

European Bank for Reconstruction and Development
The British Institute of International and Comparative Law

“The Importance of the Rule of Law and Respect for Contractual Rights in Transition Countries”

Roberto Dañino

Senior Vice President and General Counsel

The World Bank

5th December 2003

Introduction

Good morning. I am delighted to be able to participate in this session through the wonders of Information Technology. I thank Emmanuel Maurice and our Co-Chairpersons, Mr. Yakovlev and Lord Justice Mance, for their kind invitation. From a review of the list of participants, I was extremely pleased to see a broad range of experts from public institutions, the courts, the private sector, and the development community. Moreover, the regional diversity of the participants is equally impressive. It is not often that we have the opportunity to assemble such a well-informed and committed group. It is an honor to join such distinguished company, and to take part in this most important international conference.

I have been asked to address the crucial importance of the rule of law and the enforcement of contractual rights in countries making the transition to market-based economies. I personally find it frustrating that 13 years after the Berlin Wall came down, so little progress has been made in the enforcement of contracts in these countries.

We all agree that *contracts* enable people to engage in business, commerce and other activities with the security of being able to enforce those rights. The ability to enforce a contract is critical for businesses to engage with new lenders, borrowers or customers. In the absence of effective contract enforcement, trade and credit is restricted to a small community of people who have developed informal relations through kinship, repeat transactions, or the security of available assets.

Security of Property and the Enforcement of Contracts

It is a fundamental proposition that *security of property and the enforcement of contracts* are essential for investment, trade, and ultimately economic growth and poverty reduction.¹ Although nearly everyone now agrees with this proposition, the uneven and difficult transition facing the countries of Eastern Europe and Central Asia demonstrates that speaking about economic theory is much easier than putting these principles into practice. Despite many commonalities, the transition countries still face the difficult task of fully integrating their economies with Western Europe. Those of us working in the development field owe it to our clients to ask why this transition has not already been completed, and what we can do to strengthen and accelerate the process?

It is clear that property rights have played a pivotal role in the evolution of Western economies. Research conducted in my own country, Peru, confirms the importance of property rights in developing countries and the crucial role that enforceable contracts play in encouraging risk-taking---a pre-requisite for long-term investment.² This view is consistent with the vision of our Co-Chairperson today, Mr. Yakovlev, whose work as a constitutional reformer re-established the importance of private property in the Russian Federation, reversing Lenin's abolition of most private property.³ Today, it is very difficult to dispute the degree to which the protection of property rights is linked to economic performance. For this reason, if contracts are the way that we organize and transfer property rights, then without enforceable contracts we are lacking one of the basic components of the rule of law.

The World Bank Mission

This brings us to a discussion of the value and importance of the rule of law as a pre-requisite for economic development. The World Bank's mission is to promote equitable economic growth and reduce poverty in its member countries. In order to achieve these dual objectives, lending by the World Bank over the past 30 years has changed dramatically. The focus of our

lending has shifted away from infrastructure towards such crucial areas as human development, and law and public administration.

Why Aid is Vital for Development

Over the past three decades, the Bank has learned that while aid is vital for development, it must be complemented by long-term investment flows. In turn, investment, both domestic and foreign, is a prerequisite for economic growth, without which there can be no poverty reduction. Last year, aid flows from the OECD donor countries amounted to \$56 billion. International investment flows to developing countries were more than three times this amount at \$162 billion. Unfortunately, the bulk of these resources flow to only a few developing and transition countries.

Too often in transition countries the investment climate discourages both domestic and foreign investment for various reasons:

- Legal frameworks for private investment may be weak and judicial outcomes unpredictable; and consequently, contract enforcement is also weak;
- Government regulation of the private sector may be biased, heavy-handed or ineffective;
- Bureaucratic processes may lack transparency, take too long, and tend to block rather than facilitate private sector activity;
- Poor macroeconomic policy can distort exchange rates, inhibit trade, choke local credit markets, and stoke inflation;
- Poor infrastructure: Power outages, poor roads and congested ports add greatly to the cost of business;
- And, even if the formal rules are sound, they may be subverted by systematic corruption.

