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Privatization in transition economies

Toward a theory of legal reform

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Abstract

This paper describes some characteristics of a dysfunctional legal system, and then proposes some reforms of the legal rules that would encourage private agents to rely on the legal system rather than mafia to structure their transactions. We argue – using both theory and the example of Russia – that legal rules should accommodate rather than interfere with the existing business practice. Moreover, in the transition stage, good legal rules should enable highly imperfect courts to verify violations of law and tell courts what to do when such violations occur.

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1. Introduction

Virtually all observers of East European reforms have recognized the importance of the rule of law for the economic transformation. The rule of law means, in part, that people use the legal system to structure their economic activities and resolve disputes. This includes learning what the legal rules say, structuring their economic transactions using these rules, seeking to punish or obtain compensation from those who break the rules, and turning to the public officials, such as the courts and the police, to enforce these rules.

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To be accepted, the legal system has to outcompete other, typically private, mechanisms of enforcing agreements and resolving disputes. One type of mechanism is legal but private contract enforcement through reputation or arbitration. Such mechanisms are extremely important, but they are not a perfect substitute for the public legal system: they either work in specialized markets with relatively few participants and repeat interactions (Bernstein, 1992), or ultimately rely on the legal system to enforce private arbitrators' decisions (Shavell, 1995). A second type of private enforcement is organized crime. As a method of dispute resolution, organized crime has the problem that criminals exert heavy, often distortionary and arbitrary, taxes on the parties they protect. The question asked in this paper – using both theory and the example of Russia – is how to reform the legal system to make it more effective than organized crime in supporting private transactions?

2. Aspects of a dysfunctional legal system

Why would people not use the legal system to resolve disputes? Presumably, they would use alternative methods of dispute resolution, such as private arbitration or crime, when these methods are cheaper. What, then, makes a legal system expensive for private parties to use?

Bad courts raise the cost of using the legal system. Court fees may be prohibitively high. Judges may be corrupt, and so disputants may be concerned about both having to bribe the judge and having the other party pay a higher bribe. Courts may be politicized in the sense of catering to the wishes of the politicians, especially when the government is a party to the conflict, or in the sense of favoring particular litigants for reasons unrelated to the dispute (e.g., nationals over foreigners, state firms over private firms, etc.). Courts may be so inefficient that it takes years to get a dispute resolved, by which time the value of damages that might be collected falls to zero in real terms. Courts may be unpredictable because they refuse to take cases, because their decisions are difficult to forecast from the law, or because judges are uninformed and incompetent. Likewise, the police often suffer from the same problems as the courts, making the legal system expensive to use.

A second reason that people do not use the legal system is the prevalence of bad laws on the books, laws that guarantee that virtually all business is operating extra-legally. When private parties may already be breaking some laws (e.g., tax, or registration), they may come to a court only to expose themselves to authorities without resolving their dispute. Indeed, Article 168 of the Russian Civil Code takes the extreme position that a transaction which violates *any* provision of the Russian law is void. With such laws, businesses may eschew courts altogether. A further problem with bad laws is that they contradict standard business practice and common sense, making it difficult for courts to reach decisions. How could a court enforce the payment of debts of a bankrupt company by its shareholders who

have no limited liability (see articles 56 and 105 of the Russian Civil Code)? If laws are so bad that courts can't reach decisions from them, people will not use the courts.

But even if two parties come to a court, they are both 'legal', and the law does not invalidate their contract, there remains a critical problem of a dysfunctional legal system, namely that the courts cannot use the available laws to resolve disputes. For example, in a dysfunctional legal system, courts cannot effectively resolve contract disputes, even if they try, for two reasons. First, courts cannot easily *verify* whether a violation has taken place. For example, in the absence of standard accounting methods, courts cannot verify that one partner stole money from the other in their joint venture. Second, there is no body of law that specifies what a court should do even if there is a violation. For example, the Russian law does not specify who is liable when a buyer of securities discovers that these securities have been previously stolen (*bona fide* purchaser rules do not exist). In well-functioning legal systems, in contrast, a great deal more information is verifiable in court and the body of law and precedent is much more extensive, so that courts have a great deal more guidance as to what to do.

These problems can seriously handicap contracting. In particular, contracts may have to be very incomplete, in the Grossman and Hart (1986) sense, not because future contingencies are hard to describe, but because of severe limitations on what courts can verify and rule on. Non-verifiability of future states, which lies at the heart of incomplete contracts, may be a property of poor institutions such as accounting methods or access to information by the courts, rather than of the physical world. Moreover, this incompleteness of contracts can prevent many efficiency-improving contracts from being signed, or, even if they are signed, they will be enforced through extra-legal means.

