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THE NECESSARY INSTITUTIONAL FRAMEWORK TO TRANSFORM FORMERLY PLANNED ECONOMIES

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The necessary INSTITUTIONAL FRAMEWORK to transform formerly planned economies

– with special emphasis on the institutions needed to stimulate foreign investment in the formerly planned economies.

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1. INTRODUCTION

This paper starts from the premise that long run sustainable economic growth is the prime policy objective of the formerly planned economies and that in order to transform these economies into growing market economies, a particular set of working conditions for business firms is required. These working conditions are determined by the *institutions*[1] *of the economy*, in particular those governing financial transactions. In formerly planned economies these conditions have differed fundamentally from those prevailing in both Western industrial countries and in the developing countries. The formerly planned economies are in fact in a position now to select practices and rules, potentially *improving on the practice in the west* as well as gearing institutions to the particular needs in the transformation process.

Accepting growth to be the dominant policy objective our task is to identify the necessary institutions to achieve that objective. This is the policy issue. It is our opinion that in order to understand the situation of the formerly planned economies and to support their transition to market economies through policies, analysis has to be carried out in terms of the *underlying micro adjustments required to achieve macro objectives.* This is synonymous to stating that policy has to be oriented towards creating or facilitating the creation of institutions that support these micro adjustments. Incentives and competition become key factors in this dynamic adjustment process. Hence, in our analysis, the firm and its competitive behavior in financial markets, notably in the market for ownership claims and securities, with potential rights to influence decisions (the *market for corporate control*), are at the core of the growth process required for that transition. This is illustrated in Figure 1.

(Figure 1 in about here.)

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[1] We use the broad definition of institutions consistent with the dictionary and common in old economic literature. It covers what modern IO literature calls institutions <u>and</u> organizations.

The critical rôle played by financial markets is to intermediate the trade-off between the future and today. To create future growth, scarce resources otherwise used for consumption will have to be invested and individuals will have to wait for the returns. That will require patience, in return for high future profits. The important *task of financial institutions will be to make sure that those not willing to wait pay a high price and those willing to wait run a minimum risk on the average of not earning a very high return for their patience.* The totality of the institutional framework, and the dynamics of the adjustment process needed to achieve an efficient allocation of resources over time and across firms is not well understood in the West[2]. These institutions have simply evolved over a very long time through trial and error, a process that has not been well documented. Hence, the transfer of this complex of institutions to the formerly planned economies is a very delicate policy operation that will be the topic of this paper.

The policy problem is further complicated by the fact that it is likely that for considerable time the rate of growth required to avoid internal, political disturbances, aborting the creation of efficient institutions and economic progress will be larger than the rate generated internally. Thus, a successful economic and political transition of most of the formerly planned economies requires significant contributions from the West by way of aid and, in particular, investment, technical assistance, marketing and managerial knowhow. Political risks may, however, be a hindrance to participation of Western firms and Governments. We therefore pay particular attention to the special demands on domestic institutions influencing foreign investment. Internal political impediments to the privatization and liberalization processes which are important parts of the required institutional change are specially considered.

A functioning market economy requires that both the risks of political interference in economic decisions of firms and households and opportunistic

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[2] See, e.g., Pelikan, P., 1987, The Formation of Incentive Mechanisms in Different Economic Systems in Hedlund (ed.), *Incentives and Economic Systems*, Croon Helm, London, Sydney, and Pelikan, P., 1992, The Dynamics of Economic Systems, or How to Transform a Failed Socialist Economy, in *Journal of Evolutionary Economics*, Vol. 2, No. 1, 1992 (pp. 39-63).

behavior on the part of agents be brought to a minimum, but without reducing entrepreneurial incentives. The institutions of efficient markets that impose such order on and predictability of economic transactions are both formal (laws and regulations) and informal (conventions, ethics etc). The creation of such necessary institutions are critical for the success of Eastern European economies in transforming themselves into viable market economies. This paper takes stock of these necessary institutions but also takes us one step further. We classify legal institutions and conventions that determine the risks of investment in addition to business risks that directly influence demand and supply for goods and services.

Institutions and conventions regulating property rights and their use are classified by their economic role in reducing risks at different stages of an investment and growth process. The four stages or investment mechanisms of economic growth are *entry, reorganization, rationalization* and *exit*[3] of firms. We choose to classify by these stages in order to emphasize how institutions and conventions influence the dynamics of growth and innovation.

In Section 2 we define the concept of political risks and its sources. Section 3 provides an overview on the central role financial markets play in the above growth process and the dangers facing Emerging Market Economies (EMEs) by delaying reform in these markets. Section 4 discusses the role of legal institutions and contracts for incentives at the stage of transition. We focus on institutions influencing corporate governance in Section 5. Thereafter in Section 6 we discuss how institutions in EMEs develop relative to those that in our view would best promote growth. In Section 7 we ask whether EMES need to treat foreign investors differently from domestic investors to promote growth. Section 8 asks what role the West can play. We discuss the possibility of creating specially designed private or government insurance institutions to reduce political risks that impede growth in EMEs. Section 9 contains the concluding remarks.

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[3] See Eliasson, G. 1992 *The Economics of technical change. The Macro Economic Consequences of Business Competence in a experimentally organized Economy*, IUI Working Paper Nr. 349b, to be published in Revue d'Economie Industrielle, Septemer 1994.

2. DEFINITION OF RISKS AND THE POSSIBILITIES OF ESTABLISHING MARKETS FOR RISKS

The present value of future profits, or the value of the firm is negatively dependent on the level of risks of the business as seen by providers of funds in the stock market or by firm management itself, when considering future long term commitments. There are business risks associated with demand and supply conditions in the firm's markets and with the behavior of parties to a transaction, and other risks associated mostly with uncertainty about policies and legislative acts by government. The firm is supposed to be competent in understanding and controlling its business risk exposure. Other risks are determined by the organization of and the stability of the economy. While business risks can often be traded, shared and diversified in financial markets or managed by contractual arrangements, other risks are non-insurable, in the sense that the market is unwilling to trade in them and no business institutions is willing to insure such risks for a fee. One reason may be the sheer magnitude of a possible negative event. Such risks could be prohibitive for investments, even for nation states and very large international corporations. In dealing with this problem we attempt to draw a reasonably clear line between business risks and non-insurable political risks. It is the *task of political authorities to minimize or eliminate political risks as a means of achieving economic growth*.

Three types of political risks

We distinguish between three types of risks associated with the behavior of political, legislative and regulatory authorities. Such risks are called *political risks* in Table 1. The *first type of risk* is truly political and cover the collapse of the political system, including military take-overs etc. Under this heading we should also list nationalization of industries and sudden political demands of majority ownership in foreign companies.

(Table 1 in about here.)

The *second type* of political risks concerns the break down of the economic system, notably the stability of the monetary system, including a runaway inflation and severe reduction of the productive capacity of an economy of such a magnitude that the conditions under which economic transactions have been conducted change fundamentally. A large share of firms and households will be unable (as a consequence) to fulfill contractual obligations. Some of these risks can be managed within very large corporations, but they are potentially so large that even insurers may go bankrupt if a "bad" event occurs. These risks cannot often be diversified and spread over the market since events occur so infrequently that the probability of a certain event happening cannot be estimated beforehand. The market is notoriously bad at creating hedges for such risks, and fees will be very high making normal business investments unprofitable.

Some macro risks are in principle insurable as long as the magnitude of change is within "normal" ranges. For instance, the interaction of inflation, the exchange rate and the interest rate follow certain regularities in the long run, and the overall financial risk exposure can be reduced by appropriate arrangements of the balance sheet.

The *third type of political risk* is of a more subtle kind. It refers to unpredictable behavior on the part of governmental authorities in the form of changes in the institutions of the economy that regulate everyday economic behavior, notably the property rights institutions, and the legal framework for contractual arrangements among firms, their financiers, and other stakeholders. It is the task of this paper to give economic content to these institutions and to clarify to the extent possible, where the line should be drawn between such political risks and business risks of a more conventional nature. The third type of risk includes uncertainty about rules governing property rights and their contents. The content of property rights depends on the range of feasible contractual arrangements that a property owner can enter. These issues are discussed in Section 3.

The three types of political risks are to some extent interdependent. A breakdown of the monetary system of a country often compels its political authorities to lay down restrictions on the rights regulating market transactions, like removing convertibility, imposing credit controls etc.

The role of law and precedent is to give credibility to contracts. Although credibility may be seen as a collective good, in the abscence of political action there are also market mechanisms working on the establishment of such credibility, when there is individual demand for credibility. Modern economic research, in fact has had difficulties identifying truly collective goods or services with Government as the only provider. This result is particularly important for EMEs. Hence, informal provisions supporting the development of conventions in the market, in fact may often be more efficient than legal code. It should be remembered that the Common Law of England and the US developed very much in this way. We will particularly discuss the case for *enabling institutions* that facilitate the creation of informal institutions as a substitute for lacking political action. For economies in transition, a decision must be made specifying the coverage of explicit legal institutions and on the scope for development of informal contractual arrangements. We return to this issue below.

Business risks

Entrepreneurial behavior and long term financial commitments require that business firms and individuals feel secure that the only circumstances preventing them from capturing expected rents associated with ownership of a resource are *mistaken business decisions* within their management sphere of expertise.[4] The three types of political risks have in common that private insurance markets are highly imperfect, if they exist at all. The risks are "systemic" in the sense that rules governing economic transactions can be abolished, or changed without enforcement possibilities.

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[4] See further: Eliasson G., 1993, A Note: On Privatization, Contract Technology and Economic Growth, in Day-Eliasson-Wihlborg *The Markets for Innovation Ownership and Control*, IUI and North Holland.

