The Evolving Legal Framework in the Former Socialist Countries

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Introduction

The collapse of socialism and the transformation of the political, social, economic, and legal systems in Central and Eastern Europe and the former Soviet Union was an unprecedented event rivaled only by the revolution that had brought the socialist system to power in Russia more than seventy years earlier. When the wall that had separated East and West fell in late 1989, and one government after another crumbled under the weight of the inefficiencies of the past regime and the discontent of its citizens, to many the direction of change appeared obvious: markets should replace central planning, democracy should supplant the single-party autocracy, and the rule of law replace the use of law as an instrument of power in the hands of the ruling party. The term "transition economies," which is commonly used to refer to the former socialist countries, presumes a strong belief in a process with a well-defined goal and a clearly laid out path leading to it. As it turned out, the actual process of change has been far more complex and resembles an arduous process of continuous transformation rather than a relatively simple transition from one regime to another.

Law and legal institutions play a crucial role in this process. Legal change is an integral part of political, economic, and social reform. Not only are reform initiatives packaged as laws and regulations, but also many core aspects of the reform agenda are inherently legal matters. The creation of democracies went hand in hand with the adoption of new constitutions that created the legal foundation for the new political order. The privatization process entailed the reallocation of property rights from the state to private hands. It required the creation of new legal protections for private property rights and the building of institutions to protect and enforce these rights. Social reforms necessitated the disentangling of social from productive assets and the creation of the rules and regulations that defined entitlements to social welfare, pension, and unemployment systems. In addition, the legal systems in these countries are undergoing profound change. Many countries sought to move beyond using law merely as an instrument for

change, but aimed at establishing a foundation for the rule of law. In several countries, however, such as Belarus, Uzbekistan, and other Central Asian countries, law has remained an instrument for leaders to assert their rule, and these leaders have rejected legal constraints on their power.

Overview of Events I: Precursors to Post-Socialist Legal Reforms

The fall of the Berlin Wall was only the most visible event in a chain reaction that brought down the socialist empire. Many countries had experimented with reforms, including legal reforms, during the preceding decade(s). In Hungary, these reforms date back to the late 1960s. In most of the other former socialist countries they took hold in the 1980s. Enterprise laws were enacted that gave state-owned enterprises greater autonomy from state planning. Managers and employees were given the opportunity to lease companies from the state and sell a portion of their products outside the state plan. In countries across the region, including the former Soviet Union, laws were enacted to allow the creation of non-state economic enterprises, such as cooperatives. The old socialist dogma that the rule of law was a bourgeois myth gave way to reforms that incorporated legal constraints on state actions, which are core elements of the rule of law. These changes went as far as the adoption of legal procedures that allowed citizens to bring actions against the state and its agents and the creation of constitutional courts.

These reforms did not add up to an overhaul of the socialist system. Many changes were enacted as defensive strategies triggered by the realization that economic conditions were deteriorating and that the socialist countries were losing out in the economic and technological competition with the West. Internal critique of the socialist system was mounting. Against this background, reforms were enacted that combined socialist and market principles, resulting in a system of one-party rule with some legal constraints. How far this gradual process would have gone had the socialist system not collapsed is difficult to say. The gradual reforms that preceded the collapse of the socialist system do suggest, however, that many countries had constituencies for reform, and that they were experimenting with change, including legal change.

Overview of Events II: The Role of Law in Post-Socialist Economic Reforms

In most countries, the sudden collapse of the socialist system put an end to the path of gradual reform. Governments and foreign advisers looked for ways to bring about change more swiftly. They hoped to make change irreversible, to cut short a prolonged process of trial and error, and to avoid the costs of reinventing the wheel by borrowing extensively from existing models in developed market economies. Some economic advisors went as far as suggesting that a country like Russia should swiftly replace her own laws with those of Austria or Germany. For countries in close proximity to Europe, Spain, Portugal, and Greece became models for a path to European integration, and the existing legislation of the European Community became a blueprint for legal reforms.

The impetus to move swiftly was reinforced by a sense of economic crisis that resulted from budget deficits and from flaws in the trading system among socialist countries, known as the Council for Mutual Economic Cooperation (COMECON). Economic reforms in the former socialist countries consisted of three pillars: stabilization, liberalization, and privatization. Stabilization referred to macroeconomic policies aimed at stemming inflation and stabilizing domestic currencies. Liberalization meant the liberalization of product prices, which previously had been controlled by the state plan. Privatization entailed the transfer of the means of production from the state to private hands. Each of these measures was built on law. Even a measure as simple as abolishing price controls and quota systems was embodied in legal statements. To ensure their sustainability in the long term, however, these measures had to be institutionalized. New organizations and procedures were established. To maintain monetary stability, for example, independent central banks were created throughout the region. Formally, the independence of these banks was ensured by legal provisions regulating appointment procedures and by governance structures that insulated the central bank from direct political intervention. Similarly, in an environment that was dominated by monopolies, there was great concern that price liberalization would allow existing monopolies to further entrench their interests. To counter this trend, anti-monopoly agencies were established and antitrust laws were enacted.