Finally, for the legal system to be used by private parties, the decisions of courts must be enforced by the coercive force of the state. If private parties need to enforce court decisions on their own, they often choose to use mafia in the first place. To be sure, there may be a lot of value in legal rules even if the government does not enforce court decisions, since private parties can use these rules to structure their transactions even when enforcement remains private. Indeed, Hart (1961, p. 91) argues that the importance of enforcement, relative to that of good legal rules and courts, has been greatly exaggerated by legal scholars, and gives examples of functioning legal systems with public courts and private enforcement of their decisions. Still, most modern legal systems rely on (ultimate) public enforcement of rules as well as on public laws and public courts.

Russia's legal system today has all the characteristics of a dysfunctional legal system. The courts do not function effectively. There are many bad laws on the books, a legacy of the communist system that aimed to ban private economic activity. The new laws are highly incomplete, and usually lag far behind business practice. The laws are often not written in ways that enable courts to verify violations (without a significant effort that judges refuse to incur). The police often

fail to enforce the decisions of the courts. As a consequence, business people stay away from using the legal system, and use the services of organized crime instead.

The question addressed in the following sections is how to get more people to use the legal system? We believe that court and police reforms should not be the starting point, since those reforms are likely to take a long time. The legal system must begin to be used with the existing courts and police. To do so, legal reform should begin with the adoption of legal rules that the courts find usable, and that private parties find cheaper to rely on than other methods of resolving disputes. Such rules should have several obvious but important characteristics. First, bad rules – that keep people from using the legal system because they prohibit, or fail to support, legitimate market activity – need to be abolished. Second, the new rules should, to the extent possible, follow business practice, thereby enabling private parties to continue their business activities, but to rely on courts rather than crime to resolve disputes. Third, the new rules should help the courts resolve disputes by telling them what to do in the cases where existing laws are most conspicuously incomplete. In particular, courts, with their extremely limited resources, should be able to verify whether violations of these rules have occurred.

In the next section, we present a simple model that illustrates the need for legal rules, and shows how simple legal rules can facilitate contracting even in an undeveloped legal system. In the following section, we discuss our view of legal reform with a few more illustrations and examples.

3. A model of a dysfunctional legal system

This section illustrates some of the ideas of the paper using the example of a capitalist who wants to hire a manager. Suppose that a capitalist has an asset ($1 of capital), which can be put to productive use. If the capitalist works with this asset himself, he can produce output $1 + a$ next period. However, the capitalist has an alternative use of his time, valued at v, so his net payoff from working with the asset himself is $1 + a - v$.

Alternatively, the capitalist can hire a specialized manager to work with his asset, whose alternative wage is W. If the manager works with the asset, then the payoffs take the following form: With probability p, the payoff is $1 + G$ (the asset remains and there is extra output), and with probability $1 - p$, the payoff is 1 (only the asset remains). There is also a risk, however, that the manager sells the asset to his relatives at essentially zero price, in which case the capitalist receives zero. Every outcome is observable to the capitalist and the manager but, as we show below, outcomes need not be verifiable in court. Throughout, we assume that the manager does not have any resources of his own, and hence cannot either buy the asset from the capitalist and manage it himself, or even post a bond with the capitalist. We examine three contracting regimes of this model.

In the first regime, that of a well-functioning legal system, suppose that the

income of the firm, as well as the fact of asset sale, are verifiable in court. The capitalist can then write a contract with the manager that gives the capitalist residual income and that also requires the capitalist's approval for any asset sale. If it pays to do so, the capitalist simply hires the manager at the wage W and retains the right to stop any disposition of assets. The condition for this contract being preferable to the self-management of the assets is that

$$1 - W + pG > 1 + a - v, \tag{1}$$

i.e., the surplus from delegated management exceeds the surplus from self-management. This is also the efficiency condition for delegated management, which we assume holds.

In the second regime, that of no legal contract enforcement, we assume that courts are not equipped to verify either the income of the firm, or even whether its assets have been sold. In this case, no matter what the contract with the manager is, he steals both the income and the asset, and the payoff to the capitalist is zero. Accordingly, as long as $1 + a - v > 0$, the capitalist would rather manage his asset himself than use the legal system to hire the manager.