The Rule of Law

Thus, investors need the rule of law. They need transparent and equitable laws, with access to justice and due process, and enforceable contracts. We believe that the rule of law promotes economic growth and reduces poverty by providing opportunity, empowerment, and security through laws and institutions. To accomplish this mission, we start with the premise that the rule of law prevails: where the government is bound by the law, every person in society is treated equally

under the law, the human dignity of each individual is recognized and protected by law, and justice is accessible to all.⁴

Lack of Political Will

In my experience, I have found that the root of the problem lies in the lack of true political will and commitment to develop and sustain the rule of law. I agree with economists who argue that reform efforts that focus exclusively on developing institutions, and fail to develop constituencies that benefit from those institutions and support them politically, is a recipe for continued failure.⁵

So, the issue remains: how can we help countries develop the political and economic foundation necessary to sustain the rule of law?

First, knowledge. We should improve public understanding of the benefits of the rule of law. A public that understands the value of the rule of law is not only better equipped to engage in economic activities, but also better able to protect its rights and adhere to its obligations. Moreover, an empowered public will be able to exercise greater scrutiny with respect to special interests and vested interests. *Second*, inclusiveness. We should think more about those who have not benefited from the transition and reform process, and take their interests into account. *Third*, accountability. We should continue to strengthen programs that improve the competence and accountability of governments. *Fourth*, transparency. We must combat corruption and strengthen anti-corruption policies. Many believe that corruption “greases the wheels” of commerce; however, it is clear that it is a major impediment to growth and social justice. Our research shows that foreign investment is moving away from ambivalent countries to those with strong anti-corruption policies, demonstrating that the behavior of international firms is changing. *Fifth*, legal institutions. We should continue our efforts to strengthen and develop legal institutions throughout the region.

The Judiciary

This brings us to the judiciary. Before the regional transition began, few citizens believed in the rule of law as a governing concept.⁶ Judges were not independent, lawyers were not advocates for the law, and the underground business community did not believe in the importance of contracts.

Recent research shows that many of these attitudes continue --- with resulting negative effects on economic development.⁷

Empirical evidence continues to show that the judiciary in transition countries is generally not trusted. This is due, in part, to its perceived politicization, inefficiency, and corruption. Poor management practices, cumbersome procedures, limited professionalism, and low morale are often to blame for the judiciary being unresponsive to market needs and demands. In many transition countries, contract enforcement relies on personal relationships based on trust, self-enforcement through repeat transactions, third-party enforcement and private enforcement more often than on more formal enforcement mechanisms. As economic activity increases and becomes more complex, informal ties will weaken and the demand for more formal means of contract protection will grow.⁸ A failure by the judiciary to provide effective contract enforcement services will further weaken economic development and threaten social stability.

As a result of historical and political circumstances, the courts in transition countries remain the most important institutions for conflict resolution. While there is general agreement that courts facilitate sophisticated business transactions by ensuring contract compliance and enforcement, we are concerned that businesses in many transition countries still choose, or are forced, to bypass the courts or other formal dispute resolution systems.⁹ For this reason, the World Bank works to strengthen both the formal court system and alternative dispute resolution mechanisms.

Given the weakness of formal contractual enforcement mechanisms in transition countries, World Bank projects have begun to emphasize a combination of both judicial and alternative structures. In addition, Bank projects now encompass bottom-up inclusive strategies to encourage sustainable change in legal and judicial structures.¹⁰ This is because the Bank has recognized the

need to strengthen the capacity of ordinary citizens to demand better services and the formal structures required to deliver them. For example, legal empowerment of the poor enables civil society to pressure governments to develop more favorable accessible policies.

