

## CHAPTER 1

# **Assessing the Value of Law in Transition Economies: An Introduction**

*Cynthia Clement and Peter Murrell*

What role do law and legal institutions play in the economies that are in the midst of revolutionary change away from centrally planned socialism? The essays in this book address that question. The authors ask whether law can be effective in this rapidly changing and often chaotic environment, what factors determine the success of legal and institutional reform, and how law adds value to economic processes. In this introduction, we offer a road map to the book, outlining its structure and providing a snapshot of the eleven chapters that follow.

To provide context, we first examine the role that legal and institutional measures have played in the reform programs that have been implemented in the last decade in the countries of Eastern Europe and the former Soviet Union. In light of the changing emphases among academics and policymakers on the role of institutions in these reform programs, we argue that the present juncture is an especially opportune one to study the effects of law on transition economies. The latter half of this introduction then describes the contents of the book, highlighting results that are common across the various chapters and summarizing each individual chapter briefly.

### **Law and Institutions in the Economic Transition from Socialism**

#### The Rule of Law in the Opposition to Communism

On being thrust into the role of Supreme Ruler of the White movement in November 1918, Admiral Kolchak declared a straightforward aim: “My principal objective is to create an army capable of combat, victory over Bolshevism, and the introduction of legality and the rule of law” (Pipes 1993, 48). Thus, since the earliest days of the Soviet state, the demand for a politicoeconomic system based on the rule of law was an element in the struggle against communism.

This demand recurred in the protest movements that arose sporadically in Eastern Europe in the postwar decades, prominent, for example, in the goals of Charter 77 in Czechoslovakia and Solidarity in Poland. In Eastern Europe's year of revolution, 1989, the rule of law was at the forefront of popular demands (Skapska 1990, 700). When fundamental reform came to the Soviet state, Mikhail Gorbachev absorbed the goals of the opponents of Soviet socialism and cajoled his Communist Party into endorsing the concept of a rule-of-law state, hoping to see the USSR embedded in a new world order of states based on the rule of law (Iakovlev 1990; Vause 1990).

The demand for the rule of law is as much an economic phenomenon as a political one. Indeed, the central theme of that most enduring critique of the socialist order, Hayek's *Road to Serfdom*, is the idea that economic planning is in fundamental contradiction with that sine qua non of the free society, the rule of law (Hayek 1944, 72–73). Hayek's critique, and related economic ideas, were widely known and accepted among the elites who would be responsible for economic reforms after the fall of communism (Balcerowicz 1995; Klaus 1997; Åslund 1995). Hence, when the revolutions in Eastern Europe and the Soviet Union eventually came, a central element on the agenda was fundamental change in economic laws and institutions, leading to the economic rule of law.

Nobody thought it was going to be easy. The Bolsheviks had inherited, to use Witte's characterization, "an empire with one hundred million peasants who have been educated neither in the concept of landed property nor that of the firmness of law in general" (quoted in Pipes 1991, 120). The experience of seventy years of communism surely did little to enhance the understanding of private property or to promote the firmness of law. The instrumental use of law, epitomized in Khrushchev's memorable phrase "we are masters of the law," the laws ignored and the laws flouted, the telephone justice, the settling of economic disputes through an administrative process (*gosarbitrazh*) and myriad procedural irregularities (Hendley 1996), all of these left a barren land for the planting of law.

Moreover, even in the most receptive environment, the building of capitalist legal institutions presents an enormously complex task (North 1990). A law-based economy rests on many organizations, administrative contrivances, and conventions, large and small, from supreme courts to the standards that prevent the forgery of documents. These many bricks of the institutional house can only be put in place with years of painstaking effort, which is usually rewarded only in the long term. Facing such an immense task and surrounded by such an unforgiving heritage, no wonder that one prominent Russian jurist should entitle his memoirs *Striving for Law in a Lawless Land* (Yakovlev 1996).

## Legal and Institutional Reform in the Time of Shock Therapy

In Eastern Europe in late 1989 and in the successor states of the USSR in late 1991, the first postcommunist reformers had to face the immense gulf between desires and possibilities. While there was widespread recognition of the need for the legal and institutional reforms that would lead to a law-based capitalist economy, the measures needed to accomplish such change would require many years of concerted effort. Remarkably then, as a succession of shock therapies and big bangs were announced, legal and institutional reforms receded into the background.<sup>1</sup> In addition, it became very unfashionable to argue that implementation of complementary institutional reforms could be a precondition for more newsworthy measures, such as privatization, which were administratively simpler and quicker to implement. If the establishment of the economic rule of law suffered in the attempt to garner the perceived short-term political benefits of measures that could be carried out quickly, then this was simply a fact of these difficult times.