An even greater challenge for the legal systems in these countries was the protection of new private property rights. At the time the socialist system collapsed, in most countries the state owned over 90 percent of the assets, including land, natural resources, and enterprises. Private ownership was permitted only in restricted areas. In some countries, including Poland and Hungary, small craft shops and family controlled farms had remained in private hands. In others, state ownership extended even to these entities. State ownership meant that essential control rights over these assets, such as the rights to determine their use, their transfer and reallocation, or whether or not to discard them, were in the hands of state bureaucrats. Privatization implied severing established control rights from state authority and transferring them to private owners.

Economic theory suggests that private owners will use assets more productively than the state. The presumption is that, since private owners incur both the benefits and the costs that derive from the use of their assets, they will therefore make decisions that maximize their benefits not only today, but also in the future. By contrast, state bureaucrats who exercise the control rights that flow from state ownership neither benefit from the use of these assets (unless they use their control rights to engage in rent-seeking activities), nor do they have to shoulder the costs. They are therefore more likely to make decisions that may have some other benefits, but that do not ensure that particular assets are put to the most efficient use.

When applied to simple ownership relations, where a single owner owns a plot of land, a house, or a firm, private owners do indeed exercise control rights in a way that closely resembles the predictions of economic theory. It is therefore not surprising that the privatization of small- and medium-size enterprises has usually improved firm performance, even in the absence of legal reform. In the case of larger enterprises, however, ownership relations are typically characterized by a separation of ownership and control rights. A manager who is appointed by shareholders is in control of day-to-day decision-making. He has access to proprietary information and exercises substantial discretion over the use of firm assets. The shareholders, as owners of the firm, invest their capital, but they do not participate in firm management. They are passive owners, and their control rights are typically exercised by voting for representatives who in turn appoint and dismiss management. The relationship between owners and assets does not

follow from physical control over assets, but from legal entitlements and a business environment in which these entitlements are generally respected and followed.

Large state-owned enterprises comprised the lion's share (not in numbers but in value) of assets that were privatized in the post-socialist economies. They were reorganized as corporations, i.e. as independent legal entities with publicly traded shares. Their shares were then sold off to private owners. The new owners received a share certificate or other document from the shareholder registry as documentation of their newly acquired ownership. The rights that flowed from ownership in corporate shares were defined by and dependent on the legal protection and the existence of institutions capable of enforcing these rights.

Still, privatization programs were often initiated without adequate legal frameworks in place. This was justified by a combination of several factors: the urge to proceed swiftly in order to prevent a political backlash; the belief that markets themselves would ensure that property rights would ultimately be allocated to the most efficient users; and the hope that the new private owners would demand legal protection and thus fuel legal reforms that responded to their needs. In reality, many new shareowners soon learned that, without legal protections, the stock certificates they held had little value to them or to others and were therefore not tradable. In several cases, owners' names were erased from shareholder registries; owners of large blocks of shares used their control rights to funnel the most valuable assets away from minority shareholder control for use at their own discretion. Minority shareholders found few competent and honest representatives, and when they did find them, these representatives often had little access to the firms' internal information and little influence over management or controlling shareholders. As a result, in many cases these minority shareholders lost their property before they were able to organize themselves to demand better protection of their newly acquired rights.

Overview of Events III: The Supply of Law

Domestic policy makers and international agencies soon realized that privatization had not achieved the results that had been hoped for. The key words that stood for economic

reform—stabilization, liberalization, and privatization—were soon replaced with new ones—good governance and the rule of law. The message was clear: Economic reforms had taken place in an environment that lacked governance and the rule of law. This had led to rampant violations of rights, the rise of informal economies, corruption, and organized crime. It was therefore time to build new governance structures and to ensure that the rule of law would prevail.

Governance and rule of law are broad concepts that mean different things to different people. At the heart of both concepts lies the idea that those who exercise power and control on behalf of others shall represent the interests of their constituency and be accountable to them. Governments shall govern in the interest of and be accountable to citizens of their country; corporate managers shall maximize the value of their firms and be accountable to their shareholders. The legal changes now introduced were meant to enhance the accountability of governments and managers as agents to their principals, the citizens and shareholders.

