WORKING PAPER

ANALYZING THE IMPLICATIONS OF LEGAL ENVIRONMENT ON ECONOMIC TRANSITION OF EASTERN EUROPEAN COUNTRIES INTO THE INTERNATIONAL MARKET

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Analyzing the Implications of Legal Environment on Economic Transition of Eastern European Countries into the International Market

Charles R. B. Stowe and Keith Jenkins

With the demise of the Soviet empire and its trading arm COMECON, Eastern European countries are in the transition process shifting from command to market economies. The underlying basis of transition is more than a set of governmental macro-economic policies. The underlying basis for transition requires a complete overhaul of society including: macroeconomic policies (including but not limited to trade, foreign ownership, government spending, privatization, taxation, etc.), cultural attitudes towards risk and personal economic security and the role of government, and the command economy's legal infrastructure. On top of this underlying economic reform is a political reform shifting towards democratization of society which entails more than just the creation of a legislative body but literally redefining the powers, procedures, and responsibilities of government while establishing political parties, elections, and even constitutions. The transition in Eastern Europe should be viewed as a revolution without blood as opposed to a mere evolution given the rapidly and enormity of the task of converting societies from command to free market while at the same time changing from authoritarian single party control to multi-party, democratic institutions.

This paper presents a model useful for making a systematic analysis of the implications of the legal environment on economic transition of eastern European countries into the international market. While the model has applicability to any transition economy, it was developed during a doctoral examination of the transition of Eastern Europe with specific emphasis on Poland. The model is an attempt to formulate a structure for analyzing risk of doing business in transition economies. The model does not purport to offer a resolution as to the relative importance of risk based on the legal system as compared with other economic risk factors. The model does provide a framework for analyzing legal environments among different transition countries.
In Search of a Model - Review of Literature

Mancur Olson's book The Rise and Decline of Nations; Economic Growth, Stagflation, and Social Rigidities\(^1\) preceded the transition of Eastern Europe by six years if we concede that the transition began in 1989 with the first non-Communist government to assume power in Poland. What makes his book particularly intriguing and relevant to issue of the relationship of the legal infrastructure and economic growth is his assertion that legal/political policies have direct impact on economic growth. While fascinated by the question of why great civilians like Egypt and the Roman Empire collapsed, he confines his analysis to the post World War II era. Whether comparing the rapid growth of Japan with the tepid growth of Great Britain or the near bankruptcies of New York and Cleveland, compared with the economic boom in the Southern states, Olson constructs an argument that addresses economic growth but from a legal/political infrastructure basis. Building on an earlier book\(^2\), Olson builds an economic argument that the behavior of individuals and firms in stable societies leads to the formation of dense networks of collusive, cartelistic, and lobbying organizations that make economies less efficient and dynamic and polities less governable. He builds his logic on the following implications reflected in table 1.

Implications\(^3\)

Table 1

1. There will be no countries that attain symmetrical organization of all groups with a common interest and thereby attain optimal outcomes through comprehensive bargaining.

2. Stable societies with unchanged boundaries tend to accumulate more collusions and organizations for collective action over time.

3. Members of "small groups" have disproportionate organizational power for collective action, and this disproportion diminishes but does not disappear over time in stable societies.

4. On balance, special-interest organization and collusions reduce efficiency and aggregate income in the societies in which they operate and make political life more divisive.

5. Encompassing organizations have some incentive to make the society in which they operate more prosperous, and an incentive to redistribute income to their members with as little excess burden as possible, and to cease such redistribution unless the amount redistributed is substantial in relation to the social cost of the redistribution.
Distributional coalitions make decisions more slowly than individuals and firms of which they are comprised, tend to have crowded agendas and bargaining tables, and more often fix prices than quantities.

Distributional coalitions slow down a society's capacity to adopt new technologies and to reallocate resources in response to changing conditions, and thereby reduce the rate of economic growth.

Distributional coalitions, once big enough to succeed, are exclusive, and seek to limit the diversity of incomes and values of their membership.

The accumulation of distributional coalitions increases the complexity of regulation, the role of government, and the complexity of understandings, and changes the direction of social evolution.