In the early 1990s, among the leading reformers, in academia, and in the multilateral institutions, in both theorizing and practical economic policy, there was a signal lack of emphasis on the necessity of immediate, constructive institutional reforms (Nagy 1992; Benham and Benham 1997). This was especially striking compared to the central role that had been ascribed to the rule of law by the opponents of communism before 1989. Thus, while Balcerowicz (1995) describes his long-standing commitment to the notion that institutions are the central determinant of economic performance, a description of his early reform program in Poland contains hardly a mention of legal and institutional reform (Balcerowicz 1994). Similarly, Vaclav Klaus, an avowed avid follower of Hayek, gives short shrift to the rule of law when he discusses the economic reforms that were central to the “Rebirth of Liberty” (Klaus 1997). In Yegor Gaidar’s (1995) description of Russian reforms, institutional reform is absent.

This characterization of reform priorities applies as much to the ruminations of Western academic economists and advisers as to the thoughts of those pressed by the maelstrom of day-to-day events. Reflecting the authority, visibility, and positions of their authors, the essays by Lipton and Sachs (1990) and Fischer and Gelb (1991) were two of the most prominent in the Western reform debates. In these two works, macroeconomic stabilization, liberalization, and privatization take center stage, with legal and institutional reforms tagging along at the end, something for the long haul, whose profound difficulties and long gestation periods are irrelevant when determining strategy on the first three fronts. The tenor is similar in the most well-known review of the early experience of transition, by Blanchard, Froot, and Sachs (1994), in which institutions

are a sideshow. The conclusion of their book is that the fall in output in early transition is purely due to macroeconomic phenomena, rather than the result of dislocations arising from institutional lacunae. Thus, the economics profession, both in academia and in the multilaterals, echoed, and perhaps influenced, the implemented reform programs in deemphasizing legal and institutional reform.<sup>2</sup>

The above paragraphs paint what might be called a majority early-transition view of the role of law and legal institutions. Of course, the picture is not so black and white as the reader might infer from those paragraphs. There was always a large minority of academics and policymakers who provided counter-arguments to the majority view, stressing that the absence of complementary legal and institutional reforms might reduce the effectiveness of other measures. Most pertinent here, although by no means alone in arguing for the institutional point of view, was the IRIS Center, which sponsored the research contained in this book. The IRIS Center was founded by Mancur Olson in 1989 with the explicit goal of providing intellectual and practical sustenance to the institutional reforms that Olson thought necessary for successful economic performance. Aside from in its project-related activities in many countries, the early work of IRIS is best exemplified in Clague and Rausser 1992, containing the essays by Clague (1992), Murrell (1992), and Olson (1992), and in the later essays by Murrell and Wang (1993) and Olson (1996).

As the economic theory of reform sequencing developed, the absence of attention to institutional reforms in the early phases of transition even came to be seen as a virtue in some quarters. In their defense of the strategy of Russian privatization, which some have characterized as precipitate and ill-prepared, Boycko, Shleifer, and Vishny (1995, 154) argued that "Privatization has created an economically and politically powerful lobby for institutional reform. Economic institutions cannot possibly precede the reallocation of property from the government, because people do not care about these institutions until, as property owners, they have an economic interest." Rapaczynski (1996) took this argument one step further in suggesting that legal measures to protect relatively complex property rights are effective only when they are implemented within the context of private institutions produced by private actors working in the marketplace.

With these contributions to the theory of the sequencing of reforms, the mid-1990s witnessed the heyday of the shock therapy approach, which emphasized the rapid destruction of the old system of ownership and controls through liberalization and privatization and simultaneously downplayed any need to wait for the building of complementary institutions. The valedictory of this approach appeared in the measured tones of the *1996 World Development Report*. The authors of this report viewed transition as having two phases, the early challenges of stabilization, liberalization, and privatization, followed by

a period of consolidation, which was still to occur. Institutional reform and the rule of law were consigned to the future consolidation, with the acceptance of the Boycko, Shleifer, and Vishny theory that privatization and liberalization were prerequisites for the establishment of the economic rule of law (World Bank 1996, 88, 145).

The optimism that the early reforms had been well designed was especially bolstered by the encouraging performance of those economies that had reformed earliest, those in the parts of Eastern Europe neighboring the European Union. Since the economies of the earliest reformers were reviving, the argument went, one could expect the later reformers, in the Balkans and the successor states of the USSR, to show similar performance later in the decade. Perhaps the later reformers would not do quite as well in view of tougher underlying conditions, but nevertheless one could expect an economic recovery that followed the same essential pattern as already observed in the countries bordering on the European Union. This was the judgment of Fischer, Sahay, and Vegh (1996) and of the authors of the statistical exercises that supported the *1996 World Development Report* (de Melo, Denizer, and Gelb 1996).