Mistaken business decision under a given legal framework for property rights and their content could be due to misjudgements about the behavior of suppliers, customers, lenders or other stakeholders (item 4 in Table 1) or to mistaken perceptions about demand and supply factors for a firm's products (item 5 in Table 1).

The fourth type of risk can be quite large if property rights are ill defined and contractual enforcement weak. The distinction between this business risk and risks caused by uncertainty about the legal framework is naturally blurred. Business risks are often (but not always) due to asymmetric information about the behavior of parties to a transaction. Such risks can potentially be reduced by contractual arrangements, while the political risk in our terminology is caused by uncertainty about the possibility to enter contractual arrangements. These risks will be clarified in Section 4.

3. FINANCIAL MARKETS, ALLOCATIVE EFFICIENCY AND MACROECONOMIC RISKS

The investment decision is processed through, and resources are allocated in financial markets. In that process financial markets support the four investment mechanisms (Elisson 1992) of economic growth (entry, reorganization, management and exit), and hence affect the efficiency of the economic growth process. In this section we argue that this efficiency is both strongly influenced by the state of the macro economy, i.e., to which extent stability of the price level, the exchange rate and a reasonably stable and low real interest rate can be maintained and influence the state of the macro economy. Neither competition for funds, incentives to invest for growth, nor controls of allocative efficiency are efficient if the financial system exhibits macro instability.

The three basic functions performed by the financial system are [see Table 4 and Rybczynski (1993)[5]] *first,* the collection and allocation of new savings and the provision of channels of information enabling the ultimate savers to allocate new savings. There is a large variety of institutions for collecting and allocating new savings. Their character and scope differ depending on the evolution of the financial system in the regulatory framework. These two factors also determine the relative importance of different types of activities designed to help ultimate savers channel their savings directly to ultimate users, or to savings institutions collecting and allocating the new savings.

It is worth mentioning here that one type of savings collecting institution, namely banks, are in a unique position. Under the fractional banking system they have the power of credit creation and constitute the main channel through which authorities implement their monetary policy. Thus banks directly influence the macro-economic environment and the risks attaching to it.

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[5] Rybczynski T., 1993, Innovative Activity and Venture Financing: Access to Markets and Opportunities in Japan, the U.S. and Europe, Chapter 3 in Day-Eliasson-Wihlborg, *The Markets for innovation, Ownership and Control,* IUI and North Holland.

The *second* important function of the financial system in a developed economy, and neglected until very recently, is to *monitor* the performance of various firms and other economic units and to facilitate changes in management and/or ownership of past savings embodied in real and financial assets, and thereby to reallocate past savings to users where the benefits they generate are highest. This function is described, nowadays as the "market for corporate control".[6]

The *third* function of the financial system is to administer and *manage the payment* system, that is to say transfer payments covering current and capital transactions to and from individual firms, individuals and other economic units.

The growth process of a modern economy requires that risk-takers and entrepreneurs flourish. For that the financial system has to make funds available at a reasonable price. This, first of all requires that the uncertainties discussed in the previous section be kept at a minimum. Savings will be encouraged and better used if the risks and rewards associated with entrepreneurship are reasonably predictable and appropriately assessed. Above all, there should be no political risks, only business risks in the economic environment of entrepreneurs and firms. Finally, the volume of risks a decentralized market economy can assume will be greater if the financial system works in an efficient and orderly manner.

Needless to say, both the use of new savings for investment and the changing of the manner in which past investment is used involves risk-taking.

How new savings are channelled to various uses and how old savings embodied in physical and financial assets are re-directed is determined by the nature of the financial system and the system of corporate governance, the stage of development of the financial system, and the character of the regulatory (and legal) framework in which they operate. The links between risk taking and entrepreneurship in this framework can best be seen by

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[6] See further: Day-Eliasson-Wihlborg, 1993, *The Markets for Innovation, Ownership and Control*, IUI and North Holland.

reference to the main types of risk the entrepreneurs and the financial system assume and the basic functions the financial system performs.

Political risks affect directly and indirectly the macroeconomic environment, which in turn influences the workings of the financial system and the way it bears on the process of economic growth through its impact on the entry of new firms, their re-structuring and reorganization and their exit.

A well-functioning banking sector includes a rapid and secure payment system, a mechanism for allocating savings to profitable projects without undue risk, and a mechanism for monitoring and disciplining managers' behavior and for substituting good management for an incompetent one. The latter role of the banking system is often neglected but of great importance in countries without deep capital markets as in the Anglo-Saxon countries.

Although most of the transition economies now allow private banks, the old state banking system in slightly restructured form dominates. There exist plans for privatizing these banks but, so far, only Poland has taken the first step in this process. Privatization, and the proper disciplining role of banks enforcing budget constraints on firms are hindered by the back-log of bad debts on the balance sheets. These bad debts were given to state-enterprises during the communist period and expanded further in the initial transition face, when the enterprises would simply have gone under were it not for cheap loans provided by the banks and other enterprises in turn financed by banks. The state enterprises have simply been allowed to build up debt to continue production of goods that are not in demand. In some countries (e.g. Russia) enterprise debt has expanded through private banks set up by the enterprises with the sole purpose of tapping government funds.

The result of this process that still continues is that most banks as well as a large share of the state enterprises including their banks, have negative net worth making privatization difficult. Furthermore, the banks and firms with negative net worth do not have the proper incentives to finance healthy projects. On the contrary, they tend to finance high-risk projects with a small chance of a positive return, because it is irrelevant for bank and firm managers if the financial position deteriorates further.

There is a time-bomb ticking in this combination of bad-debt laden banks, and firms. Proper incentives can only be put in place by substantial debt-restructuring, but the restructuring is going to be so obviously costly that it is politically difficult to implement. When proper incentives are put in place such a large share of the old enterprises will go bankrupt that high unemployment is inevitable for a period.

It is understandable that the political authorities of most countries try to delay facing the problems hoping that they can slowly improve the enterprises and avoid the big shake-out. In most cases, however, the problem is simply getting worse because many enterprises can never be saved. Others, furthermore, are not under proper monitoring by banks and owners. Managers' incentives remain skewed as described above. The build-up of the debt problem can be made even worse over time by partial debt forgiveness schemes that do not go hand in hand with the imposition of harder budget constraints on firms and banks. The build-up of debt can then be continued by managers expecting further debt forgiveness in the future.

Poland and the Czeck Republic have taken some first steps towards the cleaning up of firms' and banks' balance sheets with the help of EBRD, and Poland is trying a process of "commercialization" of boards of directors and management. In principle, supervisory boards with the explicit task of running banks and enterprises with commercial objectives are installed. How successful this process can be while the banks and the enterprises remain state-controlled and with negative net worth remains to be seen. There are reasons to be skeptical, since successful commercialization requires that governments take a rather hardnosed attitude towards new lending and employment consequences of commercially sound decisions.

We believe that most transition economies have in front of them a difficult process of restructuring of banks and state enterprises. This process is the source of substantial risk for all investors, since it may lead to civil strife, highly inflationary macroeconomic policies, and/or severe depressions for a period of time. Political risks of types one and two will remain substantial in countries that do not face up to these problems.

Macro-economic instability impairs the effectiveness and efficiency of the financial system. Excessive instability in the price system, in exchange rates and in the level of real and nominal interest rates negatively affect growth in productivity, the amplitude and duration of economic fluctuations and employment. Such excessive instability occurs when changes in the different variables do not reflect adjustment to truly exogenous shocks but depend on badly functioning markets and on the behavior of policy authorities. Under conditions of macro economic instability the financial system cannot allocate resources efficiently, with adverse effects on the performance of the entire economy. Allocative efficiency is concerned with channelling new savings to investment projects forcing risk/reward ratios in line with the preferences of savers (see below)[7].

Under conditions of excessive instability the political risks attaching to the functions of collecting and allocating new savings are so large that it becomes impossible to price them and to trade them. Very few investment projects will then be undertaken and they will have a very short payoff period (i.e. very high rates of return will be required) tantamount to very short time horizons. The political risks associated with the re-allocation of old savings are essentially the same as those linked with the collection and allocation of new savings, resulting also in the adoption of a very short time horizon.

Finally, the risks associated with the third function performed by the financial system i.e. the management of the payments system carries a systemic banking system risk. Failure of one of the financial institutions which can be due to macro economic mismanagement, may set in motion a self re-enforcing destructive process which will bring down not only the financial system but also the real economy.

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[7] Operational efficiency has to do with optimizing output/input ratios given the state of technology and existing institutional and other constraints. The dynamic efficiency has to do with the ability of the financial system to respond to external changes in a positive manner, altering the structure of organizations, methods of operations and the instruments used.

4. THE LEGAL FRAMEWORK FOR CONTRACTS REGULATING INCENTIVES AND OPPORTUNISTIC BEHAVIOR

An inevitable source of business risks (it was argued in Section 2) is the possibility that parties to a transaction do not fulfill explicit or implicit obligations. Appropriate institutions should minimize such risks. Uncertainty about laws and conventions, hence, was classified as a political risk. In order to shed light on the nature of these risks in transition economies we discuss different forms of contracts and the rôle of laws and conventions in reducing the scope for opportunistic behavior, while providing incentives for efficient use of resources. In Sections 5 and 6 specific areas of law are discussed.

To achieve economic growth it is important to structure contracts such that maximum production value is achieved for given inputs. A necessary but not sufficient condition for efficient contracting is that property rights to resources are established. The contents of these rights determine the scope of permissible contractual arrangements. Requirements for establishing property rights and their content are shown in Tables 2 and 3. Institutions (laws, conventions) not only establish certain rights and legal procedures to protect rights or enforce contracts but also restrict the options available to business. The value of a firm depends on the set of options available.

