

LEGAL REFORMS AND IMMATURE DEMOCRACIES: A DEVELOPMENTAL CHALLENGE THE RISK OF INSTITUTIONAL IMPORTS

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In the last decade the post-communist world was subject to various attempts to build institutions, largely by implanting with little adaptation imports from the Western world. Most of the time, these well-intended efforts have failed, as we can see in the case of Russia. It is about time the international assistance shifted its focus from the transfer of institutions to creating genuine domestic demand for them. Property rights are an area where such a shift would be welcome.

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Successful transition hinges on the ability of a post-communist nation to establish and maintain key institutions of the competitive market economy. In early years of reform the emphasis was made on *supplying* such institutions by reformist governments, even if the *demand* for new institutions was weak. Establishing legal and regulatory foundations for the new economic order was the top priority of international donors; it is symptomatic that the latter preferred to work with the executive branches rather than with legislators who often opposed donor-sponsored reforms, reflecting a lack of appreciation of the proposed changes by domestic constituencies. At times, the task of economic institution-building was in conflict with another track of post-communist transformation – establishing and strengthening institutions of representative democracy.

A good illustration of ambivalent attitude to publicly provided market-augmenting institutions is an initial lack of demand for secured property rights. Early on in transition none of the major social and economic forces were champions of property rights protection and institutions that support property rights, such as efficient corporate governance, third party contract enforcement, etc. Small businesses were focusing on gap-filling activities, making arbitrage profits and operating mainly in spot markets, which did not require institutional foundations necessary for more sophisticated transactions. Traditional enterprises were opposed to restructuring and layoffs that would have inevitably ensued, were the corporate governance laws properly followed. Newly emerging financial and industrial conglomerates also resisted efforts to establish transparent and enforceable property rights regimes, as this would have restricted opportunities for extra-market appropriation of economic assets. The general public often resented the outcomes of chaotic privatization which were perceived as socially unjust and thus lacking legitimacy.

Without grassroots demand, endorsement and support, supply-driven reforms often failed to produce the expected outcomes. Ability of governments to implement the rules enacted *de jure* was severely constrained by a lack of necessary cadre and expertise, inertia of old practices, corruption in law-enforcing agencies and courts, and above all – by rejection of the superimposed rules of the game by the main players and stakeholders. Limited enforcement capacity of the state was overstretched, leading to rampant non-compliance with virtual impunity. Those few inclined to go by the book were putting themselves at a competitive disadvantage by bearing the cost of compliance without reaping the benefits of operating in a rule-based economy.

However, over time the appreciation of the institutions that underpin modern market economies has started to grow even in the countries heretofore notorious for their neglect of the formal rule of law. Several factors are contributing to these profound changes in institutional preferences and public mood. First, once a bulk of economic assets and resources have been by various means put under private control, further unrestricted contest for property rights becomes economically self-defeating, turning participants into victims of a large-scale “tragedy of the commons”. This makes those who have secured controlling stakes in the new market economies willing to “draw a line”,

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collectively endorse the status quo and henceforth abide by formal rules. Second, to move beyond the niche- and pre-existing capacity-filling stage, private businesses need investments, including those from sources external to a given firm. Such investments would be forthcoming only if the institutional regime provides sufficient assurance of contract enforcement and investor rights, thus stimulating more-than-arm's length transactions.

More generally, economic and political stabilization increases planning horizons of economic agents. Long-term transactions, unlike those conducted on spot markets, are much more sensitive to the quality of institutional environment, and potential beneficiaries of such transactions become agents for a rule-based economy. Finally, over time the ability of the state to enforce rules and ensure compliance grows, and an efficient publicly supplied institutional regime becomes a distinct possibility. This raises interest in government policies as increasingly relevant and potentially beneficial for businesses.

All of the above trends feed growing *demand for the rule of law*. Earlier prevalent institutional surrogates, such as informal sector operations, private contract enforcement, etc., are increasingly perceived as constraining economic development and growth. This creates a grassroots pressure for reforms – a major political resource which can accelerate transition and establish functional institutions in which broad constituencies of beneficiaries would have ownership and stake. Public enforcement of thus established rules would be augmented by private one, when officially imposed sanctions for non-compliance are compounded by ostracism, rebuke, undermined reputation, etc.