Legal and Judicial Reform

Building respect for the rule of law does not happen overnight. It will take time to develop the transition economies. Today, to assist this process, the World Bank has 33 free standing legal and

judicial reform projects and over 500 project activities to support the rule of law in our client countries.¹¹ In the transition countries, since 1992, we have managed 229 projects or activities promoting the rule of law and our work in this region currently comprises 26% of our total legal and judicial reform portfolio. Of these, we have five stand-alone projects and eight institutional grants. For example, we are currently strengthening the enforcement section of the Ministry of Justice in Armenia and assisting with bankruptcy reform in Croatia, and in Russia, we are providing a legal framework to protect private property and defend economic rights.

The Roles of Arbitration and Alternative Dispute Resolution

I would also like to highlight the roles of arbitration and other alternative dispute resolution mechanisms in this area. Although arbitration and ADR will not, and should not, replace the formal court systems, they can help lighten the caseloads of overburdened courts, address disputes comparatively swiftly and flexibly, and provide necessary expertise for conflicts in specialized or technical areas. When foreign business partners are involved, local courts are, rightly or wrongly, often viewed as lacking impartiality or effectiveness. Arbitration frequently stands as the only alternative that both parties can accept. In the international sphere, a network of treaties -- including in particular the 1958 New York Convention and the 1965 ICSID Convention -- make arbitration awards more readily enforceable abroad than court judgments.

Arbitration has, as a result, grown tremendously in developing and transition countries. Numerous new arbitration centers have been established and many modern arbitration laws enacted. Many countries have also acceded to the major arbitration conventions. Take my own region of Latin America as an example: Over the past decade, some 100 new arbitration centers have been established in the region, 12 new arbitration laws have been enacted, and regional membership in the New York and ICSID Conventions has almost doubled.¹²

There have been great advances, but much remains to be done. It can take many years before an arbitration center, once established, compiles the track record needed to inspire confidence in potential users. Local courts may lack the arbitration expertise to apply modern arbitration laws and conventions properly.

Technical Assistance from the World Bank has included launching new arbitration centers and the formulation of arbitration legislation, in countries such as Albania. Apart from its several well-known advantages, arbitration under the auspices of ICSID – the World Bank Group’s International Centre for Settlement of Investment Disputes – has provided an avenue for the acquisition of arbitration expertise by several developing and transition country governments previously unexposed to the field. Indeed, ICSID staff, and the many private lawyers and arbitrators active in ICSID cases, represent a pool of expertise that has gone largely untapped by our clients. The Centre is now taking steps to help make this resource more readily available to our members.

Conclusion

As you can see, I have not given you a recipe for improving contractual enforcement. I do not have one, nor does the World Bank. However, I believe that this conference will assist us further develop a shared vision of development in this area, and to further understand the complex relationship between the rule of law and contractual enforcement in transition countries.

Thirteen years ago, we were forced to rely upon conventional wisdom to assist transition countries develop their economies. But today, we have concrete evidence clearly linking prosperity to contractual enforcement. Using this evidence as a starting point, we must work together to cultivate new ideas and reform approaches to ensure the development of the transition countries and their full integration into Europe. To do so, we need to keep in mind the crucial role of political will and commitment.

Thank you

Endnotes

¹ This proposition dates back to founding fathers of both modern economic and legal theory. See Smith, A., *An Inquiry into the Nature and Causes of the Wealth of Nations*, London : Printed for W. Strahan and T. Cadell, 1776 and baron de Montesquieu, Charles de Secondat, *The Spirit of Laws*, London : Printed for J. Nourse and P. Vaillant, 1750.

² De Soto, H., *The Other Path: The Economic Answer to Terrorism*, New York: Basic Books, 1989.

³ See Yakovlev, A. M., *Striving for Law in a Lawless Land: Memoirs of a Russian Reformer*, Armonk, New York: M.E. Sharpe, 1996.

⁴ World Bank, *Legal and Judicial Reform: Strategic Directions*, Legal Vice Presidency, World Bank, 2002.

⁵ Rajan, R. G., *Saving Capitalism for the Capitalists: Unleashing the Power of Financial Markets to Create Wealthy and Spread Opportunity*, Crown Publishing Group, 2003.