Consider, for example, that institutions regulating, say, ownership of buildings and land may be missing in a formerly planned economy. It may, nevertheless, be possible using a substitute legal framework based on long term leases, to achieve the same risk reduction. The latter contractual arrangement may embody differently structured incentives, however, and have different real consequences.

Contracts and efficiency

The firm can be seen as a *nexus of contracts* regulating the sharing of income and risk among stake-holders (shareholders, lenders, managers, employees, customers, suppliers) as well as the obligations of these stakeholders.[8]

A *contract* regulates the conditions for the exchange of resources (property, goods, services, money, claims) in a transaction. It requires that *property rights* are defined, i.e. who can manage resources, access the rents and trade in the assets defining the ownership rights (see Table 3). Contractual rights must also be enforceable, requiring proof of ownership through, for instance, registration, unless simple possession is sufficient.

Efficient allocation and the alignment of incentives require that voluntary contracts are recognized and enforceable. Any hindrances to potentially mutually agreeable contracts imply that profitable transactions will not take place.

Simultaneous payment (delivery) of well-specified units is the simplest form of contract. Contractual costs and incentive problems arise rapidly when complexity increases. Sources of complexity are:

a) Specification of quality of goods or services
b) Uncertainty about factors influencing parties' ability and willingness to fulfill a contract
c) Long time horizons
d) degree of asymmetry of information

Since all contingencies affecting the performance of parties to a transaction are not known when a contract is entered, it is difficult to determine when breach of contract has occurred. All contracts are therefore incomplete in one way or another.

Fulfillment of contracts is always subject to unobserved behavior of parties causing potential "moral hazard". In other words, the contract may

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[8] Milgrom, R. and J. Roberts (1992) *Economics, Management and Organization* Prentice Hall provides a text-book treatment of this view of the firm.

induce unobservable risk-taking as is well known in the field of insurance. Institutional arrangements are often designed to reduce problems caused by such asymmetric information (incentive contracts, banks as monitors, etc.). Most of these contracts will be spontaneously formulated in the market.

Why are laws needed?

One role of explicit law is to provide *standard form contracts* reducing the costs of organizing a business venture. For example, a contract between those financing a corporation and those managing the corporation is complex. *Corporate law* should help parties to find the standard contract they would want to agree on in any case. We discuss this issue further in section 6.

Enabling rules (laws) supply either standard form contracts that can be amended and changed as desired by the contracting parties, but according to certain procedures. Such law permits parties to a contract (shareholders/managers for instance) to change their rules of governance to adopt to changing circumstances. Mandatory rules, on the other hand, prespecify the contracted arrangements among parties and have no room for deviation even if the parties would be in agreement. Enabling rules allow continous improvement on the standard contract. We discuss the potential costs and advantages of enabling law for EMEs below.

A second rôle of law is to aid the enforcement of contracts of different kinds. Without enforcement possibilities contracts are of no value and transactions/ventures may simply not take place.

We can distinguish between three types of enforcement mechanisms:

1) Self-enforcement
2) Court-enforcement of voluntary contracts
3) Court-enforcement of mandatory rules and standard form contracts.

An important question for economies in transition is how far self-enforcement in the market works, since legal expertise and experience may be lacking.

We can distinguish between three different kinds of self-enforcement[9]:

1) Reputation
2) Internalization
3) Bonding arrangements (hostages)

Contractual agreements are often self-enforcing, because parties do not want to risk their reputation in the market. Reputation is the standard enforcement mechanism in small matters, but it is important for any firm with repeated transactions with groups of firms and individuals. Internalization of transactions within firms in the form of, for example, vertical integration is a common way of solving difficult contractual arrangements. For example, if contracts between suppliers and a firm cannot be made credible, then suppliers may be integrated as subsidiaries. Countertrade arrangements, such as buy-backs, are also within this category.

Enforcement is particularly tricky for foreign investors operating in a foreign legal system. Arrangements by which contract-parties specify a law-system (foreign) that regulates their mutual transactions are possible. Even in this case it is necessary for the domestic authorities to provide legal "enforcement of last resort", however, unless reputation is sufficient to enforce decisions of a foreign arbiter or court.

Implicit contracts and legal tradition

A functioning market economy is based on implicit codes or conventions that (1) clear most transactions at low costs, (2) refer some unsettled and uncoded

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[9] See Rubin, P., 1992, *Private Mechanisms for Creation of Efficient Institutions for Market Economies*. Paper presented at the Arne Ryde Symposium in Rungsted Kyst, Denmark, June 1992.

cases to courts or arbitration arrangements and (3) leave remaining cases to be enforced by self-enforcement mechanisms.

Implicit codes of conduct that can be tried in higher courts, exist in countries that have developed a legal tradition over many centuries, a tradition that makes the consequences to investors of planned economic activity interpretable and predictable and hence reduces *political risks.*

Enabling vs. mandatory rules

Most economies in transition lack both legal expertise and a legal tradition, and there is considerable uncertainty for the foreseeable future about the capacity of the court system as well as about the ability of the courts to enforce verdicts in contractual disputes. In spite of the severe constraints on the capacity of the legal system, most transition economies seem to be in the process of adopting very detailed laws based on existing laws in western Europe and the USA. Table 3B provides a list of the great variety of laws that industrialized market economies have developed specifying in great detail how business must be conducted. The contents of property rights and the user rights to resources are thereby very specific and in many cases restricted. The capacity of the legal systems has been developed over time according to the requirements of the body of law. Existing law is therefore both enforceable and credible in the industrialized market economies although not necessarily efficient in an economic sense. Laws have been implemented with other objectives in mind besides economic efficiency.

Another characteristic of formerly planned economies in transition is that people are not used to having to consider what contractual arrangements are desirable in order to reduce the potential for parties to business transactions to behave opportunistically during the course of the business relationship. In modern economic terminology contractual arrangements in market economies are designed mainly to reduce "agency costs" implying that one party to a transaction is able to exploit the other party based on superior information at the time a contract is entered or better understanding of what

contingencies must be specified.[10] Experience is required to determine exactly what potential conflicts of interest could arise in the course of a relation when there is uncertainty about future economic conditions. Even with great foresight and considerable business experience it is impossible to cover in a contract all contingencies that may arise in the course of a longer term business relation. Thus, contracts are almost always "incomplete" and the legal system must not only be able to enforce contract terms covering foreseen contingencies but it must also be able to resolve conflicts based on contingencies that were not foreseen. The legal interpretative framework therefore should promote resolutions of such conflicts that promote economic efficiency. For one thing this means that people do not avoid entering profitable business relations for fear of being cheated. Such legal interpretative frameworks develop as legal practice in environments that look positively on economic proress.

Legal scholars in market economies have debated the relative advantages of *enabling* and *mandatory law* especially in the area of corporate law. Mandatory law rules specify the exact set of contract terms that regulate the actions of the parties to a contract under different conditions. Enabling law, on the other hand, leaves the specific contract terms open to the mutual agreement of the parties. Highly enabling law can nevertheless go a long way in specifying the potential sources of conflicts that must be addressed by the contract, thereby providing an outline of a "standard from contract" rather than its specific terms.

The distinction between enabling and mandatory law is of particular relevance for highly complex contracts such as corporate charters regulating the terms of agreement among several types of stakeholders in firms. It applies also to less complex transactions, however, as soon as the parties cannot immediately observe the degree of contractual fulfillment at the time of a transaction. For example, product liability law may specify in great detail whether the buyer or the seller must "beware" of different aspects of a

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[10] A common form of opportunism occurs when one party must invest in "relation specific" assets or knowledge. Once the investment is made the other party can extract "quasi-rents" (Klein, Crawford and Alchian, in *Journal of Law and Economics*, 1979).

product's quality, or it can leave the degree of buyer and seller responsibility to be agreed upon or determined in the market place.

The main argument in favor of enabling law is that it provides flexibility of contractual terms. These terms can be varied according to the needs and preferences of individuals and firms. The investors of firms change frequently as do products, technology, human capital requirements, etc. thereby exposing the firm to risk. Some activities of firms can be easily monitored by outsiders while others are hard to observe, even in hindsight. The argument has been made[11] that in sophisticated economies in particular there will not exist one single set of rules that will meet the needs of all investors, individuals or firms.

It is our intuition that the need for flexibility is even greater in the transition economies, where a legal tradition is yet to develop, and economic efficiency must be the primary objective of new institutions. In general, the particular legal institutions and traditions that develop are not identical across countries.[12] Cultural traditions influencing, for example, the strength of social enforcement mechanisms seem to be important for the design of efficient institutions. Similarly, education levels, industrial structures and other time-dependent factors affect the efficiency of alternative institutional arrangements. Most important for the case for flexibility is that it is impossible to know the most efficient institutional structure for a country regulating corporate governance and other complex relations involving several types of economic agents and many interrelated bodies of law. Section 5 below contains a brief discussion of the variety of corporate governance structures.

The arguments for mandatory law and against enabling law have primarily been made by legal scholars such as Eisenberg (1989), McCheney (1989), Gordon (1989), and Romano (1981)[13]. Their arguments are primarily

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[11] See Macey, J., 1992, *Corporate Law and Governance in Sweden: A Law and Economics Perspective*, SNS, Stockholm.

[12] Observe, for example, the great differences between Japan and the USA.

[13] Eisenberg: The Structure of Corporate Law, *Columbia Law Review*, 1989; McCheney, F.S., Economics, Law and Science in the Corporate Field: A Critique of Eisenberg, *Columbia Law Review*, 1989; Gordon, J.N., The Mandatory Structure of Corporate Law, *Columbia Law Review*,

based on agency costs when information is highly asymmetric among, for example, different types of investors and entrepreneurs. Macey (1992, op.cit.) refutes these arguments. Without repeating Macey's convincing arguments we would like to add one argument of particular importance for transition economies.