#### Law and Institutions as Reforms Mature

The note of triumphalism was perhaps premature. In 1996, there were already signs that the progress of the early reforming economies was not the norm despite the relative homogeneity of policies across the whole region. Instead, a large group of countries, especially those emanating from the Soviet Union, would not recover quickly from the precipitous recessions of the early 1990s (Murrell 1996). Events over the next three years in the most important country of all, Russia, served to underscore this possibility. For those concerned with the long-term consequences of the lack of attention to law and legal institutions, a warning signal appeared in the economic performance of the Czech Republic. The relatively poor Czech growth in the latter half of the 1990s has been frequently ascribed to a fragile financial system whose development had been greatly influenced by the strategy of privatization. Especially in the former Soviet Union and the Balkans, problems arising from the neglect of fundamental institutional reform have been highlighted by studies detailing the huge damage wrought by poorly performing state administrations and by corruption (Kaufmann 1994).

Spurred by a new perception of the basic facts, there has been a change in the tenor of the evaluation of postcommunist economic reforms, even among prominent advocates of the dominant early-transition view of reform. The message from studies of privatization, indicating a comparative lack of success in institutionally poor environments, suggests that “too much was promised of privatization . . . by external advisors and aid providers, whose hopes for fast and

relatively simple solutions may have clouded their judgment on whether the necessary supporting systems for privatization were in place, or on how long it would take to put them in place, and what was likely to happen in their absence” (Nellis 1999, 28). Blanchard and Kremer (1997), in arguing that the absence of basic contract enforcement mechanisms could explain the collapse in output in reforming countries, concluded: “Transition was conceptualized in a recent World Bank *World Development Report* [1996] as a movement from ‘From Plan to Market.’ If our argument is correct, then a more accurate, if less succinct, title would have been ‘From Plan and Plan Institutions to Market and Market Institutions.’” Johnson, Kaufmann, and Shleifer (1997), after examining the comparative economic performance of transition countries, suggest that “the building of market-supporting institutions is a . . . crucial requirement of a successful transition.”

This changing perspective among economists has coincided with, or perhaps spurred, a “Rule of Law revival” in which “Western policy-makers have seized on the rule of law as an elixir for countries in transition” (Carothers 1998, 99). The president of the EBRD (at the time of writing slated to become head of the IMF), for example, has declared that “policy makers in Transition Countries need to give higher priority for building the institutions necessary for creating stable market economies” (Köhler 1998). And so, in the decade ahead, institutional creation and legal development are likely to be at the forefront of the reform agenda for transition countries, pushed by the search for the ingredient of a successful transition that has yet eluded many countries, by the changing perspectives of social scientists on what is necessary for successful progress, by the persuasive powers of aid providers, and by many countries endeavoring to harmonize their legal framework with that of the European Union.

This new emphasis on institutional reform will not be played out on empty territory. In fact, away from the limelight, much institutional and legal reform has occurred over the last ten years. Such reform would have moved faster had there been more of a commitment to the rule of law by early reformers, but many changes have been made and much legal and institutional infrastructure has been built. Thus, for example, Yakovlev (1996, 8) describes Russia in mid-decade as in a “frenzy of law creation.” Many countries now possess a large chunk of the pertinent economic laws. Courts have been reformed; new regulatory agencies have been put in place; organizational complements, such as property registries, have been established. Much has happened that can be used to generate insights, and a reflective analysis at this juncture will provide information to aid future legal and institutional reforms, now that they have become a priority. (For examples of accomplishments and ongoing efforts, the reader is referred to Asian Development Bank 1998, the European Bank for Reconstruction and Development 1998, and Summers 1997. A number of the chapters of this volume provide a large amount of detail on these reforms.)

## The Genesis of This Book

Given the confluence of events described above, one of the authors of this introduction, Peter Murrell, was very fortunate in 1997 to be offered by Mancur Olson, the principal investigator of the IRIS Center, funds for a research initiative on some aspect of the transition experience. There was increasing acceptance of the view that institutional reforms are crucial for the success of the transition process. A sufficient number of institutional reforms had taken place to provide ample scope for conducting basic research on how these reforms work. There was little existing research on how law worked in the specific conditions of the postcommunist countries and on the costs and benefits of the various methods of supplying new legal infrastructure. Given that a blitzkrieg of rule-of-law reform is in the offing, there is a greater need than ever to understand which factors determine the success of legal reforms. Thus, the overall aim of the research project leading to this book was to use the experience of the transition countries to develop insights into how legal and institutional reforms work, asking to what extent such reforms added value in the transition economies, and under what circumstances they were successful, or not.