However, these opportunities come with their own problems and challenges, as political systems of nascent democracies are often failing to materialize the growing demand for market-supporting institutions and policies into the necessary laws and regulations. Sometimes, in defiance of common wisdom, a widely shared perception of an imminent “advent” of a rule-of-law-based economy creates policy and legislative gridlocks.

An explanation should be sought in intensified lobbying pressure to craft the new legal order in a way that would serve organized interests. Once there are common expectations that long-term rules of the game are to be established and credibly enforced, this greatly raises stakes in influence activities, as political actors are vying to secure for their constituencies favorable legal regimes that would release massive gains capitalized over the many years the law is expected to be in effect. Vice versa, political opposition to laws which could infringe on the interests of a lobby-represented constituency becomes much more vigorous in order to prevent losses that will also be capitalized for the life of the law.

Recent evidences show that when transition nations become ripe to establish a functional legal system, acute political conflict over the way the rule of law will be crafted could dramatically slow down legal reform, and at times bring it to a standstill, especially over potentially divisive issues. Countries of Central and Eastern Europe and the former Soviet Union are following the continental legal model, where parliaments have a virtual monopoly over law-making, and this makes major legal reform efforts vulnerable to lobbying pressure.

But perhaps most disturbingly, narrow interests have strong advantages in molding the law over broad-based constituencies which are politically disorganized, dispersed, lack economic resources for effective lobbying, and the clout necessary to have their preferences and needs incorporated into a new legal compact. Development of representative democracy in post-communist countries is lagging behind the needs to accommodate the growing demand of transition economies for legal bases.

Often, general public shows little interests in the extensive law-making agenda of the government, which further exacerbates the danger of a capture of legal reform by narrow interests. The media is not providing the necessary coverage of this process either, preferring to cater to prevailing popular demand for tabloid-type journalism. Media outlets with narrower circulation, which comment on policy matters, do not have the readership necessary for commercial viability, and are subsidized by private sector entities, thus losing their impartiality. Think tanks that are mushrooming across the region give clear preference to communicating their policy analyses to powers that over presenting such analyses to the general public. Transparency laws that have been enacted in many countries of the region to provide opportunities for public debates of draft laws, regulations, and pending policy decisions, are not used to their full extent due to a lack of political organization of large stakeholder groups, and of culture of civic participation in policy making process. Overall, for the general public the legal reform process is unfolding behind a “veil of ignorance”, which undermines the accountability of executive and legislative branches to voters, and thus increases susceptibility of policy makers to influence activities.

A lack of public involvement in the legal reform could lead to distributional distortions of the new legal order that would favor the groups capable of political organization at the critical time of intensive law-making efforts. Economic efficiency of such legal regime is also likely to be compromised, because the interests that dominate the legal reform do not fully internalize the costs of distortions resulting from lobbying. Among the potential casualties are small and medium sized enterprises which often lack political representation and which would be confronted with barriers to competitive entry raised by large incumbents.

Political representation and influence of presently unorganized large social and economic groups is likely to grow over time, and when these groups will have accumulated sufficient clout, and realized that the legal regimes are biased against them, they will demand a redress. Such delayed accommodation, however, is undesirable, as it undermines the stability and credibility of the newly established legal system.

To prevent such failure of the nascent political markets in the transition region, civil society activists need to step up their efforts to raise public awareness of the ongoing legal reform efforts, to support grassroots self-organization initiatives and movements, to make full use of the opportunities

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presented by the transparency and freedom of information provisions, etc. This is also a field for potentially fruitful international cooperation, as it would put domestic legal reform processes into a region-wide comparative perspective. Comparative analyses of legal regimes and public policies in various transition countries, including those that are scoring better in terms of participatory democracy, would allow to get early warning of impending capture of the legal reform by narrow interests, and mobilize the public against such trends.