Suppose that the capitalist has access to the (reputable) mafia, which for an up-front, non-negotiable fee of M assures that the capitalist receives all the residual income. Then, as long as

$$1 - W + pG - M > 1 + a - v, \tag{2}$$

the capitalist turns to the mafia to enforce the contract with the manager (e.g., kill him if he steals). If (2) does not hold, the capitalist manages the asset himself. With no legal contract enforcement, the gains from trade either remain unrealized, or they are realized through the extra-legal, and presumably expensive, system of contract enforcement.

In the third regime, that of simple rules, we suppose that the courts are not equipped to verify income, but can actually verify whether assets are sold, and in fact can stop an asset sale unapproved by the capitalist. In this case, the capitalist can contract the manager to run the firm except that any decision to dispose of assets must be approved by the capitalist. (We do not address the question of whether one needs just contract law, or more elaborate corporate law, to enforce this contract.) Suppose the manager gets a wage w (which we determine shortly). If the manager runs the firm, he cannot sell the asset, but he has no reason to report any income above 1, since income is not verifiable. The capitalist's payoff is then $1 - w$. The capitalist prefers legal delegation to running the firm himself if

$$1 - w > 1 + a - v. \tag{3}$$

To determine the manager's wage, note that he does not need to be paid W, since both he and the capitalist understand that he will steal G. In fact as long as $pG > W$, the manager is prepared to work for a zero wage (he would actually pay $pG - W$ for this job, but we are assuming that he has no cash to put up a bond). If

$w = 0$, then the condition for employing the manager under these legal rules is $a < v$. As long as the capitalist's opportunity wage exceeds the amount he adds to the business, he would hire the manager rather than run the business himself.

Similarly, the capitalist prefers delegation under these legal rules to mafia enforcement if

$$1 - W + pG - M < 1. \tag{4}$$

In this case, if the capitalist chooses to hire a manager, he would choose to do so legally rather than through mafia enforcement. When condition (4) holds, legal rules outcompete the mafia.

One problem with the law that requires the capitalist's consent for the asset sale is that the manager may be ingenious enough to invent an alternative transaction, such as renting the capital to his relative at essentially a zero price. One potential way to prevent this from happening is by stipulating that the manager has a 'duty of loyalty' to the capitalist. In this case, a manager who undertakes any transaction that might be interpreted by the courts as a form of self-dealing is liable to the capitalist for damages. Unfortunately, such contract clauses require a developed body of precedent to be useful, or else the courts would either refuse to interpret them or do so arbitrarily. In the long run, such a body of precedent might develop, but in the short run, capitalists have to take the risk that managers outsmart them, and courts cannot identify a violation of existing laws. Laundry lists of bright line rules, which specify all the actions that managers are prohibited from taking without an explicit permission of the capitalists (or a supermajority approval by shareholders), may make the legal system more effective even though they do not cover all the cases.

This simple model illustrates how legal rules can make the legal system more attractive to private parties than contract enforcement by the mafia. First, contracts suggested by economic theory may rely on information that courts cannot verify until other institutions – such as accounting standards – develop. Simpler rules and contracts may be more effective in transition economies in getting people to use the legal system. Second, these rules have to enable private parties to solve contracting problems they face (such as hiring a manager). Third, even simple rules, as long as they allow courts to verify violations easily, can be successful in getting private parties to structure their contracts using these rules, and thus can both facilitate trade and crowd out mafia as the means of contract enforcement.

4. Implications for legal reform

Our model may help the discussion of legal reform strategies. Note first that legal reforms often are not introduced by benevolent dictators or Parliaments, but are rather an outcome of political pressure from the property owners. For example, Hunt (1936) presents the history of the repeal of the 1720s Bubbles Act in Britain.

This Act, which prevented the incorporation of limited liability companies without consent of Parliament, was repealed only after a century of pressure from British business, covering most of the Industrial Revolution. Raeff (1983) similarly discusses how the legal system developed in Germany in the 17th and 18th centuries was shaped by pressures from the participants in an emerging market economy. In Russia today, the pressures on the Duma for legal reform are also coming from the new business, as well as from the privatized business. This is not surprising, since these businesses (who are the capitalists in our model) stand to benefit most immediately from the legal reform, and therefore are prepared to lobby for it.