In transition economies where many investors and individuals lack experience in business deals, it is particularly important that individuals have the incentive to seek out the knowledge and information that will reduce the scope for opportunistic behavior. Highly detailed mandatory law specifying the terms of a contract under most contingencies would have the effect of reducing the incentive of contractual parties to gain an understanding of the potentially opportunistic behavior of other parties and of the contingencies that influence the success of a business venture. Mandatory law has an insurance aspect. It is not an insurance in the common sense that future outcomes are made more certain but nevertheless an insurance under different contingencies. Like other insurances, mandatory law influences incentives. In this case, the incentive to seek the knowledge to develop the most efficient contractual relations is reduced.

Finally, we ask what demands enabling and mandatory law puts on the capacity of the legal system. There is no clear answer to this question. Most likely there is an optimal degree to which law should be enabling from this perspective.

Consider three alternative models. In the most enabling model for the legal system, courts recognize all contracts that are entered voluntarily unless duress can be shown by one party. This model requires also that property rights are enforceable.[14] In the most mandatory case laws provide "standard from contracts" that specify in detail contractual outcomes under different contingencies. The third model is also highly enabling but "standard form contracts" specify only the different potential sources of conflict that must be

1989; Romano, R., Answering the Wrong Question: The Tenuous case for Mandatory Corporate Laws, *Columbia Law Review*, 1989.

[14] Compare the discussions of property registration above.

dealt with in a contract. For example, product liability law could require a producer to specify the aspects of product performance that the buyer need to and does not need to be aware of at the time of purchase.

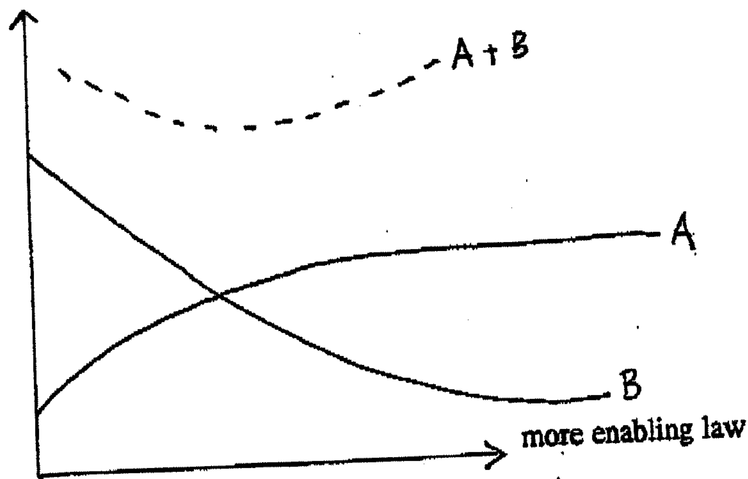
It must be recognized that all contingencies can never be specified even in detailed mandatory law. Questions of interpretation and applicability of contract terms will therefore arise in all three cases. The completely enabling case is likely to be more legally resource using in one respect, because a larger number of disputes arise when fewer contingencies are covered by contract terms. This consideration is particularly relevant for complex contractual arrangements. Mandatory law, however, is likely to be more legally resource using for other reasons. Specifically, unless the mandatory rules are perfectly aligned with the rules that the contractual parties would have agreed upon voluntarily, all parties have the incentive to argue for an interpretation of rules in their favor as soon as there is some ambiguity about interpretation. Such disputes would not arise if enabling contract models are used because contract terms would be those voluntarily agreed upon.

In conclusion we may hypothesize that there are two kinds of disputes requiring legal resources to different extents depending on the degree to which laws are enabling. Figure 2 describes our hypothesis resulting in an optimal degree to which laws should be enabling in order to minimize legal resource requirements for reaching a specific level of economic efficiency. Curve A shows how the requirements increase when laws become more enabling, because either contingencies are not covered in contracts or the costs of specifying the contracts are high. Curve B shows how legal resource requirements fall as laws become more enabling because the incentives to interpret mandatory rules in "self-serving" ways decrease. Thus, the sum of the two curves is likely to have a minimum where laws are neither completely enabling nor mandatory.

The location of the minimum point in Figure 2 depends on the complexity of the contractual relation. For simple contracts of short time-horizon between two parties highly enabling law may be most economical. For complex contracts like corporate charters, more well specified standard form contracts could be most economical. We return to this discussion of corporate

charters in Section 6, taking into account both legal resource requirements and the advantages of flexibility over time as discussed above.

Figure 2 Legal resource requirements to achieve a certain degree of economic efficiency



A: legal resource requirements to resolve disputes in uncovered contingencies/or requirements to specify conractual terms

B: legal resource requirements due to incentives to resolve disputes about interpretation

Implications for economies in transition

All formerly planned economies in Europe, except most of the (former) Soviet union, were forced after World War Two to abandon their established legal traditions or codes of conduct referring to business activities. They now have to be reinstituted and modernized. Legal code can be formally reinstituted or legislated, but *the complementary tradition has to develop.* In fact *far-reaching*

attempts to formalize tradition into legal code should be resisted since this would rather result in impossible complexity and unnecessary restrictions on behavior in places, where there would often be strong incentives to develop implicit codes of conduct without public involvement. One way to institute the corresponding reduction in political risks would be to borrow a foreign legal tradition until a domestic tradition has been developed. Many uncoded and uncodable rules and conventions, however, remain. Thus, the borrowed foreign code must be selected with care to serve as a complementary institution which grants investors (foreign and domestic) the right to take challenged domestic court judgements to a predetermined foreign court to be judged according to laws, precedent and legal tradition, in that country, if not resolved domestically.

5. CORPORATE GOVERNANCE

The behavior and success of firms (in terms of efficiency and valuation) is determined to a large extent by the institutional framework within which they operate. Such a framework comprises both formal and informal constraints. Formal constraints are those deriving from laws. Informal constraints are those based on tradition, customs, codes of conduct etc. The institutional framework determines both *transactions* costs and the so-called *agency costs*. The latter costs arise from the possibilities available to those working within a firm, and above all its managers, to capture for themselves part of the rent created by a firm by virtue of possessing information not available to others, and from emerging conditions which could not have been foreseen beforehand. If owners can only capture part of the rent from their investment, then the value of the investment, or of the firm is reduced.

Prior to industrialization and the wide-spread use of the principle of limited liability, production costs were to a large degree determined by transactions costs associated with the current business, including the extension and acceptance of trade credit. At that time agency costs were of little significance because owners were also managers. Extensive separation of ownership and management did not take place until well into the 20th century, even among advanced western countries. Until then there was no need for a separate law of Corporate Governance. With increased separation of ownership the needs for owners to monitor and enforce management performance increased. The distinction between transaction costs and agency costs became important. In the last decade the optimal way of structuring Corporate Governance to achieve economic growth has been discussed intensively in the West.

The widespread adoption of limited liability, combined with the expansion of business size meant both growing needs for external funds to finance expansion and increased reliance on other sources of finance than equity. The separation between owners and managers and the probability of a conflict of interest between them posed particular financing problems and agency costs gradually became more important. One particular agency cost has

to do with the loss in efficiency associated with difficulties of monitoring hired managers.

This was a problem in the planned economy and it still is (but in new form) highly relevant for the formerly planned economies. The dual problems of transferring public ownership entitlements to private hands through financial markets, to channel large financial resources to new ventures and to make sure that badly performing units are closed down make the institutional provisions for efficient Corporate Governance an acute policy issue.

In this context it also becomes important (see Tables 2 and 3) to understand the economic significance of:

a) separation of ownership, financing and management, and

b) transferability of ownership

The transformation of planned economies into market economies requires the re-establishment and modernization of a system of corporate governance in ex-Communist countries which (i.e. in all countries other than the former Soviet Union) was destroyed after World War 2. In the former Soviet Union an entirely new system will have to be created since no collective memory of how a system based on private property works can be expected to exist after more than 70 years. A system of appropriate corporate governance, which is concerned with rules – formal and informal – governing the economic intercourse between providers of funds to firms and those actually using them, i.e. managers, is of crucial significance in determining how effectively resources in the form of physical, financial and human capital (i.e. past savings) are used, how effectively they are re-allocated and how efficiently new savings are allocated. In so far as accumulated capital is significantly greater than annual savings the effectiveness and efficiency of the re-allocation of capital already in place is very important in determining the pace of advance of the economy, and appreciably larger than in a developing economy where capital in existence is relatively small.

Looked at from another angle corporate governance has two dimensions. The first has to do with the restructuring of firms. Apart from property rights legislation it covers rules regarding the entry and exit of firms - the former cover various types of legal forms of firms and the latter covers rules relating

to bankruptcy and liquidation - and also rules relating to changes in the ownership and management of existing firms.

The micro economic aspects cover the way management can manage the resources at its disposal and the constraints it is subjected to as for example regarding pricing, labor relations, trade and environmental restrictions as well as those arising from patent laws and other formal and informal rules. It is the restructuring aspects of corporate governance that are of overriding significance when considering the process of transformation.

The two important points which must be made here are *first,* that the system of corporate governance (which is linked to the financial system) changes as the economy develops and the financial system evolves. *Second* efficiently working market economies tend to be characterized by a secular shift to a market oriented and securitised financial system where capital markets play the pivotal role and where the corporate governance system increasingly relies on capital markets as a means of not only evaluating the relative performance of individual firms but also as a means of disciplining those whose performance is inadequate by means of threat of, and actual take-over. This development, now very marked in Anglo-Saxon countries is gradually being adopted in other industrial countries as an increasing proportion of savings is collected by non-bank financial intermediaries and also managed by them in fiduciary capacity.