Olson's book goes further to suggest that what makes a nation and the majority of its citizens rich is not its natural resources but an institutional and legal framework which secures individual property rights and provides for the enforceability of contracts and a freely competitive environment. One example cited by Olson is Switzerland which enjoyed a solid growth rate. Switzerland even with its lack of natural resources enjoys a very stable legal infrastructure which encourages active money flows for safety and investment. On the other hand, Olson points to Great Britain after World War II as a nation on the decline. Olson deduces that Great Britain suffered a tepid recovery because its vested interest groups were choking the economy through self interest while other economists cite Great Britain's socialistic policies. However, Olson notes that France had even more "socialistic" policies after World War II, but managed to enjoy a stronger growth rate. Why? Olson observes that France's which actually had more of "socialist" economy had interest groups that were essentially in disarray due to the war as compared to Britain's that were left intact and continued to exert negative influence on the overall growth rate.4

According to U.S. Assistance for International Development (USAID) contractor, KPMG Peat Marwick, "Mancur Olson's work attracted the attention of USAID ... since it explains the connections between economic growth, institutional reform, and democracy."5 USAID began funding an organization called IRIS which stands for Institutional Reform and the Informal Sector which has field programs in India, Mongolia, Nepal, Chad, Russia, the former Soviet Union, and Poland. In 1991, an IRIS field activity was established in Poland to promote legal reforms. The methodology has been to create a coalition of Polish lawyers, bankers, and government officials
who understand collateral law reform. Their objective was to lead the process of creating a central registry of liens and to reform bankruptcy and secured lending laws. Their objective was prompted by a survey of small to medium enterprises by the Gdansk Institute of Market Economics which cited credit as a major problem facing entrepreneurial enterprises in Poland. The problem according to the Gdansk study was that lacking a central lien system, banks were reluctant to lend except against cash collateral deposits.

Whether one accepts Olson's thesis or not, his linkage of legal infrastructure, growth rates, and monetary policies apparently influenced the United States Government's approach to USAID funding. Furthermore, it is logical that the relationship of organizational infrastructure has significant implications for growth rates. Olson's work indirectly raises the issue of the role of the legal infrastructure on not only the economic growth rate but on the entry and competitiveness of transition economies engaging in world trade.

On a more pragmatic level, the Heritage Foundation commissioned a comparative study of all nations' policies relating to "free market". Their 1996 Index of Economic Freedom report examines trade policy, taxation policy, government consumption of economic output, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulation, and black market for 142 countries giving each an overall "grade". The lower the grade the more economic freedom the country has according to the study. The first section of the report includes a chart that depicts per capita GDP in purchasing power parity with their ratings of countries as free, mostly free, mostly unfree and repressed. While few "repressed" countries enjoy a high per capita GDP in purchasing power, those that are "mostly free" are not necessarily assured of the highest per capita GDP either. Whether the Heritage study has selected the right issues for defining economic freedom and whether a country's economic growth rate is solely determined by these factors when population growth, natural resources, degree of available technology, and governmental stability are ignored, is questionable. However, the mere compilation of data and analysis into a structured model raises questions over the relationship of "legal reforms" and "legal infrastructure" to that of macroeconomic governmental policies. For
purposes of clarity, legal infrastructure refers not only to the administrative, civil and criminal court system, but to the statutes, codes, and other sources of law. While I do not propose that macroeconomic, fiscal and monetary policies are not important, a legal infrastructure is a critical component of the transition process from a command to a free market economy for reasons that the proposed model enumerates.

Other studies and commentaries of the transition process mix macroeconomic governmental policies with issues over the development of a legal infrastructure. These studies and commentaries include Jeffrey Sachs's *Poland's Jump to the Market Economy*, United States General Accounting Office Report to Congressional Committees *Poland: Economic Restructuring and Donor Assistance*; Clague and Rausser *The Emergence of Market Economies in Eastern Europe*; Blanchard et. al. *Reform in Eastern Europe*; Nagel et. al. *Eastern European Development and Public Policy* and Keren and Ofer's *Trials of Transition* to name a few. These studies suggest that privatization, monetary, fiscal and legal reform constitute the creation of a free market economy. However, none of these studies separate the purely legal infrastructure issues and what specific reforms are necessary to promote a free market economy other than citing the need for modern contract law, banking reforms, and privatization of state owned enterprises.