⁶ Dahan argues that the very concept of law and its role in society is being reformed in Central and Eastern Europe- see Dahan, F., “Law Reform in Central and Eastern Europe: the ‘Transplantation’ of Secured Transaction Laws”, Vol. 2, No. 3, *European Journal of Law Reform*, 2000.

⁷ For example, see discussions of continuing attitudes in Pistor, K. “Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement” Volume 22, No. 1, *Review of Central and Eastern European Law*, 1996 and Hendley, K. “Legal Development in Post-Soviet Russia” Volume 13, No. 3, *Post Soviet Affairs*, 1997.

⁸ World Bank, *Building Institutions for Markets*, World Bank Development Report 2002.

⁹ World Bank and the European Bank for Reconstruction and Development, *The Business Environment and Enterprise Performance Survey* (BEEPS), at <http://info.worldbank.org/governance/beeps/>.

¹⁰ World Bank, *Legal and Judicial Reform: Strategic Directions*, Legal Vice Presidency, World Bank, 2002.

¹¹ World Bank, *Initiatives in Legal and Judicial Reform*, Legal Vice Presidency, World Bank, 2003.

¹² Frutos-Peterson, C. L’emergence de l’arbitrage comercial international en Amerique Latine: L’efficacite de son droit, Paris: L’Harmattan, 2003, pp 207, 231, See also <http://www.worldbank.org/icsid>, and <http://www.uncitral.org/en-index.htm>.

Bibliography

- Briner, R., "The Changing Landscape on International Commercial Arbitration" Vol 19, No. 2 *International Centre for Settlement of Investment Disputes*, 2002.
- Dahan, F., "Law Reform in Central and Eastern Europe: the 'Transplantation' of Secured Transaction Laws", Vol. 2, No. 3, *European Journal of Law Reform*, 2000.
- De Soto, H., *The Other Path: The Economic Answer to Terrorism*, New York: Basic Books, 1989.
- Dincer, O. "The Effects of Property and Contractual Law on Economic Performance", Department of Economics, University of Oregon, at <http://www.uoregon.edu/~odincer/fieldpaper.pdf>, accessed 1 Dec 2003.
- Frutos-Peterson, C., *L'emergence de l'arbitrage comercial international en Amerique Latine: L'efficacite de son droit*, Paris: L'Harmattan, 2003.
- Glazebrook, S., "The Role of the Rule of Law in the Asian Economic Crisis", paper based on Presidential Address given at Plenary session of *Inter-Pacific Bar Association Ninth Annual Conference*, Bangkok, May 1, 1999.
- Hendley, K. "Legal Development in Post-Soviet Russia" Volume 13, No. 3, *Post Soviet Affairs*, 1997.
- baron de Montesquieu, Charles de Secondat, *The Spirit of Laws*, London : Printed for J. Nourse and P. Vaillant, 1750.
- Pistor, K. "Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement" Volume 22, No. 1, *Review of Central and Eastern European Law*, 1996.
- Rajan, R. G., *Saving Capitalism for the Capitalists: Unleashing the Power of Financial Markets to Create Wealthy and Spread Opportunity*, Crown Publishing Group, 2003.
- Smith, A., *An Inquiry into the Nature and Causes of the Wealth of Nations*, London: Printed for W. Strahan and T. Cadell, 1776.
- World Bank, *Initiatives in Legal and Judicial Reform*, Legal Vice Presidency, World Bank, 2003.
- World Bank, *Legal and Judicial Reform: Strategic Directions*, Legal Vice Presidency, World Bank, 2002.
- World Bank, *Building Institutions for Markets*, World Bank Development Report 2002.
- World Bank and the European Bank for Reconstruction and Development, *The Business Environment and Enterprise Performance Survey (BEEPS)*, at <http://info.worldbank.org/governance/beeps/>, accessed 1 Dec 2003.
- Yakovlev, A. M., *Striving for Law in a Lawless Land: Memoirs of a Russian Reformer*, New York: M.E. Sharpe, 1996.