

## **BUILDING THE LEGAL AND REGULATORY FRAMEWORK: DISCUSSION**

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In his paper, John L. Walker argues that an efficient and effective market economy (and, by extension, sustained economic growth, stability, and effective crisis management) require a well-developed legal and regulatory framework. Here, we examine certain of the premises underlying this argument.

### **SLEEPING IN THE SAME BED BUT DREAMING DIFFERENT DREAMS: DEFINING THE DIALOGUE**

Although it is fashionable in financial, legal, academic, and development circles to assert that the rule of law is critical for sustained economic growth and stability, one explanation for this unusual level of consensus is that the “rule of law” means very different things to different people. We understand the concept of the “rule of law” to comprise the following three attributes:

- (i) Public availability of laws and regulations;
- (ii) Well-developed legal and political institutions (for example, the judiciary, tax administration, and regulatory bodies); and
- (iii) Governmental compliance with the law and public participation in law-making.

The first two of these attributes are sufficient to characterize a system of “rule *by* law” that is prevalent in many Asian countries. All three elements, however, are necessary to constitute a system governed by the “rule *of* law,” as this term is typically understood in western countries.

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Whereas laws are enacted to serve the power of the state in a “rule *by* law” regime, laws also limit the power of the state in a “rule *of* law” regime.

Current western efforts to influence legal and economic reform in developing countries usually implicitly, if not explicitly, seek to advance the rule of law. It is unclear, however, whether or not governments of countries targeted for reforms have a similar perspective. Although almost all countries today acknowledge the benefits of public availability of laws and regulations, and many have agreed with the need to reform their legal institutions, far fewer are prepared to subject their own government to the laws they enact and to permit popular participation in the law-making process. Issues related to this third attribute of the rule of law, democratization, are discussed below in more detail.

A final definitional point: In examining the relationship between the rule of law and economic performance, and in thinking about reforms and their effects, it is important to keep in mind distinctions between (i) laws and legal structures that govern voluntary relationships between economic agents (“transactional rules”) and create mechanisms that enable parties to resolve disputes and enforce their rights, (ii) laws and legal structures designed to regulate behavior by restricting the activities of market participants, and (iii) bankruptcy laws. Examples of the first category include laws related to the creation of security interests and institutions and procedures for judicial and arbitration proceedings. Examples of the second category include bank supervisory regulations such as capital adequacy requirements, laws governing the permitted scope of banking activities, laws and administrative bodies regulating securities markets, usury laws, and exchange controls. Although it is clear that weak laws and legal structures in Asia pertaining to the activities and policies of banks contributed to the Asian financial crisis, it is far from clear that ineffective bankruptcy laws or transactional rules and laws governing dispute mechanisms had much of an influence on the inception or severity of the crisis.

## **THE RULE OF LAW, SUSTAINED ECONOMIC GROWTH, AND FINANCIAL CRISES**

### **Intuitive Arguments versus Empirical Evidence**

It is argued that the rule of law fosters sustained economic growth and assists in the prevention and management of economic crises. The appeal of this argument, however, rests more on its intuitive resonance than on empirical evidence. Little if any rigorous modeling has tested the relationship between the rule of law and economic performance. The paucity of such studies derives partly from difficulties of comparing and quantifying the extent to which the “rule of law” exists in different countries and from difficulties in separating out the influence on growth

and economic performance of the rule of law and other important contributing factors that vary widely from country to country, and partly from the fact that researchers have only recently begun to make a serious effort to study this question.

There is little doubt that in general, today, countries with a well-established rule of law have a better record of economic performance than countries without a strong rule of law. It is unclear, however, to what extent the rule of law has fostered economic growth in the first group of countries and to what extent economic growth has allowed these countries to devote more resources to the development and refinement of the rule of law and (in particular) of specific mechanisms designed to promote and protect economic activity and markets, which in turn may have promoted further economic growth. The relationship between the rule of law, economic growth, and economic stability may well vary during different stages of a country's economic development. It is important to note in this regard that Taiwan, South Korea, and Indonesia, for example, achieved remarkable economic growth under regimes not known at the time for their adherence to the rule of law, and that China for the past few years has recorded an impressive economic performance despite having a morass of conflicting laws and regulations, a weak judicial system, and an authoritarian political structure.