As mentioned before the problems of corporate governance are closely linked to the separation of ownership and management which came to characterize industrial economies after the adoption of the principle of limited liability as embodied in various types of company legislation. Firms owned and managed by the same individual (or family) could, hence, gradually be replaced by joint stock companies that were financially more efficient for the emerging large scale industrial production organization. Hence, earlier family financing, except for small amounts of borrowing obtained as a rule from banks was also replaced by access to the larger funding capacity of financial markets. While the limited borrowings of the family owned firms did place the lender in the position to monitor, the performance of the borrower his interest was essentially limited to ensuring that the borrower would service his loan

and not in the most efficient use of his capital and other resources, let alone in expanding business in accordance with well perceived investment opportunities. Furthermore the rate of interest charged would be decided subjectively in each individual case. Such arrangements tend to be associated with what is described as a *bank oriented financial system* where the bulk of external funds is obtained from banks, and where the monitoring and disciplining functions are performed by banks in an administrative manner.

As is now the case in Germany and Japan, banks may also be holders of equity and debt in business firms and thus be central agents of financial control of the business sector. The function of monitoring and disciplining, involving change of management and strategy is performed within the group. The rationale behind that practice is that a reduction in transactions costs is believed to yield greater benefits than the cost incurred through agency costs. However, as economies expand and wealth is spread more widely among individuals and other savings collecting institutions a gradual shift in the exercising of corporate control has taken place. Above all, capital markets have assumed increasing importance in the monitoring and disciplining of firms and increasingly become responsible for the re-allocation of financial resources.

A bank-oriented financial system is often described as an "insider system". This is contrasted with a *market oriented system*" where the monitoring and disciplining in the form of take-overs are centered on capital markets. Such a system depends on an impersonal assessment of the performance of capital markets which gives rise either to internal measures intended to improve performance associated with a take-over, or an actual take-over embarked upon by those regarded as willing and able to achieve better results. Under such a system transfer of ownership can be considered as based less on more subjective and non-market related criteria than is the case of a bank orientated system.

The capacity of Western capital markets will be needed to finance the transition of formerly planned economies into viable market economies. Capital markets will furthermore be needed to facilitate necessary changes in ownership and/or management and impersonally assess performance of firms.

While the initial role of the system of corporate management will be modest and complementary to Bank centered groupings, its assistance in improving the efficient use of the existing limited stocks of capital and consequently the allocative efficiency of the economy will be critical for long-run macroeconomic success and rapid economic growth. An independent mechanism capable of evaluating the performance of individual firms and capable of being used to help reallocate existing resources, hence, is an indispensable and pivotal element in the transition of the formerly planned economies. The way the corporate governance institution is organized in each of the formerly planned economies will therefore be a distinguishing feature in their future success in transforming themselves into viable and growing market economies.

6. CRITICAL INSTITUTIONAL CATEGORIES

The institutions important for minimizing risks of opportunistic behavior in business relations are either formal (coded) or informally established as traditions and conventions. As noted, all western legislative practice rests on a vast structure of procedures relating to implementation and interpretation on top of coded law and precedent. Investors in transition economies face political risks even when written law exists, because implementation and interpretation practices have not had time to develop. For the foreign investor there is the additional problem of differences in encoded rules. Some problems may be overcome by the employment of locals, with experience of the host-country of the firm. In this section we discuss how a new market orientation might be introduced in order to promote efficiency. Practices in transition economies are very different, however, with potentially severe consequences for growth.

General considerations

To reduce political risks for foreign investors, they should feel confident, that all rules and regulations applicable to business firms will be applied in a non-discriminatory manner to domestic and foreign investors. Allowing for discriminatory treatment of foreign investors in a formerly planned economy, in an underdeveloped economy or in any economy will raise the fear for arbitrary treatment of potential foreign investors and contradict the purpose of creating institutions conducive to long term economic growth.

Some formerly planned economies like the Baltic countries, Poland, the Czecho Republic, Slovakia and Hungary, and, of course, East Germany, can fall back upon a legal Germanic-French tradition from a not too distant past; this tradition has to be reestablished and updated. In Poland, in particular, a functioning market economy based on pre-communist legal traditions has

existed continuously. Thus, for Poland the transition to a market economy implies an expansion of the coverage of this tradition[15]

An important *first* source of political uncertainty refers to unclear definitions of what is allowed and not allowed. The legal system of western market economies is primarily negative in the sense that what is not explicitly forbidden in law is permitted. In the socialist economies prohibitions were instead often general. Under such rules economic actions had to be explicitly listed in law to be allowed. Other economic activities were forbidden. Law, hence, became de facto positive allowing, for example, trade in "personal property", while transfers that were "excessive" relative to "personal" needs (commercial trading) were forbidden (e.g. in Hungary). Obviously, the free establishment of business ventures requires that exceptions from the right to trade are well-defined. By well-defined is meant, for example, that the state cannot by administrative decree abrogate rights to trade on general grounds such as "the good of the people". The establishment of new ventures, although in principle permitted, may be stifled by requirements that a number of permits and licenses be issued by administrative decision, without a well-defined legal foundation.

In spite of the rapid progress of legal reform in many formerly socialist economies a number of sources of uncertainty for business ventures exist.[16] One reason is that the socialist legal system was not generally abolished. Old laws have been allowed to remain in effect until new laws have been explicitly substituted for them. Similarly administrative procedures granting licenses have remained. Thus, vested interests have been able to hinder new ventures by means of, for example, permit-requirements. New and old laws may also be conflicting.

A *second* source of uncertainty regarding legal rules is *enforcement*. The court system, including judges and lawyers have to learn to implement a new set of laws without a tradition to build on. The capacity to deal with a new set

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[15] Professor Wjicynski, Poznan Academy of Economics.

[16] The series of "Policy Research Working Papers" on legal reform in formerly socialist countries published by The World Bank.

of cases is often insufficient. The lack of a strongly enforced legal structure need not, however, be a serious obstacle to a wide variety of business relations.

A *third* source of uncertainty is that property and legal persons are rarely well-defined in registers to ensure that transfers are effective and that contracts are enforceable. A particular and important problem arises if property cannot be used as collateral for bank lending. In particular, in the West individuals' real estate is often an important source of collateral for loans supporting entrepreneurs.

The areas of law important for the functioning of a market economy are real property-, company-, contract-, bankruptcy-, competition-, intellectual property, foreign investment, and financial institutions law. Constitutional law may also contribute to the definition of general rules for a market economy. These areas of law contribute to (i) the definition of property rights, (ii) the specification of means to exchange rights, (iii) the definition of rules for competitive market behavior, (iv) the enforceability of credit transactions, and (v) the definition of rules for corporate governance. Progress and problems in these legal areas are discussed briefly below. First we ask what minimal legal framework is necessary to promote growth in a market economy by enabling economic activity, while reducing the risk in economic transactions.

A minimal legal framework

As mentioned the socialist economies have substituted new law for old law and often retained administrative procedures governing business. An alternative strategy for the transition could have been to abrogate a whole set of commercial laws, thereby (implicitly) freeing a large range of activities previously prohibited.

Obviously, however, some law is necessary. It is not acceptable, for example, that physical force or the threat of violence define property rights or become the primary means for contract enforcement. In a legal vacuum with no enforcable prohibitions and/or no rules regulating allowed transactions, mafia type regulation and enforcement will develop to make socially necessary

commercial transactions possible. This is, however, a very inefficient system with high transactions costs. A viable market economy requires that parties to a voluntary transaction must feel secure that traded property changes hands securely, with a minimum of transactions costs, and each party must have some recourse to corrective action, other than threat of violence, in case of non-performance by the other party to the transaction. One requirement for this security is that the buyer knows that the seller has the right to sell. For many kinds of property simple possession satisfactorily defines ownership, but real estate transactions require more formal proof of ownership in the form of registration and title of ownership. This area is still unsettled in many of the formerly socialist countries.

Enforcement of financial contracts requires that property of a delinquent borrower can be identified. Similarly, contractual arrangements with and among firms require that property of the firm, and individuals signing for the firm are identifiable. Thus, firms as legal persons must be registered with the names of individuals acting as their agents.

Apart from these registration requirements for some property, security of contractual relations in the absence of detailed law requires that the state enforces voluntary and "reasonable" contracts i.e. those that are not entered under duress. Some kind of arbitration and dispute settlement mechanism is necessary, although such a mechanism can be agreed upon in contracts. Most important is that decisions of arbiters or courts are enforced by the state, even if arbiters and courts are foreign.

In the absence of state supported enforcement parties to contracts, fulfillment must rely on self-enforcement. As noted the most important mechanism of this kind is reputation. The threat of lost reputation is sufficient for many transactions involving established firms with repeated transactions within a well-defined group. Other types of self-enforcement are more costly. Requirements for advance payments, a bond, or the internalization of transactions within a firm are examples.

Does this reasoning imply that, for example, *company law* or *bankruptcy law* are unnecessary? The answer is no. Most likely entrepreneurship and a wide variety of business-ventures would exist without such laws, but "standard

form contracts" defined in law lower transactions costs and information requirements for stakeholders. Hence, efficiency requires that a minimum formal legal system exists. It is a matter of political economic competence to make sure that such a system is developed and/or allowed to develop.

The absence of company law would enable founders of firms to construct the corporate charter they like. The corporate charter protecting outside stakeholders, defining the liability of investors, and setting the rules for corporate governance would have to be submitted for registration and be made available to stakeholders. The main disadvantage with lack of standard form contracts is that suppliers of financial resources to a firm would have to study each corporate charter and devote resources to understanding specific conditions. With standard form contracts lawyers in a country are able to specialize and become experts on specific types of contracts. Similarly, judges who resolve conflicts become experts on a particular set of contracts, and interpret general aspects based on common business practices. The incentives of founders of a firm to choose a known contractual form in order to make the firm attractive to financiers, would reduce these disadvantages associated with the absence of explicit company law. Thus, standard form contracts and general business practices are likely to develop in any case although at a slower pace as argued in Chapter 4.