While Olson's book, *The Rise and Decline of Nations*, apparently led to funding legal reforms in transition economies by the United States Government, the book does not offer or build a model for analyzing what specific legal reforms or conditions promote economic growth. And, most of the studies or commentaries on transition economics acknowledge specific reforms and their importance for creating "free market conditions", few have set forth a model in which to build an analysis of legal infrastructure.

**Methodology**

Traditional research through referenced publications is not adequate for fully exploring the development of new approaches to transitional economics or institutional economics. The reason is that much research and development in both fields is being done under U.S. government contracts and by quasi-governmental organizations whose incentive system is not academic publication but justification for continued financing through both private and public funding. As a
result, many reports cited in this study are published in the sense that they are printed, but basically uncirculated and unreferenced publications.

In order to gain insight necessary to begin to explore the development of a model for analyzing legal infrastructure and reform, interviews with attorneys, accountants and leading proponents of legal reform were conducted during the month of May 1994. This initial effort does not attempt to present all the background material that went into the development of a model for the reason that such an exploration would be extremely lengthy. Rather, key concepts have been integrated from such interviews and accordingly are given attribution where permitted. Unfortunately, due to the sensitivity of some of the observations, some of the ‘experts’ only offered their candid opinions on the basis of anonymity due to client confidentiality and sheer difficulty of public relations in the event that their remarks were attributed to them.

The legal, political, economic and social situation in Eastern Europe is hardly static so that the information contained in this paper is dated. In so much as the purpose of this study is to promote the concept of a model for analyzing legal infrastructure of transition economies, the problem of reporting absolutely current status of legislation and laws is not fatal to accomplishing the objective. Obtaining current information on the status of legislation and laws is not easy given the language situation. Even more complex is the problem of determining how laws are actually implemented and how the courts are actually dealing with new laws which is an aspect of the model that requires additional methodological research on how best to arrive at salient observations.

The "launching pad" for developing a model is based on a World Bank Discussion paper authored by Cheryl W. Gray titled Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe. The problem with the "framework" approach is that it is extremely broad and is used only for the purpose of comparing specific legislative initiatives.
Building a Model

The World Bank Discussion Paper by Cheryl Gray does provide some of the components of a model for analyzing legal infrastructure. Gray observes that:

"The legal framework in a market economy has at a minimum four basic economic functions:

• to define the universe of property rights in the system,
• to set a framework for exchanging those rights,
• to set the rules for the entry and exit of actors into and out of productive activities,
• to oversee market structure and behavior to promote competition."\textsuperscript{14}

Taking the four economic functions, we can define particular general areas of law within each function:

Universe of property rights:

Real property laws
Tangible property laws
Intellectual property laws

Framework for exchanging those rights:

Contract law
Privatization law*
Securities law*
Banking law
Tax law*
Arbitration/Mediation law*

Rule for Entry and Exit of Actors...:

Business Organizations law
Licensing & regulations*
Foreign investment law
Bankruptcy & liquidation
Anti-monopoly & Unfair Competition Laws:

Anti-trust laws
Consumer laws*
Tort laws*
Deceptive Trade Practices law*

The areas of law that have an asterisk were added by this author. This framework is still too general to serve as a model for analysis.

The areas of law need to be placed into a hierarchy and then specific attributes of those laws and what role they play in a free market need to be identified. Certainly the essence of a free market economy as contrasted with a command economy is that individuals and private entities have the right to own the means of production. Private property rights are the foundation of the free market economy. The next level are the laws related to the formation of business enterprises and related taxation issues. A third element of the model are the laws related to the market. Market related laws involve freedom of and enforcement of contracts, marketing regulations, etc. A fourth element are the rules related to the development of a financial services sector and capital formation. This fourth category is extremely important because the means by which the economy aggregates and distributes capital to its enterprises will in part determine the ability of the economy to be responsive to the market. This categorization complements and does not contradict the categories as stated above.

A second feature of a model to analyze transition economies is that the model must not presume one particular route to transition. For example, there are several different strategies or models being used to pursue privatization. Most commentary on transition features extensive discussion of privatization laws. The combined impact of privatization of major industries and the formation of entirely new business enterprises has resulted in an almost explosive growth of the private sector in Poland, Slovenia, Hungary, Croatia, RYR Macedonia, Czech and Slovak Republics. Within the context of joining the international marketplace, privatization is only a first step. The privatized entities face the challenge of increasing marketing finesse, increasing quality
of goods, identifying and exploiting market niches, remaining competitively priced, and acquiring the capital to deal with those challenges. Here is where the issue of the capital sector and related legal infrastructure reforms help to determine risk and likelihood of success.

