

Private Enforcement of Public Laws: A Theory of Legal Reform

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In the last several years, the countries of Eastern Europe and the former Soviet Union (FSU) have made tremendous progress in price liberalization, privatization, and macro-economic stabilization—the standard steps of the so-called shock therapy. Yet in the aftermath of these reforms, the East European countries have begun to grow rapidly, while the countries of the FSU, particularly Russia, are at best beginning to turn around. It is not possible to explain these differences in performance in terms of either having too much shock therapy or not enough of it, since the reforms that the different countries have pursued have been broadly similar.

A more plausible reason for the difference in performance is that institutional reforms, such as those of government regulation, the legal system, and the bureaucracy, have advanced much further in Eastern Europe than in Russia (Shleifer, 1997; Simon Johnson et al., 1997). Indeed, institutional failures have arguably deterred small-business formation, foreign investment, and enterprise restructuring in the FSU. For growth to take off, Russia and other FSU countries must radically improve the quality of their institutions.

In this paper, we discuss the principles of perhaps the key institutional reform, that of the legal system. The ideas we describe were developed at the Institute for Law Based Economy in Moscow. Since its inception in 1994, the Institute has been a key player in the Russian legal reform, and we were both involved in its work. Despite the Russian specificity of some of the analysis, we believe that these ideas apply to the problems of legal reform in the rest of the FSU, as well as in emerging economies more generally.

I. The State's Failure To Provide and Enforce Laws

Business people in Russia use the state legal system a lot less than they feel they need to. In a survey of shopkeepers in Russia and Poland, for example, 45 percent of Moscow respondents said that they needed to use the courts in the last two years but did not, compared to only 10 percent of the Warsaw respondents who gave this answer (Timothy Frye and Shleifer, 1997). There are two apparent reasons why the state legal system is not used in Russia: the low quality of the services it provides and the unwillingness of business people to expose themselves to the legal system, and to the government, more generally.

The quality of the legal system is notoriously bad (Avner Greif and Eugene Kandel, 1995; Katharina Pistor, 1996). The legal rules are incomplete in crucial areas needed to support existing business activity, such as real-estate registration. When legal rules do exist, in many instances judges do not know what they are. Many judges, for example, are unfamiliar with the relatively new securities law, which comes up in securities-markets disputes. Even when the law speaks to a particular matter, judges may not have the resources or inclination to verify the relevant facts. And when the facts are available and the legal rules exist, judges may be biased, corrupt, or partial to political sentiment, and hence it is by no means certain how they will rule. Finally, once a judge rules, there are often no institutions to enforce his ruling. For example, contracts between Russian and Western partners often specify London courts as the venue for dispute resolution. When the Russian partner breaks the agreement and the London court rules against him, the Western partner is still left with absolutely no mechanism of collecting his claims.

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A further reason that private parties in Russia refuse to use the legal system is that they operate to some extent extralegally to begin with and, hence, do not want to expose themselves to the government. The tax system in Russia is sufficiently arbitrary and draconian that private firms are either in violation of tax law or even operate unofficially. By some calculations (Johnson et al., 1997), over 40 percent of the Russian economy is unofficial. Given that many firms have both some official and some unofficial business, the majority of Russian businesses are probably in violation of some tax, customs, foreign-exchange, or regulatory rules and, hence, would not use the official legal system to resolve disputes for fear of exposure.

The consequence of this avoidance of the legal system is that private rather than state mechanisms are used to resolve disputes. These mechanisms range from social norms and pressures, to arbitration, to employment of private but legal protection agencies, to organized crime. In some cases, where parties interact repeatedly and the stakes in individual disputes are small compared to the value of long-term relationships, peaceful private mechanisms work extremely well (Robert Ellickson, 1991, Lisa Bernstein, 1992, Greif, 1996). For example, arbitration succeeded as a means of resolving disputes between brokers on Russia's commodity and stock exchanges, who interact repeatedly and can use the exchange to enforce the arbitrator's decisions (Frye, 1996). Even illegal private enforcement organizations that gain monopoly in dispute resolution in a particular area and manage to gain acceptance for their rules and enforcement mechanisms may be reasonably efficient. Why, then, has the private resolution of disputes left Russia with what is widely regarded as a dysfunctional legal system?

The trouble is that private dispute resolution often does not work efficiently. Many commercial disputes do not fit the nice picture of repeated interactions over long periods of time, where access to the system is a valuable asset that the trading parties would not give up. This is so with debt collection, where borrowers are too far underwater to worry about the future, or with big ownership disputes. In

these and other cases, there needs to be some force in enforcement.

Moreover, private rules, including those for using force, are often neither known nor accepted by the disputing parties. If person A borrows money from person B and does not repay, A's protectors might think that the appropriate rule is to extend the period of repayment, whereas B's protectors might think the appropriate rule is to kill A. Once A is dead, there may be no public lesson to be learned about what the rules are, since the potential future borrowers from B or other lenders, including A's associates, would not even generally know what rule A has violated and why he was killed. Private rules are often unrecognized, unknown, and not enforced consistently, which makes it prohibitively expensive for private parties to rely on them to structure transactions.