The contours of a rule of law are likely to be shaped as well by the nature of the market participants. In a country with little reliance on foreign capital and strong cultural identity and institutional continuity, a well-functioning legal system may well look very different from, and embody wholly different notions of fairness from, a system designed to attract and retain foreign capital.

### **Political Structure and Economic Performance**

One of the more interesting and unresolved questions is whether or not the third attribute of the rule of law mentioned above, which is critical to the process of democratization, is also essential for sustained economic growth and economic stability. Prior to the Asian financial crisis, leaders of many developing countries asserted that this "democratic" component was unnecessary and that suggestions to the contrary constituted an illegitimate imposition of western values. Following the Asian financial crisis, however, the "Asian values theory" of economic and political development holds less appeal. It is increasingly argued that although in the past a political system reflecting the "rule by law," or perhaps even a stable dictatorial regime, was sufficient to promote economic growth and stability, in the new globalized economy, with its emphasis on speed, flexibility, and the free flow of information, "rule by law" and dictatorial regimes are unable to respond effectively to the challenges posed by global or regional economic dislocation or exogenous shocks, or at least

are less able to do so than their “rule of law” counterparts. Recovery from crisis requires fresh infusions of capital and increased risk-taking. It would not be surprising if, after absorbing the losses resulting from the crisis and its effects, investors seek to redeploy funds in places where the political authorities recognize their obligations to play by the same rules as private market participants, and prevailing rules are buttressed by social consensus that they are fair and appropriate.

### **Foreign Investors: Voting with Their Feet?**

It is interesting to note that whereas many foreign investors are now trumpeting the virtues of the rule of law for economic growth and stability, just a few years ago they seemed to have no problem pouring billions of dollars into countries that not only failed to satisfy the third, democratic attribute of the rule of law but also in many cases manifestly lacked strong legal institutions and enforcement mechanisms as well. In fact, it could be persuasively argued that prior to the Asian financial crisis, the legal and political structure of a host country was not nearly as important to foreign investors as the perceived stability of the regime itself. An unchallenged dictatorship was viewed by some foreign investors as a more secure site for their funds than a fledging, and perhaps unpredictable, democracy. Without doubt the Asian crisis, and the responses of many governments in the region, have focused the minds of investors on the virtues of a legal regime with predictable rules and outcomes. Where rules and laws are imposed by fiat, they can be and often are changed by fiat to suit the convenience of the governing authorities. Where rules evolve by and are supported by consensus and acceptance of their fairness, they are far less likely to be changed abruptly.

### **The Asian Financial Crisis**

John Walker examines the relationship between legal regimes and economic performance, in part, by comparing the impact of the crisis on South Korea, Thailand, and Indonesia and positing a direct relationship between the severity of the crisis in each country and the weakness of its regulatory and financial systems. As evidence to support this hypothesis, he cites the post-crisis credit ratings of these three countries. It would seem useful as well to compare pre-crisis economic data. Before the Asian financial crisis, South Korea had the fourth largest economy in the world, whereas the economies of Thailand and Indonesia, despite impressive growth, were much more fragile. Korea also has an industrial structure and a culture of strong government involvement in the economy that, despite obvious inefficiencies, served as a source of strength. It is therefore not surprising that South Korea emerged from the crisis in a stronger economic position than Thailand and Indonesia and continues to

enjoy a better credit rating. The case of Japan is also instructive in this context. Although Japan has been in a recession for almost a decade, it has an extraordinarily rich and resilient economy. Rich countries can weather economic adversity better than poor countries.

Another potential contributor to the relative severity of the Asian financial crisis is the source of investment capital. South Korea and Japan have relied predominantly on domestic sources of capital (both debt and equity) to finance their economic growth, whereas Indonesia relied predominantly on foreign borrowings. Indonesia was therefore far more susceptible to exogenous financial shocks than South Korea or Japan.