In implementing this aim, the goal was to eschew broad assessments that relied only on the application of general legal or economic reasoning and to avoid studies conducted at the macroeconomic level. Rather the project was to focus on analysis of the individual economic agent who is subject to the new institutions, examining the microeconomic pathways through which legal and institutional reforms change economic activity. Thus, the essays in this volume examine the economic decisions of the individual actor, the shopkeeper (the essay by Frye), the lawyer (Hendley, and Hendley, Murrell, and Ryterman), the courts (Hendrix and Pei), the legislator-politician (Polishchuk), the enterprise (Hendley, Murrell, and Ryterman; Kali; Lee and Meagher; and Pei), the bureaucrat (Frye and Berkowitz), the regulatory authority (Berkowitz and Pistor), managers (Heller, Hendley, and Pei), and outside investors (Heller and Pistor).

Given the large variety of economic and legal actors examined by the essays, this book examines many subthemes within the overarching goal of assessing the value of legal and institutional reforms in transition. Thus the essays investigate such questions as: How exactly do legal and institutional reforms affect behavior? What are the microeconomic mechanisms by which law contributes to the activities of economic agents? How do the characteristics of economic agents affect the ability to use legal institutions? Which spheres of the economy are most affected by legal and institutional reforms and which sectors remain unaffected? What are the preconditions for effective legal reforms? Which types of political processes are most conducive to the production of workable legal reforms? To what extent are reforms path-dependent?

These are difficult questions to answer. There is a paucity of research by

social scientists and legal scholars that addresses such questions using evidence at the level of the individual economic agent. Thus, when deliberating on such issues in the context of transition, the researcher cannot draw upon a large stock of existing methodologies that have been tried and tested elsewhere. This point can be illustrated from the research leading to Hendley, Murrell, and Ryterman 2000. In this work, the issue of concern was how Russian enterprises ensure that their transactional agreements are enforced. The seminal empirical essay on enforcement in the United States is that of Macaulay (1963), who asked “What good is contract law? who uses it? when and how?” and answered with the then startling proposition that U.S. businesses relied little on formal legal mechanisms in conducting their transactions. Given the veneration of Macaulay’s study and given the importance of his results in the general theorizing of later years (Williamson 1995), an alluring assumption was that the research on Russia could rely on the use of methodologies that had already been developed to test Macaulay’s thesis. But this assumption turned out to be optimistic. Macaulay’s work is often the only study cited as providing empirical support for his hypothesis, because as Hillman (1997, 246) observes, there is “a dearth of new studies testing Macaulay’s thesis.”

The lesson then is that applied analysis of the effects of legal and institutional reforms is still in its infancy. This had important implications for the organization of the project leading to this book. Given the relatively uncharted territory to be explored, it was important to include a wide variety of approaches, to cast as wide a net as possible for new ideas and methodologies. Thus, among the authors contributing to this volume are economists and political scientists, legal scholars and a practicing lawyer, devotees of law and economics and of law and society, practitioners of economic theory and of applied econometrics. They use a variety of methodologies, theoretical and empirical, econometric and case study. They examine a medley of legal contexts, from the resolution of nonpayment, to corporate governance, to the allocation of oil pipeline capacity. The book covers a wide swathe of the legal process, from the enterprise decisions that turn an inchoate unhappiness into a legal dispute to the lawmaking process of a federal state. The reader will find lessons from a broad cross-section of countries. But within the variety there is a common thread. The focus of all the chapters is on examining decisions at the microeconomic level, to understand the channels through which legal, policy, and regulatory reform affect behavior and add value in the transition process.

### **A Road Map to the Book**

Given the variety of studies in this book it would be quixotic to attempt an integrated summary, trying to bring together their various methodologies and analyses. Instead, this road map does two things. First, it highlights those re-

sults that do reverberate across studies. (While reflecting on these shared results, the reader should keep in mind that this introduction does not report all of the large variety of results in the individual chapters, path dependence itself being a common conclusion.) Second, this guide to the book summarizes the various chapters individually, giving a flavor of the contents for the reader who is ready to begin sampling the individual chapters. (Again, the short one-paragraph summaries in this introduction cannot do justice to the detailed content of the essays. Much more information is contained in the opening sections of the essays themselves.)