**Financial Sector Development’s Implications for Transition Economies**

As in privatization, there are several different models for financial sector development. The importance of refining the legal infrastructure to support a market sensitive financial services sector cannot be overstated. Without capital either internally generated or externally invested the viability of the transition economies will be jeopardized in their entry into the competitive world market.

Gerald Caprio and Ross Levine suggest that there are certain tasks or services offered by the financial services sector: "Make payments and facilitate transactions, Mobilize savings, Facilitate risk management (hedging and insurance), Monitor firm managers (corporate governance); Select firms to finance (credit assessment)." Identification of these functions does not suggest one particular set of legal reforms, however.

The German model has the result that capital is obtained primarily through financial institutions. German banks have the right to invest directly in equities. The American model results in capital aggregation not only through large financial institutions but through many routes to equity capital. As a result, the percentage of GDP in US stock exchanges is much larger than in Western Europe. U.S. laws prohibit banks from making equity investments but has more liberal provisions for companies seeking equity capital and a much more active secondary market for securities.

An important segment of the capital sector among Western nations with free markets is the public policy toward retirement. Chile has a totally private pension system whereby worker's pensions are invested in securities and long term financial instruments. A purely private pension system provides substantial capital to the economy. The U.S. has a mixed system toward retirement. The U.S. Social Security system is merely a government sponsored redistribution of wealth scheme and does not aggregate capital for investment in the private sector. However, the
U.S. system also permits private pension funds which invest in long term debt obligations as well as equity securities. Currently, Poland is still debating the issue of retirement because there are fewer and fewer workers as compared with those eligible for retirement. In other words, like the US, Poland faces an aging work force.\textsuperscript{18} Currently, the tax on payroll is 49% in order to fund pensions. Privatization could release millions of dollars into the capital market to fuel faster growth. However, the political problem of removal of government as the guarantor of retirement might not be realistic.

The issue of insurance laws also impact the extent to which that industry aggregates capital and makes capital available to private enterprise in the form of debt and equity investments. At present, Poland has just started the process for granting licenses to foreign insurance companies to compete against the state owned insurance enterprise.

Laws relating to foreign ownership and foreign investment have a very strong influence in the growth rate and economic stability during transition. Foreign financial institutions and foreign companies interested in participating in Eastern European economies represent a large potential of much-needed capital injection for the modernization of former state owned enterprises and newly formed private enterprises. Issues such as licensing or ownership, taxation of profits, direct and indirect regulation of foreign owned enterprises , all bear on the extent of foreign investment. Coupled with the laws relating to the financial services sector and the growth of secondary equity markets or exchanges can provide a strong incentive for foreign investment.

Viewed from the above perspectives, a model to analyze transition economies from a legal perspective must incorporate all the issues of managing a private enterprise. These issues would include, but not be limited to: corporate governance, contractual relations, marketing, finance, accounting and human resources law ranging from resolution of conflicts, collective bargaining, and not just "tax law".
Adding the Dimensions of Predictability, Cost and Time

Simply identifying types of laws to incorporate into a model for analyzing the quality of the legal infrastructure of Eastern European transition economies is insufficient. Three other factors must be introduced into the model which at this point is very static or one-dimensional. The other factors are predictability, costs (transaction costs associated with each area of law) and time (the amount of time the legal system requires for resolution). If cost of seeking judicial remedies are so high as to make enforcement unlikely, then the economic efficiency of the existence of the law is going to be negated according to Ron Dwight, Director of IRIS-Poland.\(^{19}\) One of the reasons why IRIS works not just with legislators and bar associations but with the judiciary is that if the administration and interpretation of collateral laws are not carried out in the spirit of the law, the benefits to the economy of having legal reform will be nonexistent.

"A primary focus of our activity is to build an understanding of the purpose and value of collateral laws to a judiciary that is totally unfamiliar with private property disputes and uncomfortable with the morality of foreclosure and eviction against individuals."\(^{20}\) For example, under socialist law, private property rights were tiered with state ownership being given the highest form of protections and rights. The next category was local government ownership or control. A lower category was worker-council ownership or cooperatives. The last category was individual property rights but these were limited to non-productive categories of property such as one's personal residence (but not one owned and rented out), personal clothing, etc.\(^{21}\) The entire concept of using the state to evict someone out of their apartment for failure to pay rent runs counter to the former social policy of government providing housing for all citizens. This sense of social justice still prevails among the judiciary according to legal practitioners in Poland.\(^{22}\) Eviction for commercial tenants is less sinister than evicting a family in the eyes of many Eastern European citizens.