John Walker's discussion of Taiwan's bankruptcy laws is also instructive. One of the hypotheses he offers is that good bankruptcy laws can mitigate the effects of a crisis, and he suggests that Taiwan may have avoided experiencing a severe crisis because of its strong regulatory framework. There is an alternative hypothesis, however. John Walker notes that Taiwan's highly effective bankruptcy system can be explained, in part, by the fact that Taiwan's economy consists mainly of small firms, and bankruptcies of these small firms can take place without resulting in large-scale unemployment. If this is true, perhaps it is not the bankruptcy law that should be given credit for mitigating economic crisis, but rather an economic structure based on small businesses that conditions the acceptability of bankruptcy as a fit response to crisis, and therefore conditions acceptable legal structures.

No doubt the differences in legal regimes may have contributed to the severity of the financial crisis experienced in different Asian countries and the speed and ease of recovery. In order to evaluate the "legal variable," however, it is critical to take account of differences in other important factors, including relative economic strength prior to the financial crisis, variations in economic and employment structures, and differences in the importance of foreign investment. Without a good deal more research with respect to these issues, it will be difficult to draw any firm conclusions regarding the relationship between the rule of law and the Asian financial crisis.

## **INAPPROPRIATE STRATEGIES AND UNINTENDED CONSEQUENCES**

### **There Is More to Life than Economics**

Foreign institutions, and particularly the investment community, have a tendency to interact only with the economic and political elite when promoting the benefits of the rule of law. In a number of Asian countries, the members of these circles are particularly sensitive to changes in political or legal structures, but they are open to arguments that legal reforms can enhance economic performance. To the extent that

foreign institutions exclusively trumpet the economic virtues of reform, their advocacy may be perceived by the general populace in the host countries as a self-serving effort designed to protect their investments in a manner that will further entrench the domestic economic and political elite and perpetuate an inequitable distribution of income. When local elite are viewed as corrupt or authoritarian, the recommendations of the foreign community may be perceived with even greater skepticism. These reactions can be particularly visceral in countries with a legacy of European colonialism.

Even if the suspicions of the populace in developing countries are misplaced, and even if the reforms recommended by foreign institutions do not exacerbate inequalities or entrench a corrupt elite, the perception that this is the case can be equally damaging to long-term prospects for the development of a market economy and the rule of law. The successful establishment of a regime characterized by the rule of law necessitates the broad support of the citizenry. Without this support, a regime can be characterized at best as based upon the rule *by* law, and at worst, as a dictatorship. Foreign investors should be cognizant of the fact that to the extent their advocacy of the rule of law in developing countries unintentionally undermines popular support for these initiatives, it will also undermine prospects for these reforms to take root and for a successful market economy. Even in an environment where the government is genuinely interested in economic, legal, and political reforms, foreigners must be sensitive to the fact that there may be local politicians who, for their own purposes, will be looking for an excuse to paint reformers as tools of foreign influence. Foreign institutions promoting market transitions and legal reform should consider expanding their base of contacts within host countries to include entities and groups outside elite circles.

As a final note, another drawback of focusing only on the potential economic effects of developing the rule of law is that this approach conveys an instrumental view of law without also conveying a sense of individual rights. Such an approach might thus foster a rule *by* law, but not necessarily a rule *of* law. In China, for example, officials have learned to “legitimize” their new laws restricting the establishment of private voluntary organizations by noting that these restrictions have been formulated “in strict accordance with the rule of law.”

### **Dinner or a Roof**

A failure to understand the social, economic, political, and legal contexts in which reforms are proposed to be implemented can be even more damaging to the prospect of successful reform than an exclusive focus on economic benefits. Everyone has his own favorite example of well-meaning development assistance gone awry. Thus: To assuage a severe lack of protein in the local village diet, a development organization arranged to ship large quantities of dried fish to an African village. The

villagers applauded the timely arrival of a new, splendid roofing material . . . until it rained.