### Common Themes

What common themes are in the conclusions of the essays? A number of the essays ask whether legal and institutional reforms have been effective in the transition countries. Several highlight the contribution of institutional reforms. Hendley, Murrell, and Ryterman show that Russian enterprises obtain more value from their transactions when they effectively marshal their legal resources. Hendrix reviews the experience of foreign businesses in Russian courts and concludes that foreign litigants have experienced considerable success. Berkowitz argues that new laws on the allocation of oil pipeline capacity have had a significant influence in Russia. Lee and Meagher observe that Kyrgyz legal reforms are beginning to affect the behavior of the large enterprise sector. Pei makes a convincing case that China's emerging legal system now provides the basic protections required for successful economic transactions.

The essays collectively provide the warning that rhetorical, less empirically focused descriptions of institutions in transition countries often provide misleading impressions. This is in contrast to much of the existing literature based on anecdotal evidence or general description, which contains hyperbole on the inefficiency of legal institutions, their corruptibility, their incompetence, and their irrelevance to economic processes. (See the essay by Hendrix, who reviews some of this literature.) The essays in this volume belie that picture by identifying areas in which law works. This is especially notable given that the essays in this volume do not, by and large, reflect the experience of central Europe but rather that of less hospitable places, most notably Russia, but also China and Central Asia. Therefore, the evidence from this book's detailed studies suggests a danger in forming judgments from anecdotal evidence and macroeconomic data, rather than from undertaking assessments of institutional quality at the detailed microeconomic level.

Nevertheless, the glass is only half full, at best. Many of the essays also identify areas where law is not effective. For example, Heller argues that Russian corporate law is largely irrelevant, given the structure of property ownership created by privatization. One observation common to several essays is that

legal reforms are much more important for larger enterprises than for smaller ones. Lee and Meagher show that law is much more relevant for larger firms in Kyrgyz and Kazakhstan than for the small firm sector, the latter eschewing formal legal arrangements and systematically downplaying the helpfulness of law and legal institutions. This is also implied by the contrast between Frye's conclusion that legal measures are relatively inconsequential for shopkeepers and that of Hendley, Murrell, and Ryterman, who show industrial enterprises using the law. However, even in the large firm sector, productive use of the law can be conditional on enterprise characteristics. The essays by Hendley, by Hendley, Murrell, and Ryterman, and by Lee and Meagher pinpoint the importance of human capital and attitudes within enterprises. Of central importance are the heritage of the passive Soviet lawyer and the ability to accumulate new information and master new procedures. Although the mere passage of time can solve some of these problems, in some enterprises there is little chance of change while the incumbent personnel have power, as Hendley shows in her essay.

The essays in the book thus present a large variety of conclusions on both the conditions under which law has been effective and those where it has not worked. In the immediately following paragraphs, we synthesize these disparate elements by distilling into a number of general categories the many determinants of law's effectiveness identified in this book. We list seven such categories, each of which reflects analysis that is contained in several of the essays.

First, several essays comment on the importance of the character of the process of legal and institutional reform. Lee and Meagher argue that reforms have been more successful where they are more open and participatory, since firms' perceptions of legal mechanisms greatly influence their use of their legal system. Pistor's conclusion of path dependence, based on Eastern European experience, suggests the importance of ensuring that the reform process takes account of preexisting legal and economic conditions. Polishchuk examines the generation of legal reforms in the Russian federal state and argues that competition between localities has not led to the selection of efficient local legal regimes because of the absence of the coordinating constraints of a well-designed federal structure and because of the absence of large quantities of mobile factors that would spur productive competition. Pei emphasizes the sound political foundations of legal reforms in China.

Second, a number of the essays reflect on the preconditions of productive legal and institutional reform that are located in the surrounding economic environment. Economic circumstances, such as the degree of competition in the relevant market, the degree of macrostability, and the concentration of ownership, to name a few, will constrain or expand the role that law can play. Pistor, Polishchuk, Berkowitz, and Heller make this a central point of their conclusions, and Lee and Meagher and Pei also comment on the constraints posed by factors outside the legal environment. Heller shows how the laws on corporate

governance in Russia are rendered ineffective by the structure of property rights. Hendley, Murrell, and Ryterman identify the importance of legal human capital in enabling Russian enterprises to use the law. Kali argues that legal reforms are less effective when they are introduced into an environment that relies heavily on interpersonal networks supporting market transactions.

Third, in a similar vein, the nature of relationships outside or apart from the formal legal sphere may influence how well legal institutions function. A majority of the essays explicitly compares and contrasts the use of law and the use of extralegal processes. For example, Frye's essay suggests that criminal elements sometimes undertake activities that would normally be conducted by enforcement agencies. Kali's essay concludes that informal networks hinder legal processes because they are substitutes for them. In contrast, Lee and Meagher argue that formal and informal arrangements are often complements.