Last but not least, private enforcement is unhelpful in legal disputes with the government. As a consequence, private parties remain vulnerable to the threat of discretionary regulation and extortion by public officials, without any effective legal recourse (see Shleifer and Robert Vishny, 1993). The standard function of the judicial system of providing a check, however rudimentary, on other branches of government is lost with purely private enforcement of private rules.

In sum, private enforcement of private rules in Russia has emerged as a market response to the failure of the state to provide and enforce its own rules, largely because of very weak incentives in the government to provide law and order. This private mechanism has the advantage that both the disputing parties and the enforcers have economic incentives to pursue enforcement. Yet it also has the major disadvantage that private rules are often different for different enforcers, insufficiently well known, and not legitimate enough for business people to rely on them in structuring their transactions. The result is that the legal system is viewed as a failure, and a lot of trade and production simply does not take place.

A common recommendation to address this problem, in line with the traditional economists' view that laws should be publicly enforced (Douglass North, 1981), is to beef up

the state legal system, through administrative reforms of police and judicial system, accelerated production of laws, training of judges, and so on. Unfortunately, such recommendations often overlook the fundamental problem that the incentives in the government to reform itself are lacking, and hence these reforms may fail or even backfire. When the elite units of the Russian police obtained bigger guns to fight the mafia, they simply sold these guns to the mafia at higher prices than the previous, less powerful, weapons could fetch. The reforms of the tax bureaucracy have not gone well either, in part because no government official has enough authority to shake up a system that benefits, at least indirectly, other government officials. And increases in the power of tax police have led to greater arbitrariness, abuse, and corruption. Without a "benevolent" dictatorship, a common collective memory of law and order, or at least a very strong and unified democratically elected government (none of which describes the reality of Russia at the moment), strengthening the state's legal apparatus can do more harm than good. What, then, can be done in the interim to improve law and order?

II. Private Enforcement of Public Rules

The principal argument of this paper is that the appropriate legal-reform strategy for a country like Russia is private enforcement of public rules. Public rules can address the problems of multiplicity, obscurity, and illegitimacy that plague the private rules. Private enforcement of these rules introduces powerful incentives that the public sector does not have.

The strategy of private enforcement of public rules begins with the creation of legal rules that can be enforced jointly by an extremely limited public judicial system and the much more extensive private enforcement system. From the viewpoint of the state legal system, public laws can help well-intentioned judges to resolve disputes, and even restrict the discretion of the not-so-well-intentioned judges. To the extent that laws make judges more predictable, business will rely on these laws more and hence demand the services of the official legal system.

Even when disputes are ultimately resolved by courts, however, much of the benefit of public rules comes from private parties structuring their transactions so that courts become more usable. For instance, suppose that a rule completely prohibits, and actually annuls, certain "self-dealing" transactions by corporate managers, such as sales of corporate assets to affiliated parties. When this rule exists, large shareholders will try to institute procedures that allow them to review corporate transactions and to document who the buyers are. Most of the information collection will be done by private parties who have powerful incentives to verify violations, and who can then come to a court for a very simple decision based on verifiable information that the private parties themselves provide. All a judge has to do is annul the sale. The likelihood of such annulment would make managers wary of breaking the law, and buyers wary of losing their money. Moreover, when public rules exist and are clear, judges would come under public pressure to enforce them, rather than rule corruptly, politically, or arbitrarily. Without a specific rule, it is not clear what large shareholders need to do or to document in order to use the court. Public rules work because they tell private parties what they need to do to use the legal system and thus provide incentives for them to use it.

But public laws have a further, perhaps even more significant, benefit in an emerging economy: they become the focal point of totally private contract enforcement and dispute resolution. Unlike the private rules, public laws are public, and hence private enforcers can free ride on them to structure their own activities, and to create their own reputations. Public rules can thus coordinate the expectations of market participants even with little public enforcement, similarly to the idea of coordination of beliefs in Thomas Schelling (1960), Robert Sugden (1989), and Greif (1994). Public law is particularly attractive for belief coordination because in the eyes of many people law has a degree of legitimacy that private rules do not have. In an emerging economy, these coordination benefits of public rules may be enormous.

Take the case of reputation development by private enforcers. A public rule on loan de-

faults may encourage both A's (the borrower's) and B's (the lender's) protectors to use it to resolve the dispute. Suppose this rule is quite unfavorable to the lender, B. B's protectors may still accept it, because they can then become known for enforcing widely accepted public laws and thus further their public reputation. Indeed, it may no longer be in the interest of either A's or B's protectors to enforce their own rules, because these rules would be much less well understood, undermining their reputations, and hence the demand for their services. Indeed, if B's protectors try to enforce some other rules, A's protectors can tell all market participants that B's protectors are acting arbitrarily, thereby triggering some form of collective punishment or exclusion. Last, but not least, other borrowers (and lenders) can now structure their contracts with better knowledge of what happens when a borrower defaults. A's and B's protectors now have a larger share of a larger market.