Similar arguments can be made about the advantages of formal bankruptcy law, although with less force. Without formal procedures for liquidation and reorganization, banks as primary lenders and monitors of borrowers would be able to establish control over firms in distress by withholding financing. Thus, the major conflicts of interest would exist between banks and other stakeholders, but banks would have incentives to ensure that suppliers of inputs and workers would not withdraw their services and force liquidation prematurely. For firms to gain access to direct borrowing in securities markets well-defined bankruptcy law is, however, necessary. Thus, the development of bankruptcy law is likely to be correlated with the development of financial arrangements discussed in Chapter 5 above.

This discussion implies that rules and regulation governing all depositary institutions (i.e banks and similar organisations) and other financial

institutions and intermediaries become important for the resolution of potential conflicts in distressed firms. It is particularly important that laws do not distort the attitudes of financial institutions towards risk. State protection of depositors' and investors interest must therefore be structured very carefully, if banks and other depositors institutions are involved in distressed firms. Similarly, restrictions on depository institutions' holdings of equity and other assets must be structured in a way which, while protecting the interests of depositors do not prevent them from assuming a degree of risk acceptable to owners of such institutions.

7. THE DEVELOPMENT OF LAW IN TRANSITION ECONOMIES – CASE DESCRIPTIONS

The transition of legal systems from those of socialist economies to those designed for market economies has in fact progressed rapidly in most countries of eastern Europe. Severe problems of enforcement and conflicts among old and new law, however, exist. As an illustration relevant law in Hungary and Estonia is reviewed here. We will follow the classification in Tables 2 and 3 for requirements and contents of property rights.

THE CASE OF HUNGARY:

Requirements for property rights (Table 2)

The *constitution* establishes protection of private property and general rights to freedom of association. It lists a number of fundamental rights as is common in democracies. Those rights are no longer subject to interpretation in terms of the higher "interests of socialism".

Real estate ownership and rights associated with it has been defined in "Act I of 1987 on Land". A private Hungarian may acquire real estate without any legal limitation. There is still ambiguity with respect to title to land, that was nationalized during the socialist years.

Foreign ownership of agricultural land is generally prohibited. Other types of land can be owned by foreigners if permission is granted. Hungarian subsidiaries of foreign corporations can own land for purposes related to the objectives of the corporations.

Foreign ownership of firms and real property is allowed with no percentage restriction. No permission is needed and foreign investors are guaranteed compensation in case of expropriation.

Rights to intellectual property exist or are proposed, but enforcement capabilities are lacking. Although rules are, or will soon be harmonized with the European norm, infringements are not easily curbed.

Contents of property rights (Tables 3 and 3B)

Table 3B specifies in greater detail than Table 3 the many areas of law influencing the content of property rights. Laws are divided into three groups. The first determines managers' "and owners'" ability to establish and run a business as they desire. The second group influences how profits can be used according to owners' discretion, and the third group determines owners rights to trade resources of different kinds. The groups overlap to some extent but provide a rough classification scheme and it illustrates the wide ranging fields of law influencing different aspects of a business operation.

Without going into details of the Hungarian laws determining the contents of property rights a few observations illustrate the progress that has been made and the problems that remain.

User rights to real estate are still restricted or ambiguous as a result of regulation from the socialist period. For example, restrictive eviction procedures remain. Authority over zoning and building regulation is unclear. A number of public authorities previously involved in giving permits still exist and clear procedures for seeking permits have not been established.

Company law recognizes a number of business forms. It is a Roman based law as distinct from the Anglo-Saxon approach. Procedures for registration of firms as legal persons are well-defined and reasonably simple (this is not the case in all formerly socialist economies).

A new *bankruptcy law* exists. It deviates from international norms in one respect. Claims of creditors secured by lien on assets have lower priority than claims for wage and severance payments. This provision could dampen the supply of credit against security. A major problem of implementation exists, as well. The capacity to deal with the surge of bankruptcies simply is not there.

Regarding *ownership rights*, Hungary has removed legal impediments to trading for commercial purposes and private property is granted the same level of protection as state property.

Contract law incorporates standard western concepts but many obsolete administrative requirements and restrictions remain. Courts do not have much

experience in dispute resolution. Thus, the substance of contract law and the extent of freedom of contract will be determined over the years.

A new *competition law* took effect in 1991. It gives wide discretion to the antimonopoly office and the courts. Interpretation and application of the law is a challenge for the future.

Profit repatriation is allowed provided the firm has local currency (the forint) on reserve. Thus, profits must be received in forints before repatriation is possible. Hard currency accounts in Hungarian banks can be maintained. These rules are liberal relative to many formerly socialist economies.

The corporate tax is 40 percent but the law offers industry-specific tax incentives for foreign investors. The incentives are temporary, as well as time-limited, however.

In summary, Hungary has moved quickly to establish the legal framework necessary for a viable market economy. Efficient markets for trading in privately owned land are hindered by inaccurate land registry and a surviving inefficient regulatory structure. Implementation of the new legal structure is made difficult by a lack of court capacity and legal expertise, as well as by a lack of well-established business practices in the new environment. Thus, foreigners trading with Hungarian firms and individuals must rely heavily either on self-enforcement, by dealing with parties with a reputation at stake, or on contractual arrangements for dispute resolution by foreign courts or arbiters.

THE CASE OF ESTONIA[17]

Requirements for property rights. (Table 2)

The Estonian constitution states that citizens, foreign citizens and stateless persons enjoy equal rights, liberties and duties, listing all fundamental rights common to a democratic state.

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[17] This section is taken from Kukk, M., 1993, Privatization in Estonia: Political Risks for the Foreign Investor, IUI, mimeo.

Private property rights are given basic guarantees by the constitution, but ownership rights are stipulated in more detail in the Property Act (13.06.90) which defines the rights the owners enjoy and confirms the equality of the owners before the law. Private and state property are equal before the law. The owner is vested with the right of control, use, and disposal of his property. (Property Act, $ 4, 1). This act also states that the fruits, yield and revenue obtained from property belong to the owner of the property, unless provided otherwise in the law or in contract. ($ 6, 2).

Real estate ownership and rights associated with it are defined in detail in the Law of Estate which also regulates mortgage and collateral transactions. Ambiguity remains with respect to title of real estate

a) *which* was nationalized and is now claimed back by former owners whereas the present owners (the state has given them the right to own the estate) have substantially improved the real estate under question (have built new buildings, etc. on it);

b) *which* has to be first re-nationalized (trade union property, etc.).

Acquiring real estate is not limited to an Estonian citizen. Legal persons however, cannot be land-owners according to current law. This situation is expected to change in the course of time.

Foreign ownership of agricultural land is prohibited, but leasing land is allowed for foreigners. The Privatization Law enables a foreign investor to purchase land which is directly related to purchased property, provided the Government of Estonia so approves.

Foreign ownership of real property and firms is allowed and the regulations are reasonably clear and manageable. Nationalization, expropriation or confiscation of property is not allowed, except in cases listed by the law. In

such cases the foreign investor has a right to fair compensation and appeal to the court in case of dispute.

Rights to intellectual property are acknowledged by the Property Act. The Trade Mark Act regulates intellectual property rights connected with business activities. The copyright Act regulates protection of literary, artistic and scientific work. The implementation of the protection of these rights is however in the initial stage and is to a large extent dependent on contractual arrangements.

Contents of property rights. (Tables 3 and 3B)

User rights to real estate which is obtained by privatization or restoration of ownership, are clarified by the Land reform Act and the Law of Estate. The former foresees several restrictions for using land acquired by restoration or replacement and privatization. Those restrictions also count for the lessees of land. Foreign enterprises can lease land under the same conditions as Estonian enterprises. User rights to real estate within a city or a borough can be limited by the local authority via licensing in case of establishing enterprises with foreign capital. The foreign investor can appeal to a higher state body and finally to court if the decisions by the local authority do not satisfy him.

No spheres of activity are prohibited for foreign investors. Licences are however, required to operate in the following fields:

- mining;
- energetics, gasworks and waterworks;
- railway and air transport;
- waterways, ports, dams and other water transport establishments;
- telecommunications, communication networks.

There are fields of activity where all enterprises, even Estonian firms require a license, such as the establishment of commercial banks, the provision of medical treatment, producing and selling medical substances, insurance, producing and selling alcoholic beverages and of firearms and ammunition, etc. Foreign investors have the right to export foreign currency which is received as a profit from the sale of their share of an enterprise's assets or from the dissolution of an enterprise.

The Enterprise Act recognizes a number of business forms. Procedures for registration of firms as legal persons are reasonably simple and clear. *The Partnerships Statute and Stock Corporations Statute* regulate the formation, liability and termination of general partnerships ("full partnership"), limited partnerships ("trust association") and joint-stock companies, as well as stock corporations. *The Leasing Act* regulates the use of property on the basis of a leasing contract which is rather common in Estonia.

The accounting law stipulates the responsibility of top managers and persons responsible for book-keeping of all enterprises. The law follows European standards in guaranteeing the presentation of correct data by entrepreneurs.

Rights to fair competition and to the safeguarding of business secrets are guaranteed by the *Competition Act*. This law also prohibits all action by the state authorities or local governments which is in contradiction with it, and is not allowed by other laws. The Competition Act will be in force since two stages: antimonopolist part since October 1, 1993 and contractual part since January 1, 1994. Implementation of this law will present a serious challenge for both the state agencies and the court system.

The Foreign Investment Act establishes a legal platform to determine the benefits to foreign investors and guarantees of protection of foreign investments. Together with the Law on Tax Concessions for Foreign Capital Enterprises this Act establishes the main framework for foreign investments.