The problem with introducing the three factors of predictability, cost and time is that these will vary for each area of legal reform. The issue of predictability is not case specific but refers to the overall sense that certain laws are equitably enforced. Determining predictability of laws is a
complex process. In part it represents a degree of confidence in the legal system. In part it represents consistency of rulings and interpretations. And in part it represents stability of laws. One of the difficulties facing business enterprises in Russia is the constantly changing tax laws. The result is that business transactions are conducted as one time events with little commitment to long range operations.

The issue of time is also complex, because the length of time involved in the legal process varies by area of law. For example, a patent system that requires several months before patents can be granted may well be within parameters of acceptability. Even waiting an average of two years for final resolution of patent disputes may be acceptable. However, a two year time frame for the eviction of a non-paying tenant may so raise the risk factor that the transition economy will not see adequate investment in real estate. Incorporating the dimension of timing into a model is highly subjective.

The issue of cost is more quantifiable as the cost of seeking legal redress must not be higher than the amount in dispute. However, even this dimension requires some analysis. Charging a modest fee for registering a lien is not going to have a detrimental impact on the economy if the other factors of predictability and time are reasonable. However, a tax on transfers of securities however small, may discourage capital formation as investors have many other international opportunities.

**Compatibility with European Union & Western Trading Partners**

A final dimension to be incorporated into a model to analyze the implications of legal environment on economic transition of Eastern European countries into the international market is the issue of compatibility with the laws of European Union and western trading partners. The problem is applying this factor to the model in a manner that is consistent with reality. Japan, for example, has a legal system that is quite different from its trading partners. However, this has not negatively impacted their competitiveness in the world marketplace. One may even concede that their tolerance of cartels may even have helped their industries. Therefore, it is important to
confine the issues of compatibility with those that are proven to have substantial implications for international trade.

Clearly the implementation of laws compatible with trading partners on contracts, sales, commercial paper, negotiable instruments, etc. that are directly related to trade itself is vital. For the European Union, the establishment of the legal infrastructure related to ISO standards is an absolute necessity and this has been accomplished from a legal perspective. From the perspective of changing industry practices in the manufacture of goods to conform with the ISO standards, there has been great progress made.

Intellectual property laws have been reformed, but the other dimensions of predictability, cost and time are more difficult to evaluate. Basic ownership of real property has been reformed but there are serious problems remaining in creating central registries for liens and in resolving claims of former owners. Here, the United States has actually played a role that has aggravated this issue. The United States has argued against imposing a statute of limitations against former owners to remove clouded titles.23

**Value of a Model**

Economic analysis of transition economies has heretofore been based on broad analyses of political, social and economic reforms. The development of a model specifically oriented to analyzing the development of the legal infrastructure offers researchers and investors a more precise tool for exploring investment opportunities and for analyzing the ability of the transition economies to mobilize the resources to effectively compete in the world economy.

Much more work needs to be done to build this model into a working framework. There remains the problem of how to accommodate different paths towards the same objectives within the model. However, this initial examination of the issues brings us closer to understanding perhaps the greatest revolution since the demise of monarchies - namely the transition of Eastern European economies from command to free market economies.

2 Olson, Mancur, *The Logic of Collective Action*.


4 Ibid. pp. 75 - 117.


6 Ibid. p. 3.

7 Sachs, Jeffrey  *Poland's Jump to the Market Economy* Massachusetts Institute of Technology, 1993.


10 Blanchard, Olivier; Dornbusch, Rudiger; Krugman, Paul; Layard, Richard; and Summers, Lawrence,  *Reform in Eastern Europe*. United Nations University, 1991.


14 Ibid. p. 1.


18 Interview with Dr. Stefan Kwiatkowski, Professor of Management, University of Warsaw, May 1996.


20 Ibid.

21 Interview with Polish attorney, Tomasz Leptowski, Warsaw, May 1995. See also pages 3-4 in Gray, op.cit.