Several writers on transition (e.g., Intriligator, 1994; Laffont, 1994) have argued for the introduction of legal and regulatory institutions before privatization, so that privatized firms can from the start operate in a market environment. Unfortunately, before privatization, when all property is state-owned, no private parties are interested in institutional reform, and hence such reforms are unlikely to take place. The effective political pressure for legal reform appears only after privatization (Boycko et al., 1995). Surely, some of the laws that the property owners lobby for serve their private, rather than social, interest (protection from imports and from entry are good examples). Still, property owners would typically oppose the bad laws that prevent them from using the legal system, and support laws that conform to the standard business practice. Both of these positions are part of a good reform. Besides, some of the worst recent laws in Russia have been supported by the remaining state institutions (e.g., the draft Land Code – supported by the managers of collective farms – makes private ownership of and transactions in land all but impossible). The politically feasible order of institutional reform, then, is privatization first, introduction of legal rules second, and bureaucratic reform only in the very long run.

Our paper has three observations to contribute to what the new laws should do in order to start off the use of the legal system. First, they should undo the effects of the bad laws, that keep private parties away from using the legal system more effectively than even the bad courts. Even the repeal of a few bad rules (such as that of unlimited liability in the Russian Civil Code that was recently repealed by a Presidential Decree) on the margin brings more and more activity into the legal system.

Second, to compete effectively with organized crime, bad rules should be replaced with those that facilitate and support the existing contractual arrangements and market transactions. In Russia, as elsewhere in Eastern Europe, business is developing at a fantastic rate, and a good goal for commercial laws is to keep up with good business practice. For example, some of Russia's recent draft laws, such as the Securities Law and the Law on Fund Transfers, essentially legalize already existing market transactions, thus enabling private parties to rely on the legal system to resolve disputes in their already on-going activities. If, in contrast, laws make the existing market practice more difficult, as in the case of

Russia's draft Land Code, they are only encouraging criminal enforcement of the existing practice.

Third, laws should enable very imperfect courts to verify violations and correct wrongs. In the language of the law school classrooms, bright line rules are preferred to the vague rules. The bright line rules have the disadvantage that they are necessarily incomplete. On the other hand, vague rules would leave courts too much discretion, and would therefore either not be used at all, or be abused by courts. Thus, as our model suggests, managerial duty of loyalty to shareholders is not a workable legal rule in Russia. In contrast, laundry lists of prohibitions against managerial misconduct, mandatory disclosure rules, and requirements of supermajority approvals by shareholders of major corporate changes, may form the basis of a workable Corporate Law, even though, in the short run, they fail to cover all the cases of managerial misconduct (Black et al., 1995).

Enforceable laws, even with poorly run courts, also serve the critical function of providing the threat points in private negotiations (Hay, 1994). Most of contract enforcement will remain private in the sense that parties will try to resolve their difficulties through bargaining. However, the ultimate threat to the non-performing party may now be a lawsuit rather than death. If a manager is stealing from a capitalist, the capitalist will put a lot of resources into reducing this theft. But if he cannot keep his manager from stealing, it is better to have clear-cut laws that the manager has violated, so the capitalist may take the manager to court as the last resort. The private action of the capitalist in preventing his manager from stealing is here directed toward enforcing the public law, rather than undermining it. In this respect, introducing a simple legal system, but one that addresses the most egregious yet still verifiable cases of contract violation, can do a great deal to get private contract enforcement to reinforce, rather than supplant, public contract enforcement.

The strategy of legal reform described in this paper may produce fairly crude and still incomplete laws. Why not instead simply borrow a legal system from another country? While it is possible to borrow significant parts of, say, a Civil Code, as Russia has borrowed from Germany, this is not sufficient. As Merryman (1969) shows in general and Buxbaum and Hopt (1988) for the case of corporate law, even in Civil Code countries most legal rules come either from subsidiary laws that are quite country-specific, or even more important, from judicial decisions. Napoleon's hopes for a self-sufficient Civil Code notwithstanding, without a history of precedents, a Civil Code does not tell judges what to do in specific cases. In the short run, then, a reforming country needs a system of rules that is specific to its business practice, and that enables judges to make decisions and thus begin developing precedents.

In this situation, simple bright line rules have the major advantage that they can immediately begin to be used by courts and hence by the private parties. Unlike the more elaborate rules, they fit the existing legal institutions and business practice. For example, if corporate law mandates that companies pay a fraction of

profits (or sales) as dividends, or prohibits all asset sales, even the Russian courts might succeed in detecting the violations of these rules. As laws are used more, courts will begin to gain credibility and places to resolve disputes. They will also become more predictable as a body of precedents develop, and private parties begin to anticipate more clearly how courts make decisions. In this way, laws will converge to those of developed market economies even if the initial system is more primitive.

The basic point, then, is that to get to the rule of law in the intermediate term, it is best to begin with rules that are suitable for both private agents and the courts, and then to allow this system to develop as the needs of private agents and the capabilities of the courts develop over time.

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