bankers and businesspeople in recent years. And these are only the visible costs. What cannot be seen are the investments forgone for fear of extortion and the legitimate businesses that have failed because they could not compete with mafia-run enterprises.

Both corruption and organized crime are deep, long-term problems without easy solutions, particularly given the scale on which they are now emerging in some transition economies. Strong and internationally coordinated law enforcement efforts are needed. These in turn require an efficient and law-abiding security apparatus and dispute resolution mechanisms that ensure due process. Governments at both the national and the local level must therefore tackle internal corruption if they hope to control organized crime. Italy's recent success in combating the Sicilian mafia shows that dedicated, honest prosecutors and judges can make inroads against corruption and organized crime, but only if given strong political and logistical support from the top levels of government.

The agenda

It is a hard fact of transition that the features of a market economy that many of these countries need most are the very ones that will take the longest to build. As this chapter has emphasized, moving from plan to market requires a new way of thinking about the entire legal system. Partners to contracts, the lawyers who help draft them, and the courts that enforce them all must stop behaving as if they were still the instruments of a single central planner, and start working in the interests of the countless private individuals whose activities make up a market. People have to know—and respect—the law and the institutions charged with enforcing it. Just as important, they must have some faith that the government will apply the law consistently and will itself abide by certain constraints, refraining from arbitrary intervention and corruption. None of these ingredients will spring up overnight. But the message is not necessarily to proceed slowly toward a market economy, to allow these institutions and laws to develop at their own pace. Many of the countries now without an adequate rule of law are already market economies; governments cannot reassert control through the old mechanisms but must instead develop new policies and institutions to suit a new relationship between state and citizens. And as noted above, many market reforms—such as liberalization and demonopolization of industry—can actually speed the development of the rule of law, both by fueling demand for new laws and, just as important, by reducing the number and influence of groups who profit from their absence.