As a general rule, all regulations which apply to Estonian enterprises equally apply to foreign-owned enterprises.

Foreign investors enjoy certain *customs benefits and tax relief.*

The Bankruptcy Act is largely based on the experience of Sweden and Finland. It is the first of its kind in Estonian history. The fundamental principle of the Bankruptcy Act is that the rights of lenders are given strong protection. The concept of bankruptcy and bankruptcy proceedings are essentially the same in the law of Estonia as they are in the laws of other countries. The Estonian Bankruptcy Act reduces the functions of the court to give creditors a more active role to agree voluntarily. The trustee has a rather extensive, independent mandate that enables him to guarantee the claims and lawful interests of the creditors. The order of satisfying claims: 1) secured claims (guaranteed by collateral); 2) wages and income which may be regarded as wages; 3) taxes and social security payments; 4) all other approved claims.

The Securities Market Act regulates the questions related to securities and stock markets in Estonia, stipulating that by November 1, 1993 all professional traders in the securities market have to adjust their documents and activities to this law. All professional traders of the securities market are licensed by the state authority. Stock markets and money markets exist in Estonia, but their activities have until now been rather limited.

The right to just treatment and appellation to court or arbitration is provided to the foreign investor by all the aforementioned legal acts, and, as stated in the constitution, before the law, the foreign investor in Estonia is equal to an Estonian citizen.

Besides the legal system of Estonia it has to be noted that a number of guarantees for the foreign investor are provided by international treaties and conventions. The Estonian constitution states that universally recognized principles and norms of international law shall be an inseparable part of the

Estonian legal system. Investment protection and trade agreements have been negotiated between Estonia and other states.

Mutual investments have been protected under the provisions of investment promotion and protection agreements concluded with Denmark, Finland, France, Germany, Netherlands, Norway and Sweden.

Iceland and Sweden have concluded Most Favoured Nation (MFN) agreements with Estonia.

Free trade agreements have been concluded with Finland, Sweden, Norway and Switzerland.

Relations with EFTA are characterized by the joint declaration by EFTA member states and Estonia.

The Estonian Government is currently negotiating with several countries for the completion of bilateral agreement for the avoidance of double taxation.

HINDRANCES FOR ESTABLISHMENT OF NEW BUSINESSES – AN INTERVIEW STUDY OF ESTONIAN FIRMS[18]

We report here on an interview study of 24 Estonian firms' contractual relations and hindrances for business establishment. This report is preliminary. Our plan is to extend the study to a larger number of firms and to repeat the study three years in a row. The study will hopefully be conducted in three other transition economies, as well.

The 24 firms reported on in this section were of varying size. Eleven firms have less than ten employees, six have more than 100. The state held a substantial interest in only four. Most small businesses are privately owned.

Start-up financing

Private savings dominate as a source of start-up financing. Only one of the firms had obtained a bank-loan to finance the purchase of a building. No equipment had been financed with a bank-loan. This result indicates that the banking system fails in an important function.

Supplier relations

In 19 of the 24 cases suppliers had to be paid at the time of the order or cash on delivery, reflecting a lack of belief in the enforcement capacity of the legal system.

Customer relations

The response here was similar to that for supplier relations. Trade credits were given domestically in only four cases. Credits were provided for export sales, however.

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[18] The study was conducted by a research team led by Vello Vensel, Tallinn Technical University.

Banking services

Firms expressed dissatisfaction lacking the possibility to borrow short-term to finance working capital. There were also wide-spread complaints about the high level of interest rates. The speed of banking services, including payments seemed satisfactory, however.

Regulatory hindrances

The Estonian regulatory system does not seem to seriously hinder the establishment of new business, although 80 percent of the firms faced some difficulty in the form of requirements by the tax-authority, or bureaucracy in government offices.

Restrictions on the *closing of businesses* were perceived to be more severe. The government restricted the right to sell enterprises, and the cost of firing workers was perceived as burdensome, unless the whole firm was permanently liquidated. Firm managers expressed views on whether temporary lay-offs were legal or illegal.

Conflict resolution

All firms reported on conflicts in the form of non-payment by customers, non-delivery by suppliers, and failing transfers by banks. In the vast majority of cases, firms relied on direct bargaining with the other party to resolve disputes. The interviewers argued that Estonian legislation is not sufficient for the resolution of conflicts. Arbitration and, in one case, international arbitration, was used in six out of 85 disputes. Courts were used in seven cases.

General hindrances for business establishment

The most severe hindrance for business establishment or expansion in Estonia during 1991 and 1992 was a lack of demand and excess capacity in existing industry. Formal regulatory hindrances are nearly irrelevant but the

government prevented the sale of enterprises and temporary lay-offs of workers are discouraged. There are severe financial constraints on business establishment as well as business operations. Start-up financing depends almost entirely on private savings. Retained profits is the dominating source of financing of operations. Conflict resolution must generally be handled informally.

8. SEPARATE RULES FOR FOREIGN INVESTORS?

Many countries, and especially developing countries have often treated foreign investors in a discriminatory manner, applying one set of rules and laws to them and another set to domestic investors. They have done so by first restricting, in an arbitrary manner, acquisition of assets and trading in them; second, by restricting transfer of profits; third, by applying to them special rules of arbitration. This is synonymous to the removal to the three critical aspects of property rights (see Table 2). It is an effective way of increasing political risks of type three (in Table 1) and of reducing growth promoting foreign investments.

The first two methods limit options available to the foreign investor and insulate domestic capital markets and indirectly also markets for goods and services from world markets; in addition the third method introduces an obstacle to the foreign investor in that he is made subject to different and arbitrarily imposed rules and regulations.

Restrictions on the purchase and trading in assets prevent the foreign investors from appropriately valuing the assets in the light of changing market and other conditions, and to alter their portfolio composition against the background of internationally accepted and prevailing criteria. Such restrictions are often politically motivated with little economic justification and indeed, economically detrimental for the long run economic development of the receiving country. Restrictions on the transfer of profits tend to reflect inability of domestic producers to earn an adequate rate of return because of a low level of competence and/or a distorted domestic price. The use of either of these methods prevents full use to be made of resources available.

If rules are applied in a changing and non-predictable manner they increase political risks. The introduction of special rules of arbitration, allowing recourse to internationally accepted and recognized as well as binding judicial court rulings, reduces political risk and the potentially very large risk premia required by foreign investors. Hence, to attract foreign investment in sufficient volume to help transform the formerly planned economies, enforceable rules of the type institutionalized in western market

economies will have to be established in the EMEs for them to become at all EMEs. The analysis of the previous chapters, however, also establishes very strongly that exactly the same rules should also apply to incumbent investors, if the emerging market economy is concerned about eventually seeing also domestic investors capturing a fair share of the market for corporate control.

9. WHAT CAN THE WEST DO?

In the light of the analysis presented the main task of the West must include the following: first, to help set up appropriate institutions; second to provide seminal managerial and related know-how, third, to provide financial assistance for the establishment of a viable financial system including above all the banking system as well as other savings collecting and savings allocating organizations such as venture capital companies; fourth, to underwrite certain political and commercial risks that private institutions are unable to insure. Such measures would increase the inflow of capital.

Needless to say these measures should be linked with the policy package designed to secure macro-economic stability and involving the liberalization of prices, budgetary equilibrium and responsible monetary policy.

(Table 5 in about here.)

To facilitate the transition of formerly planned economies to market economies the West must emphasize (see Table 5) the creation of the necessary institutional structures, not only to make changes in the way firms operate possible but also for macro-economic stabilization. Without the new institutional framework economic advance is likely to be slow, erratic and inadequate to build the political support without which the process of reform is easily de-railed. We do not believe that efficient help from the west should come in the form of direct Government financial aid. All experience from the underdeveloped world suggests strongly that such help is detrimental to long term growth. The west should focus on supporting the creation of institutions that provide private incentives for long term investments and that support competition and an effective disciplining in the use of resources through markets. Three such institutions are especially important; the creating of a functioning *property rights system*, the building of a viable *banking system* and the *reduction of political risks in business transactions*. This is not only necessary for initiating investment and growth in domestic institutions. It is absolutely

critical for inducing foreign investors to commit large volumes of long-term investments to transaction economies.

In more specific terms what is desirable is *first of all* a clear, indisputable and irreversible *commitment to property rights* applied in a non-discriminatory manner to residents and non-residents. The setting up of this basic foundation will benefit from the encouragement the West can give by supporting intellectual debates and participation of scholars, politicians and serious students.

The creation of formal and informal rules specifically supporting property rights in the business sphere to be accepted in countries that have been isolated for more than half a century from western culture, will have to be (in turn) supported, encouraged and facilitated through debates and discussions, scholarly and policy oriented, covering legislation and business affairs and extending from the setting up of enterprises, their management and sales and liquidation to the running of their day-to-day affairs. Formal rules in this field have to be embodied in commercial code, and also civil and criminal code must be clear and non-discriminatory as between residents and non-residents. They should be supplemented, however, by the creation of informal constraints imposed by professional bodies of various types, be it in the legal, accounting and actuarial or other areas. Direct intellectual help in this field can be expected to yield very good returns. What needs special emphasis in this context are the facilities which are made available by various international institutions concerned with business intercourse, as for example those of the ICC which provide model approaches as well as facilities for arbitration. It should be stressed that ICC cooperates closely not only with various governments, with which it has been involved but also cooperates with a number of world-wide officials and private institutions such as the World Bank.