The pace of this legal change has been remarkable. Virtually all parts of the legal systems in the post-socialist countries underwent reform, including criminal law, administrative law, civil law, and commercial law. New regulatory agencies were established, such as securities and antitrust commissions. Most countries borrowed extensively from abroad. Foreign advisors sponsored by bilateral or multilateral aid agencies were dispatched to these countries to ensure that they adopted Western "best practices." The Central and Eastern European countries that aspired to join the European Union (EU) used the directives of the EU on the harmonization of laws of its member states as guidance. The accession agreements many countries soon concluded with the EU list different areas of the law that have to be harmonized before these countries will be admitted. Even countries further east relied primarily on foreign models to reform their laws. Russia, for example, now has a corporate law that resembles U.S. corporate law, but its civil code was modeled on the Dutch civil code.

It is not easy to assess the impact of legal reforms. Legal reforms can be enacted swiftly, but it takes time for new laws to take hold. The benefits of legal institutions may also escape direct measurement. Their absence or weakness can be related to bad outcomes, but the precise

contribution of each legal institution to economic growth and political stability is difficult to measure. Nevertheless, empirical methodology is increasingly used to assess the role of law in socioeconomic development. Available evidence suggests that, at least so far, legal reforms have had little impact on economic performance. The level of shareholder and creditor protection in corporate or bankruptcy codes, for example, is not positively correlated with the development of financial markets in transition economies.[1]

A possible explanation for these results is that institutions capable of enforcing the law are only now emerging. Most courts in these countries are carry-overs from the socialist past. They were staffed with judges trained under a different system who had little to no experience with complex economic transactions. New regulatory agencies were newly established, and their personnel were inexperienced. Still, this seems to be only part of the story. Even countries with highly developed legal systems cannot rely primarily on law enforcement by the relevant law enforcement agencies to ensure that the legal system functions. Law works because in most cases most people comply voluntarily with the law. One explanation for this is that they may fear punishment should they violate the law. When law enforcement institutions are ineffective, as they are in many former socialist countries, the law's deterrent effect is undermined. An alternative explanation is that people follow the law because they perceive the laws and the institutions that make them to be legitimate. They follow the law even if they don't agree with it or might derive greater benefits from ignoring it, because to a certain extent they have internalized the practice of following it. The key question then becomes how law is legitimized.

Historical Controversies

At the beginning of the transformation process, the major dispute was over the pace of reforms and their appropriate sequencing. Proponents of radical economic reforms argued that only a radical shift away from the state planning system and the attendant creation of new parameters for economic development would ensure that countries would move forward and avoid prolonged periods of stagnation. Absent radical reforms, existing state bureaucrats would

[1] Pistor, et al. (2000).

use their influence to block change. Moreover, their supporters claimed, radical economic reforms would soon create powerful constituencies for institutional change. Opponents held that an institutional framework to accommodate radical reforms did not exist in most of the former socialist countries, leaving the holders of new property rights unprotected. Radical change would demolish existing institutions and create a power vacuum that could be exploited by special interests.

Both sides can mount some evidence to support their claims. Poland, the country that stood for the “Big Bang” approach to economic reform, is today the most successful of the transition economies as measured by a variety of indicators of economic and institutional performance. Poland did indeed move swiftly to implement macroeconomic reforms. Yet Poland was a slow reformer when it came to privatizing large enterprises. Companies were not privatized and shares were not issued to the public until relevant laws were put on the books and institutions, such as a securities commission, were established. By contrast, Russia attempted macroeconomic reforms and began to implement a mass privatization program all at once. The political upheavals this caused and the severe downturn in economic activities the country experienced through much of the 1990s are often cited as examples for the failure of the Big Bang approach. Advocates of the Russian reform program, however, point out that neighboring Ukraine, where reforms were stalled amidst political power struggles, fared even worse.

Thus, even after more than ten years of reforms and reform analyses, clear answers to the question that had been raised at the outset have not emerged. In fact, it is increasingly clear that some of these questions need to be rephrased in light of the lessons learned. There is a growing recognition that a deeper understanding of the complex interactions between political and economic variables, between law, finance, and governance, and between historical preconditions and reform paths is required to understand the process of transformation and further its ends. A consensus, however, is emerging that the success of reform strategies ultimately depends on the effectiveness of local institutions, and that institutional reform therefore must be an integral part of any successful reform agenda.

Another controversy concerned the process of legal reform. The governing consensus was that countries should adopt "best practices" from existing market economies. Rather than reinventing the wheel, they could and should borrow freely from the experience of other countries. This view assumes that laws can cause socioeconomic change. It also assumes that laws, once enacted, will have an impact on the behavior of citizens and state agents alike.

Historically, these processes of legal transplantation have played an important role in the development of legal systems around the world. Not all of them, however, have been successful. In many countries, the imported laws rarely gained more than a "book life," as entrepreneurs avoided state law, governments ruled by decree, or social norms that were at odds with the transplanted laws persisted. Empirical analysis has revealed that countries around the world that imported laws without adapting them to local conditions and whose population was unfamiliar with the principles of the transplanted laws (as a result of migration, for example), have suffered from the "transplant effect,"[2] meaning that they have far less effective legal institutions today than countries that developed their legal order internally or with only limited borrowing.