*Law, Society and Values.* The role of law and legal institutions within a given society derives, in part, from that society's view of the appropriate role of an individual within society as well as from society's shared values. It is unclear whether or not a western-style rule of law can be transplanted successfully without modification into an environment characterized by different relationships between individuals and society. Take China or Taiwan, for example. A sociologist has likened western society to a haystack, with individuals banded together like strands of hay, whereas in her view, Chinese society resembles the concentric ripples formed when stones are thrown into a pond.<sup>1</sup> In the Chinese model, each person is at the center of a unique network of countless relationships, and although no two persons share the same network, all individuals are part of the broader network. Different national social structures can lead to different perspectives on the appropriate role of law in society. In the more "relational" Chinese society of Taiwan, for example, studies have shown that people tend to view law more as a sanction to be used as punishment, and to view non-legal forms of social networking as more appropriate for encouraging voluntary activities, including the activities that constitute most market transactions. Thus, reforms designed to facilitate formal judicial resolution of transactional disputes between domestic parties in such a "relational" society may be perceived as redundant at best, if not counterproductive. It is interesting to note in this regard the paradox that arises when domestic structures are adequate to govern domestic transactions, but inadequate or inaccessible from the perspective of the foreign investor. Foreign institutions recommending sweeping reforms to facilitate foreign investment must be sensitive to the potential clash between these suggested reforms and established practices that are working well.

National laws and legal institutions also derive from the values embedded in society. It is unclear to what extent western laws and legal institutions can effectively take hold in societies with very different values. Bankruptcy laws, for example, are premised upon notions of fairness and legitimate property rights, but concepts related to fairness and property rights can vary significantly from place to place. The recent reform of Indonesian bankruptcy law, which is modeled like its predecessor on Dutch practice, illustrates this point. A widely shared perspective among Indonesian borrowers and a number of other sophisticated observers is that foreign lenders should share in the losses arising from

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<sup>1</sup> See Jane Kaufman, "Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan," *Law & Society Review*, Volume 28, No. 2 (1994), p. 1999.

the collapse of the rupiah, as they shared this risk with their borrowers. Thus, from 1988 to today, Indonesian borrowers solemnly declaim that they could (and would) repay their debts at Rp2,450 per U.S. dollar, at a time when the exchange rate has varied from 6,000 to 15,000 rupiah per dollar. To require borrowers to bear the full brunt of a "temporary" dislocation of exchange rates that is clearly not their fault is considered unfair. Against this background, it is not surprising that despite the new bankruptcy law, judges (even in the absence of corruption and favoritism) are reluctant to apply this law to nonperforming borrowers when the results appear to them as manifestly unjust. The long-term success of reforms in support of a market economy and the rule of law requires broad support. To the extent that reforms are incompatible with values that enjoy wide support, it is unlikely that they will take root.

*A Brief Indian Case Study.* This discussion of the relationship between state, society, and individuals, on the one hand, and legal institutions and economic structures, on the other hand, is not intended to suggest that a market economy and the rule of law should not be recommended to non-Western countries, but simply to underscore the importance of understanding and adapting to the context. A recent study<sup>2</sup> regarding the introduction of formal courts in colonial India demonstrates the disastrous economic and political effects that can emerge from well-intentioned, but uninformed efforts to promote the rule of law. Prior to the introduction of these courts, moneylenders in rural areas relied on informal enforcement mechanisms to ensure that defaulting debtors paid their debts. Because of the difficulty of enforcement, interest rates were high. These high rates, however, provided the moneylenders with a cushion, allowing them to grant extended repayment terms to borrowers in difficulty. When formal courts were introduced, other institutions began lending in rural areas and, as the supply of funds increased, interest rates declined. When drought unexpectedly hit the following year, the farmers could not repay their loans, and the lenders went to the newly established courts to foreclose on the farmers' land. The moneylenders, who were now charging lower interest rates, no longer had the cushion necessary to carry the farmers through periods of difficulty. Riots ensued. The moral is not the virtues of loan-sharking, but rather that familiarity with local context is critical to the success of proposed reforms, and an insensitivity to local context can actually wreak harm.