Fourth, the text of the law does matter. Some laws are adequately articulated and thus fill their intended function, but others contain ill-considered provisions, ignore important issues, or are simply technically unsound. Polishchuk enumerates the ways in which regional laws work against economic efficiency in Russia. Lee and Meagher point out strengths and weaknesses in the secured finance laws of several countries. Pistor catalogs the rights afforded by law to shareholders in three Eastern European countries and compares those rights, sometimes favorably, to Western legal environments. None of the authors, however, claims that law on the books is the most important determinant of economic outcomes, and indeed Hendley concludes that the written law cannot explain variations in litigation behavior across Russian enterprises.

Fifth, several of the essays highlight the functioning of the organizations that enforce or carry out the law, such as the courts, the police, and regulatory agencies. Frye finds that small businesses care more about the quality of police services in enforcing basic property rights than about laws and regulations that define and delimit those rights. Hendrix and Pei demonstrate that courts in Russia and China apply the law and are capable of providing fair, reasoned, and predictable judgments of contract disputes. Berkowitz observes that the allocation of pipeline capacity in Russia roughly conforms to law, but that regulatory authorities also take into account efficiency considerations, as well as providing benefits to oil companies who have been responsive to the demands of government.

Sixth, the essays collectively identify a difference between the areas where law has been effective and where it has not been, echoing Rapaczynski's (1996) distinction between the enforcement of simple and complex property rights. Hendley, Hendrix, Pei, and Lee and Meagher report that in relatively simple transactions many businesses often utilize legal mechanisms to structure their transactions and to resolve related disputes, typically over nonpayment. In contrast, Heller, Pistor, and Lee and Meagher observe that more complex arrange-

ments of property rights (corporations and long-term finance) are much more problematic and that a narrow focus on legal reform is unlikely to provide any real solution. This dichotomy within the set of essays tends to support Rapaczynski's prediction that property rights of a complex nature cannot simply be legislated.

Seventh, the attitudes and the knowledge of microlevel economic decision makers determine whether they use, ignore, or evade the law. Hendley argues that one important cause of variation in the litigation behavior of Russian enterprises is the inherited role of lawyers. A minority of firms have legal departments with standing strong enough to recommend their use as business counsel, but most Russian firms continue the tradition of viewing lawyers as technicians with only a narrow role to play. Lee and Meagher relate the use of law to positive attitudes toward legal institutions. An important question of policy that arises from this observation is how to shape perceptions and how to overcome inherited mistrust of the source of the law. Lee and Meagher find the answer in a process of legal and institutional reform that is inclusive and responsive to existing business norms, while Pei's essay suggests that spillover effects will gradually solve the problem, as the initial use of legal institutions by a few firms in China has led to increasing usage over time.

With the diversity of topics studied and methodologies used, it is impossible to give a full impression of the content of this book by focusing on common themes. Indeed, the diversity of experience across transition countries and in different legal contexts might itself be a major conclusion of this book. Thus, to complete this reader's guide, we now describe each essay in sequence.

### The Individual Chapters

Given the variation in the subject matter of the essays, there are many ways to order them in the book. We choose one such way arbitrarily. One extremity of the workings of legal and institutional processes takes place deep within the bowels of the firm, as it makes its detailed day-to-day decisions on how to trade with other enterprises and how to enforce its agreements with them. The other extremity is in the constitutional and politicoeconomic setting, where legal initiatives take place. As one moves from those mundane microeconomic decisions to constitutional politics, one encounters the firm dealing with larger-scale, longer-term problems, on investment, for example, and interacting with a wider set of actors, shareholders, lenders, and regulators. The essays in this book examine all these different levels of interaction, from Kathryn Hendley's case studies of enterprises dealing with nonpayment to Leonid Polishchuk's study of the effects of chaotic federalism on the development of the Russian legal environment.

Kathryn Hendley explores the genesis of disputes between trading part-

ners in Russia, identifying the social and economic factors affecting those enterprise decisions that turn inchoate feelings of being wronged into formal litigation. Her case-study approach, interviewing decision makers as they do their daily work, provides a deep understanding of the role of law, legal actors, and legal institutions in producing litigation. Hendley's study shows that the nature of an enterprise's legal expertise and the assigned role of lawyers within the organizational structure play an important part in determining the level and types of disputes that reach the courts, there being great variation in the propensity to litigate across enterprises. She finds that the level of product market competition is positively correlated with the tendency to litigate and that financial desperation can lead to legal impotence.