Interestingly, private enforcement organizations in Russia often ask disputing private parties for copies of their written agreements. The enforcers do not want to enforce arbitrary claims; they want to establish reputations for resolving disputes according to rules, and public rules are a chosen focal point. As a further step, dispute resolution can proceed in the shadow of private law-enforcement organizations, but without their direct participation.

Through these mechanisms, public rules acquire a reputation and legitimacy of their own. In some cases, these rules are enforced by courts, though with significant efforts by private parties to simplify the courts' decision process. In other cases, these rules are enforced by private parties without any reliance on courts. In still other cases, the parties to a dispute agree to a resolution in line with these rules without any help with enforcement, since they know what is going to be enforced. In all these ways, private enforcement of public rules can work reasonably efficiently even when public enforcement remains ineffective.

III. Which Public Rules Encourage Private Enforcement?

So far, we have spoken of legal rules, and their coordination benefits, in general terms,

without distinguishing between good and bad rules. But, of course, good rules are more likely to be used by economic agents, as well as by both the private and the public enforcers, than bad rules. What, then, constitutes good legal rules?

In line with Section II, good legal rules are those likely to be adopted by private parties for both structuring and enforcing their transactions, as well as used by courts. In general, rules that are usable by private parties and those usable by courts are the same, since both types of users are looking for simplicity, consistency with standard business practice, efficiency, the ease of verification of violations, and most importantly, effectiveness of enforcing decisions.

The standard rule-making strategy is to borrow legal rules from advanced countries, rather than to reinvent the wheel. Indeed, virtually every country in the world has borrowed most of its commercial law from a few legal systems, particularly French and German civil law and English common law (Alan Watson, 1974; René David and John Brierley, 1985). But the decision to borrow does not end the story. Legal rules both within and across traditions vary enormously, and some rules facilitate trade better than others (Rafael La Porta et al., 1998). There is thus a question of which rules to pick. More importantly, rules are specific to other elements of the legal system. In particular, Western legal rules rely on vastly more extensive judicial verification and public enforcement mechanisms than are available in a transition economy. Western rules must therefore be adjusted to facilitate private enforcement.

On this basis, we suggest three general lessons for developing legal rules for a country like Russia. First, as argued by Bernard Black et al. (1996) and Hay et al. (1996), it is better to have "bright line" rules (i.e., rules that make it easy for judges, or private enforcers, to verify violations). For example, in an advanced economy, it may be best to have a flexible anti-self-dealing rule that allows managers to undertake transactions as long as (they can show in court) these are in the interest of shareholders. Such a rule would not work in Russia because a judge could not use it and is likely to side with the manager, or with

whoever pays him more, in a dispute. A better rule for Russia would prohibit and annul all transactions between the corporation and any entity in which the manager has an interest. Violations of this rule are easier to verify and punish, even if it is less flexible.

A second idea, which has not had sufficient impact on Russian law-making, is that there needs to be a private right of action, and a clear private remedy, in a dispute. In the previous example, if shareholders have no clear right to sue for self-dealing and be rewarded through a higher value of their shares (or even a part of a fine), the likelihood of enforcement is negligible. Counting on an administrative agency to enforce the law is a mistake, since the agency is more likely to listen to corporate managers than to complaining shareholders. If, in contrast, a large shareholder can bring a specific violation to a court, he is more likely to monitor the managers. The role of private enforcement in making this law work is overwhelming.

Third, whenever possible, laws must agree with prevailing practice or custom. If public laws violate the practice, then private parties may refuse to enforce them either on their own or with ultimate reference to courts. The coordination benefit of public laws would then be lost. Alternatively, when laws absolutely must change the existing practice, it is crucial to write them keeping in mind what groups of private agents would enforce them. Thus the Russian mass privatization program relied on the incentives of corporate managers to implement its rules (Maxim Boycko et al., 1995), whereas the fledgling Russian corporate law relies crucially on the incentives of large private shareholders to control the managers.

To summarize, it is difficult but possible to construct legal rules, based on adjusting the best world practice, that become the focal point of both private and public enforcement, and that are usable even in a country with extremely limited public enforcement of laws, largely because they make private parties do most of the enforcing.

IV. Toward Public Enforcement

Although this paper has advocated the benefits of private enforcement of public laws, ultimately, as a country develops, the role of the

public sector in law enforcement is likely to increase. The final question we address is what can be done to improve public law enforcement.

In many cases, public law enforcement is most likely to benefit from institutional reforms outside of the law-enforcement sector proper. In Russia, these reforms include tax reform and federalism reform (see Johnson et al., 1997; Shleifer, 1997). The simplification of tax rules, combined with the reduction of marginal rates, would draw firms out of the unofficial economy thus increasing the demand for official law enforcement and reducing the demand for unofficial services. Federalism reform can create the incentives for regional governments to provide high-quality courts to attract business and expand the tax base, as well as to improve police and other protective services for business. Indeed, these incentive-based reforms are likely to do more for law enforcement than the difficult-to-implement administrative reforms, which, as we mentioned earlier, can fail or even backfire.

Public enforcement is surely the ultimate goal of any legal reform. Yet it is important to remember that the strategy of private enforcement of public rules can serve Russia, and many other emerging economies, extremely well in the short and medium term.

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