Case study: Russia

I think we all agree that over time the percentage or the sheer of knowledge in international assistance to transition countries has been declining and that shouldn't come as a surprise because in the early years of the transition there was a great demand for very basic fundamental institutions which were developed and set elsewhere, so that these countries hadn't their own experience of such basic institutions as market institutions, stock exchanges, tax systems, so on and so forth. However, over time, the percentage of knowledge and the share of knowledge was declining and my question is what sort of intellectual contribution from elsewhere, from the outside of a transition country is still required. People usually disagree about a large number of things concerning post-communist transition, but if there is something that anyone agrees about that is the conviction that economic prosperity should be domestically grown. It's certainly impossible to supply from outside of the country all the necessary resources. Another thing which was a part of the common wisdom about transition was that economic prosperity is contingent to the reliability of institutions – institutions which are required for a competitive market economy. But then the question was whether the institutions that are required should also be grown locally or should be implanted from elsewhere. I think the first attempt over at least the first half of the last decade was to as much possible implant institutions. Sometimes this approach worked, most of the time it did not. In Russia, for example, there is a vast cemetery of failed reform efforts, where institutions were attempted to be implanted from outside, without any concern for local conditions and peculiarities. I think it is incidental that as far as assistance in democracy development was concerned, much of the assistance was concentrated at the legislative part of government. However, as far as the economic reform was concerned, much of the technical assistance concentrated at the executive branch of government, for a variety of reasons – Parliaments were not usually particularly receptive to prescriptions of Western experts and the prevailing mode was to rely on a small core of reformers that were trusted to push through the reform and it comes as no surprise that such reforms were usually rejected by the legislature. As a result, people became to realize that it is quite important if the society is mature enough to adopt some of the institutions in question and for that matter if the society requires these institutions. And that changed the focus of technical assistance from delivering institutions, as an immediate objective, to perhaps

creating demand for such institutions and, as a result, to enhance the chances that these institutions will get rooted and will function efficiently.

In this context, I would like to bring to attention an attempt to create demand for a particular institution, again I'm talking about Russia, attempt that in my opinion failed nonetheless. I think it is instructive for us to have look at this. The idea in question is Russian privatization. Most of you remember that in early 1990s a bulk of Russian assets have been privatized in a very rapid and in some way nontransparent, chaotic way in a year and a half. Although many people had misgivings about the efficiency and legitimacy of such a privatization, the main justification was that most of the national economy privately owned was supposed to create a constituency for secure property rights, because, naturally, private owners would expect that the government would support and enforce their property rights. So, in this case, the creation of a demand for a particular institution was a very specific objective that those who were behind this effort had in mind. Well, that didn't happen and, despite of the fact that much of the economy has been privatized, until quite recently secure property rights have not been provided in Russia. What this privatization created instead was a pattern of oligarchic capitalism and these oligarchs were not the ones to secure the property rights.

I would argue that at least over the last couple of years the situation is changing in Russia. In fact, it has changed quite significantly in that people are becoming more appreciative of the role of public institutions and of the rule of law in general. Granted if you look at the current attitudes to public institutions, to the government and, a notable exception, the president, these attitudes can still be described as mistrust and contempt. But at least there is a feeling in the society that public institutions start to matter. The society has passed the survival mode, there is more stability and predictability and people are becoming increasingly aware and concerned about how the rules of the game in the society should be structured not in the short run, but for the years to come. And that creates awareness of public institutions and feeling and hope that maybe the society can develop an efficient system of rule of law, that will be conducive to economic growth and will be useful for the market economy. Why these changes of attitude have occurred, have happened, I think is a separate story and I have some explanations. What I would like to do instead is to point out that this new situation creates new opportunities, new challenges for policy makers and for the international community and that, I think, will allow us to address the question we asked in the first place, that is what sort of intellectual contribution post-communist transition could require at this stage. Opportunities are quite clear – there is a chance that politics will be finally taken away from opportunistic and often corrupt elites and put back in the hands of the people. This in itself is a very important end, but it is also a very useful means, because that will probably allow to customize the institutional framework of the country to the needs of the society and that in itself should probably provide an efficient outcome of the post-communist transition.