Next, Kathryn Hendley, Peter Murrell, and Randi Ryterman examine whether law and legal institutions add value to Russian transactions, using enterprise survey data. They find that enterprise officials view legal institutions relatively benignly and that the courts are used frequently when negotiations fail to resolve disputes. In an econometric analysis of the outcomes of a sample of transactions, they show that the potential for holdup reduces the value of transactions, that the nature of ownership and control affects an enterprise's ability to sustain relationships, and that legal factors influence transactional success. The authors find that the economic and institutional environment rewards those enterprises that invest effort in constructing contracts, that possess superior legal knowledge, and that reorient their legal work to new opportunities, hence the essay's conclusion that "law works in Russia."

Given the fairly prominent role of the courts in the affairs of some of the enterprises analyzed in the previous two chapters, an important topic of analysis is examining how well the courts function. Glenn Hendrix does this for one set of enterprises that might be expected to face difficult times in Russian courts: foreign companies. He analyzes the experience of foreign companies in Russia's commercial courts, examining the common wisdom that the Russian judicial system is, among its other ills, implacably biased against foreigners. He uses a new data set collected through the court system. Although the data provide some evidence of antforeign bias, particularly outside of Moscow and St. Petersburg, they do not support the conception held by many Westerners that foreigners face dismal prospects in Russian courts. In the trial courts, foreign plaintiffs win more often than they lose, and in the appellate courts foreigners appear to do better than domestic parties. Hendrix concludes that the likelihood of a foreign business obtaining a fair outcome in the Russian court system is greater than is generally believed and that the success of foreign litigants against domestic parties may indicate that the Russian judiciary is, in fact, becoming more independent.

How typical is the evidence from Russia? The next two chapters pursue similar themes in different contexts. Young Lee and Patrick Meagher examine

business finance and commercial transactions in a number of settings using a variety of empirical information, a survey of financing practices in Kyrgyz, a smaller parallel survey in Kazakhstan, and secondary data on other countries. They show that growth-oriented financial transactions are consistently linked with the use of formal legal arrangements, but that such transactions are not common. Most enterprises limit themselves to maintaining existing production, relying largely on informal arrangements. For these enterprises, financing arrangements, and the problems and disputes arising from them, are usually not handled legalistically. The use of relatively complete contracts and formal enforcement methods is associated with positive views of the legal environment, and informality with less positive views. They conclude that the preconditions for successful legal reform lie in the wider social context, suggesting that the style of reform (e.g., whether open and participatory) can influence firms' use of legal mechanisms.

Minxin Pei obtains empirical information from a very different context, examining legal processes in a country that is usually presumed to be even less hospitable to the rule of law—China. Indeed, China has sometimes been held up as providing an alternative model of economic development, one that largely does not rely on legal processes (Jones 1994). Pei shows that the rhetoric is far removed from the reality. He examines both aggregate data, on legislative output, rate of litigation, composition of commercial disputes, and patterns of disposition, and microeconomic data, on commercial disputes that were litigated through the court system. Both aggregate data and the sample of disputes support the proposition that China's emerging legal system provides the basic protections required for successful economic transactions. Pei concludes that the court system performs this role because the country's legal reform has solid political foundations and it benefits from a preexisting institutional framework that helps reduce the problem of corruption and political interference.

Raja Kali's essay extends the analysis of the transactional phenomena in a different direction, reflecting on what economic theory has to say. The starting point of his essay is the claim that, in many emerging countries, networks of informal relationships between businesses dominate economic activity. In recent years, many scholars have suggested that these networks are a productive response to inadequate legal infrastructure. The overwhelming message that emanates from these studies is the functionality of these networks (Landa 1997; Jones 1994). Kali uses a simple general equilibrium framework to argue that, while such networks benefit the participants, these networks can reduce overall economic efficiency. Kali then applies his theoretical model to a review of the recent empirical literature on business networks, examining the link between the sustainability of networks and the unreliability of the legal system and whether the existence of networks stunts the effectiveness of formal institutions.

The next three essays examine processes that are longer-term in perspective, focusing on investment, corporate finance, and corporate governance. Timothy Frye analyzes the investment activities of shops in Warsaw and Moscow. Using the results from a survey of small businesspeople that focuses on the determinants of the security of property rights, Frye concludes, not surprisingly, that the rule of law is stronger in Warsaw than in Moscow. More important, he shows that several factors (e.g., confidence in the courts) that are commonly perceived to affect the security of property rights did not play an important role in shopkeepers' decisions to invest. Rather, a functioning police force is the most important predictor of secure property rights. Shopkeepers who viewed an unreliable police force as a significant problem were less likely to feel secure enough in their property rights to renovate their shops, compared to shopkeepers who had a more positive perception of the police. Frye concludes that the social order produced by an effective police force is temporally prior to a concern for functioning courts in the calculations of small businesspeople making investment decisions. The contrast with the results of Hendley, Murrell, and Ryterman suggests the very different institutional needs of small business and large industrial concerns.