Thus, the supply of "good law" from the outside does not offer a quick fix for institutional problems. Instead, local demand is necessary to ensure that law will not only be put on the books, but that it will be used in practice and will be changed in response to the new challenges that constantly arise in the process of socioeconomic development.

The lack of local demand may also help explain why the scale of legal reform we have witnessed in the former socialist countries throughout the 1990s has resulted in so few measurable outcomes. The imported laws and legal solutions to the local lack of "good governance" were well-intentioned, but they were not well received. Several factors may account for this. Local constituencies may not deem law an important "tool" for defending their rights and interests. They may be suspicious of state institutions that make and enforce the law, because of past legacies, corrupt or predatory practices, or they may simply doubt their effectiveness. In other words, they do not perceive these institutions as legitimate. Alternatively, the principles embodied in imported legal structures may not resonate with them. This may be the result of

[2] Berkowitz, et al. (2002).

differences in norms and values. For example, in some countries in the past, any form of trading with the intention to make profits was deemed speculation and was punishable under the law. To many, trade and price liberalization seemed to suggest that now anything was permissible. Legal systems were struggling with drawing a new line between free trade and private autonomy on the one hand, and fraud or anti-competitive conduct on the other. In addition, legal solutions that were developed in the context of one country may not be suitable in another. Rules developed to ensure that highly dispersed shareholders have some control over management, for example, may not be a good fit in countries where ownership is highly concentrated and the real threat to shareholder control comes from fellow shareholders, not from management.

Theoretical Relevance

The process of transformation in the former socialist countries has been a unique opportunity to test existing theories about the role of law in the functioning of markets and complex social systems. Many assumptions about how our own market economies and political systems work have been challenged and refined. At the outset of the reform process, many believed that all that was necessary to transform the socialist economies was to unleash market forces by liberalizing economic activities. The fact that, in all former socialist countries, economic output declined drastically after these measures had been introduced came as a surprise. It forced scholars to reconsider how real markets (as opposed to textbook markets) function, and how dependent they are on an effective legal system. In fact, many scholars and policy advisors who initially believed in the ability of markets to regulate themselves increasingly turned to the study of law and legal institutions. The architects of the Russian privatization program, for example, who pushed for the dissemination of shares in thousands of companies to Russian citizens before effective legal protections were in place, have started a new field of empirical research on the relation between law and finance.[3]

The theoretical proposition that law is an important prerequisite for the functioning of market economies is not a new one. Max Weber, the German lawyer and sociologist, stated in

[3] Compare Boycko, et al. (1995) and La Porta, et al. (1998).

the early twentieth century that a rational legal system was a prerequisite for the functioning of capitalism.[4] Other observers of another great transformation in the West—the industrial revolution—had been keenly aware of the importance of law and legal institutions in this process. Few of these theoretical insights had, however, been tested empirically. Moreover, the excesses of state regulation experienced by many industrialized countries in the second half of the twentieth century gave rise to doubts about the positive impact of law and legal institutions for economic growth and development. Many economists came to regard legal structures primarily as cost factors, or as interventions to promote rent-seeking activities. What is more, many of these views were shared by lawyers. Law was regarded as trivial, if not superfluous, to the functioning of market economies, as rational actors freely responded to market pressures.

These conceptions arguably influenced the initial reform agendas in many former socialist countries. In Eastern Europe, the prototype case for a reform agenda based on a deep trust in the self-regulatory powers of the market, and a corresponding distrust of legal interventions, was the Czech Republic. Early successes, including the rapid privatization of most of its large enterprises, however, gave way to the realization that effective legal institutions were required to ensure that these reforms became sustainable. Many observers now hold the absence of effective state regulation accountable for the fact that the Czech Republic has been less successful than Poland.[5]

In sum, the transformation process in the former socialist countries has highlighted the crucial importance of the institutional underpinnings for economic growth and development. Legal institutions have come to play a central role in comparative analyses, and legal reforms loom large on the agenda of international development agencies. Many open questions remain. Why, for example, do some countries have more effective legal systems than others, even if we control for the quality of the laws on the books? What are the determinants of effective legal institutions? What does it take to build them? Why have legal transplants so often failed to take hold? These and similar questions cannot be answered by one discipline alone. In fact, there is increasing collaboration taking place across disciplines to further our understanding of the

[4] Weber (1981).
[5] Coffee (1999).

process of institutional change.[6] From an academic perspective, this is one of the most exciting results of the study of countries in transition.

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[6] A good example for this is the edited volume by Murrell (2001).