*Ethnicity.* Another variable that advocates of reform should examine is the extent to which the proposed reforms will affect existing ethnic tensions within a given country.<sup>3</sup> Although such tensions exist within

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<sup>2</sup> Cited in Richard Messick, "Judicial Reform and Economic Development: A Survey of the Issue," *The World Bank Observer*, vol. 14, no. 1 (February 1999), p. 128.

<sup>3</sup> See Amy Chua, "Markets, Democracy and Ethnicity," 108 *Yale Law Journal* 1 (1998).



almost all nations, developed or developing, they can be particularly explosive in developing countries characterized by an economically dominant minority and a politically dominant, but economically impoverished majority, most of whom believe that members of the minority group are not the “true” citizens of the land. This dynamic exists, for example, in many Southeast Asian countries with respect to the Chinese minority, in some African nations with respect to the Indian and Lebanese minorities, and in some of the Central Asian republics with respect to the Russian minority.

There is significant evidence that the initial stages of market reforms have a tendency to improve the financial condition of the existing market-dominant minority without offering a corresponding improvement to members of the majority ethnic population. If democratization is pursued simultaneously with market reform, undesirable scenarios can emerge. First, political opportunists from the majority population may seize upon popular jealousy or disenchantment with the economically dominant minority population to foment an ethnically fueled and anti-market backlash, which could include the confiscation of property of the minority population or restrictions on their participation in certain sectors of the economy. Second, the same political opportunists may foment more drastic measures aimed at eliminating the presence of the minority population within the country through coordinated violence or expulsions. Third, the existing elite within the politically dominant majority population, fearing that economic disruption could threaten their position, may seek to consolidate their power, thereby delivering a setback to reform.

*Sequencing of Reforms.* This risk that reform can exacerbate existing ethnic tensions makes particularly significant John Walker’s observations as to the importance of appropriately sequencing reforms. Markets and the rule of law are not necessarily mutually reinforcing at all points in their respective development. A comparison of Russia and China is instructive. Whereas Russia favored political liberalization prior to, or simultaneously with, economic liberalization, the Chinese approach has focused first on economic liberalization. The Russian strategy has been disastrous both economically and politically. Improper sequencing of reforms in Russia, among other things, has led to land-grabbing and asset stripping by the elite under the guise of instituting a system of private property, leading to further entrenchment of corruption, economically motivated violence, and political illegitimacy. Although the Chinese approach has produced initial economic successes, the scope of reform and adherence to a transparent rule of law is severely limited. It is unclear whether China can sustain its high level of economic growth and even less clear whether or not political liberalization will follow.

## SUMMARY AND CONCLUSIONS

Although we cannot establish conclusively a correlation between economic growth, a successful market economy, and the rule of law, arguments in favor of this hypothesis have a persuasive resonance. It is important to recognize, however, that a number of countries have experienced impressive economic growth under regimes hardly characterized by an adherence to the rule of law and that foreign investors prior to the Asian financial crisis did not hesitate to make very sizable investments in these countries, despite the fact that they were fully aware of the absence of adequate legal rules and structures and of the ensuing legal risks accompanying their investments. We do not know enough to measure the extent to which variations across Asian countries in the rule of law influenced the severity of the crisis in these countries, or whether other factors were more important, such as pre-crisis financial conditions, variations in employment structures, or differences in levels of foreign investment. Further research in this area should also attempt to distinguish between transactional rules and legal structures that govern voluntary arrangements between market participants and the resolution of disputes, on the one hand, and laws and legal structures designed to enhance the stability and efficiency of the market by regulating the activities of market participants, on the other hand.

Discussions regarding the relationship between legal regimes and economic performance (particularly across regional boundaries) have been hampered by a failure to define what is meant by the "rule of law." Rarely do people explicitly address the question of whether compliance by a government with the laws it enacts and the participation of citizens in the law-making process are important, if not critical, to economic growth and stability over the long term. If so, advocates of market reform and the rule of law might wish to address this sensitive issue directly. Similarly, western institutions should be particularly wary of focusing exclusively on the perceived economic benefits of establishing the rule of law.

Lastly, advocates of reform should give careful consideration to whether and how specific reforms can be integrated into an alien economic, political, social, and legal context and try to anticipate the consequences if things do not go just as they should.