Katharina Pistor examines equity market development in the most developed transition countries: Poland, Hungary, and the Czech Republic. She argues that the regulatory framework and the state's capacity to enforce this framework has been crucial, because property rights in the form of securities are too complex to rely on self-enforcing mechanisms. A complex legal and institutional infrastructure is required to enforce these rights. Three sets of rules are relevant to that enforcement: shareholder property rights, protection of potential investors, and trading rules. Pistor concludes, on the basis of the evidence provided by the three countries, that investor protection rules are the most important. She further argues that the specific rules adopted must address the central conflicts that prevail within a given system. Because different problems are more prominent in different systems, productive institutional change is necessarily path dependent.

Path dependence is also a theme of Michael Heller's essay, which examines corporate finance and corporate governance. But Heller's context, Russia, provides a very different environment than Pistor's, and his perspective on the determinants of legal performance starts at a very different point, the property regime. In Russia, the low rate of restructuring and the extremely low valuation of Russian stock suggest fundamental problems in the corporate sector. Heller argues that property theory can explain why privatization and the new corporate law have not had the positive effects that reformers predicted. The fragmented ownership of Russian enterprises provides an example of anticommons property, where initial share ownership is distributed to competing groups of insiders who then block each other from making moves that would maximize

the value of corporate assets. Corporate governance in Russia is an unfortunate example of a tragedy of the anticommons. Heller argues that a precondition of the creation of a successful corporate sector during privatization is the avoidance of anticommons property when property rights are initially bestowed.

The last two essays focus on the interaction of the law and the activities of the state. Daniel Berkowitz examines the effect of law on regulators, those with the power to allocate Russian crude oil pipeline capacity, which determines whether firms have access to profitable export markets. One clear feature of the law was that domestic access to world markets should be proportional to a firm's previous oil output. This aspect of the law was operational in 1996 and had a significant effect on the allocation of capacity. However, controlling for this law's effects, scarce capacity was allocated to reward firms that incurred debts from sales to favored customers. While export allocation was driven by these legal and political criteria, attention was also paid to efficiency considerations, such as distance to port and production efficiency.

The last essay, by Leonid Polishchuk, focuses on the reform of institutions in their broadest context, examining how the nature of the constitutional and political environment affects the character of reforms. Since 1992, Russian regions have exercised much discretion in choosing their legal and regulatory regimes. However, regional choices have not been subject to the coordinating constraints of an efficient federal structure. Hence, the incentives of regional leaders favor control over local economies instead of the creation of impartial rules. The regions attempt to supplant federal legislation with their own laws and to develop exclusive "legal enclosures," which are insulated from the national legal system. Regional experimentation could have facilitated the selection of efficient legal regimes as the various regions competed with their different institutional setups. However, competition and selection are weak in Russia because of the absence of new investment during the protracted recession, the grossly inadequate federal institutions, and the lack of factor mobility. Without a market-preserving institutional framework policed by the central government and without effective competition between regions for additional factors of production, competition between regional legal frameworks does not necessarily lead to the selection of market-oriented regimes.

In sum, we have argued that future reforms will increasingly focus on strengthening the legal institutions that support market economies. However, the knowledge necessary to guide such reforms is relatively sparse; there is little existing empirical research on how well law has worked in the specific conditions of the postcommunist societies and on the costs and benefits of the new legal infrastructure. Thus, the overall aim of the research reported here is to develop insights from the experience of legal and institutional reform in the transition countries, asking when and under what circumstances such reforms were successful, or not. The essays that follow use a variety of perspectives in ana-

lyzing the economic impact of past reforms, because no one methodology has yet emerged as clearly demonstrating its power to analyze the economic effects of law. Nevertheless, underlying a seemingly eclectic set of essays on a wide variety of countries and topics, we do find a set of common themes that reverberate throughout the following chapters, as suggested in the immediately preceding paragraphs. Our introduction can only begin to highlight the richness offered by this collection, and so we leave it to the reader to enjoy the bounty.

## notes

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1. At least, the constructive element received little emphasis; institutional change in the form of destruction of the old system did receive its due.

2. Scholars outside economics placed more emphasis on institutions, on the building of the political and legal institutions of a civil society especially, but that emphasis had surprisingly little effect on the role that law and legal institutions played in the economic reform programs.

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