Because of the subordinated and mechanistic nature of banking under the Communist system, (they were used merely to distribute funds collected by the fiat of the state to uses determined by the planners), their assets include a large number of bad or doubtful loans extended to state firms. These loans cannot be repaid because the firms which obtained them are in

no position to service them. Without going into various technicalities, what is needed in this context is a direct injection of new funds to help write off genuinely non-viable-loans. This re-capitalization of banks and to a certain extent also of enterprises enabling banks to begin to operate as proper lending institutions, i.e. allocating savings, monitoring their use and discipling those responsible for the employment of savings. Thus, the *second* requisite for a viable market economy where the West can effectively support the transition economies will be in the creating of a viable banking system. Such a system is also necessary to solve the macro-economic problems of fiscal deficits. To reduce fiscal deficits the burden of write-offs require that taxes be raised, and/or that financing be arranged by the printing of money. This requires both fiscal and monetary discipline on the part of authorities. A viable banking system should impose such discipline on authorities.

Direct financial assistance could also be extended from the west to set up joint-venture capital companies which would benefit from foreign expertise and assist the growth of small and medium size companies. They would be the acorns from which large trees would grow in the future.

Similar assistance, in creating financial institutions should be extended to the insurance sector, including pension funds. General and life assurance business - apart from technical considerations - should be integrated into the world markets by liberalization and acceptance of Western standards. Special efforts should be made as regards insurance covering foreign trade with the view of stimulating the progress of exports and investment led growth.

The *third* critical institution where western help is necessary concerns *the minimization of political risks* to induce local, but above all foreign investors to make long term investment commitments. The nature of a political system in general and the special instabilities of the political system of transition economies in particular, makes it difficult for such economies to establish the needed credibility in their systems themselves. The creation of that credibility is their most important policy. It will involve extraordinary social and political competence. In that task the West could be instrumental in underwriting certain political risks in a manner that minimizes, or eliminates the

opportunistic political behavior of so many underdeveloped nations that have received aid from the west. This idea[19] (developed in detail in xxx) is to extend direct aid to the transition economies in the form of underwriting of the political risks of foreign investors' long term commitments. The equity of those insurance institutions would be made available to the receiving countries over a very long time period (50 years or so) provided it has not already been used to cover losses of foreign investors due to opportunistic political behavior on the part of receiving countries. On the other hand, this scheme would be a very good business for countries that can manage themselves politically through the transition.

Summarizing so far, the private sector in the West, can help the economies in transition to establish the desirable priorities as regards institutional arrangements and especially those covering the financial area, with special reference to the role of foreign finance. The private sector should supply technical and commercial knowhow for a profit. The Governments should focus their support on intellectual support to shape the necessary institutions for growth and direct aid in the form of underwriting political risks for foreign investments in the receiving country. Such arrangements should minimize opportunistic behavior on the part of both Governments in receiving countries and private foreign investors, they should minimize political risks and involve a minimum of direct Government funds. The arrangement would operate on private incentives and private capital and be monitored by efficient capital market institutions. The West would thus be able to assist in helping to increase standards of competence and to establish or re-establish links with Western institutions. On the basis of their knowledge and experience these in turn can help provide basic models of specific private institutional arrangements which can be modified and adjusted to suit special conditions. Those covering in detail the approaches to foreign investment would be of special importance.

[19] developed in more detail in Eliasson, G., 1993, *Reducing Political Risks and Moral Hazard in East West Financial Relations*, IUI Working Paper No. 388.

The institutional aspects of the transition of formerly planned economies to market economies have not yet received the attention they deserve. Yet the costs for the West of helping setting up proper arrangements in this field are likely to be relatively low, and from the cost-benefit angle the results of efforts devoted in this field can be expected to produce excellent results. In fact, for the western and the transition economies together the long term outcome would be positive through a dramatic increase in output per capita due to increased internationalization of resources and more efficient production.

10. CONCLUDING REMARKS

The main thrust of this paper is that the transformation of ex-Communist economies into market economies needs the creation of sound, viable and flexible financial institutions at the micro-level. This in turn requires macro-economic stabilization. Without macro economic stability individual enterprises, which constitute the core of economic progress cannot function properly and cannot adjust themselves to changes in market demands, technology and competitive pressure.

Institutional aspects of the transition, together with those relating to the restructuring and recapitalization of banks and the re-establishment of a properly functioning financial system deserve special emphasis. A well structured and orchestrated approach as outlined in this paper can be expected to handsomely and quickly produce the desired results.

Figure 1 The structure of political objectives, agents of growth and supporting institutions

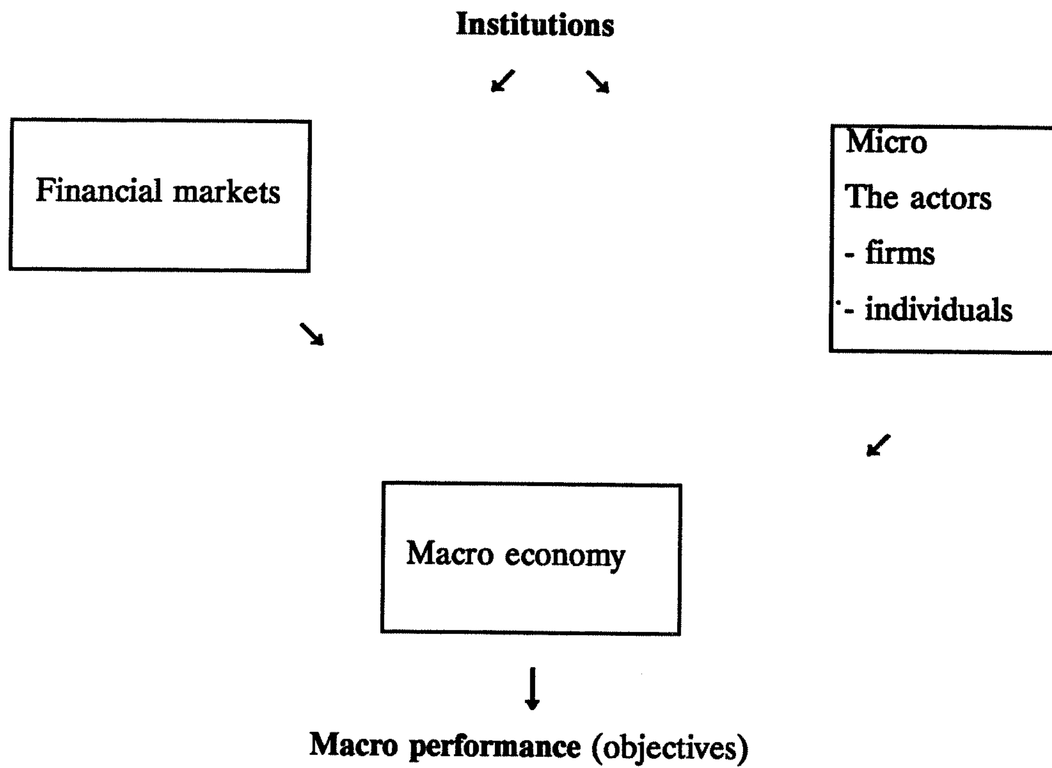

Table 1 Risk Hierarchy

Political

1) Force Majeure – *first* order risks referring to non-economic events – military etc.

2) Force Majeure – *second* order risks referring to macro mismanagement – collapse of monetary system

3) Institutional Deficiencies controllable by political authorities - *third* order risks

Business

4) Rules monitoring and controlling opportunistic behavior on the part of business agents.

5) Business risks

Table 2 Legal requirements for property rights

1. Property rights legislation
2. Registration of legal persons
3. Exact rules for identifying property rights with legal persons.
4. Court recognition of voluntary contracts
   a) implicit
   b) formal

Table 2B

Institution	Economic transaction supported
1. **Property rights**	– constitutional property rights – criteria for possession – purchase law – land law – copyright law – patent law – trademark rights
2. **Registration of legal persons**	
3. **Exact rules for identifying property rights with persons**	– land and property registers – company law – accounting law
4. **Court recognition of voluntary contracts**	a) Enforcement of voluntary contracts – laws regulating the resolution of disputes – instance of last resort b) Procedure and stability of law – enforcement – implementation – interpretation – change

Table 3 Economic Dimensions of content of property rights

Right to

1) *Manage* the property
2) *access* and use the profits
3) *trade* in the property rights.

Table 3B

1. MANAGEMENT RIGHTS*

New Establishment/exit (access)

- entry restrictions
- company law
- bankruptcy law

Corporate Governance (finance)

- laws regulating mergers and acquisitions (commercial codex)
- laws regulating industrial (universal) banks in German and the corresponding Anglo-Saxon tradition
- Poison pills, hostile take overs
- Insider trading

Operations (production)

- Labor relations law
- Renting or buying land, buildings, machines
- Licensing
- work permits for foreign nationals in local subsidiaries (work permit regulations)
- work quotas for local people
- Payment restrictions
- Regional policy
- Environmental and health standards
- Liability and Tort law

Competition (markets)

- trade restrictions
- anti trust law
- restrictions on predatory pricing
- patents
- price controls
- credit controls
- laws & regulations on transfer of technology
- discriminatory environmental laws

Monitoring and Control (disciplined)

- accounting law
- auditing law
- contract law
- reporting requirements

2. ACCESS AND USE OF PROFITS

– convertibility of currency/exchange controls
repatriation of profits
– restrictions on the transfer of funds
– tax law
– income taxes
– deductions
– stamp taxes, etc.
– double taxation rules
– extraterritoriality
– judicial appeal in tax matters
– bankruptcy law
– investment guarantees
– laws on insider trading

3. TRADING RIGHTS

– Restrictions on selling assets in secondary market
– Ditto, ownership contracts
– Restrictions on investors to buy
– Stockmarket law and regulations
– Laws regulation foreign ownership
– Rules of indiscriminatory treatment
(level playing field)
– Laws requiring local ownership
– Special financial facilities to hedge

Table 4 The three functions of financial markets

(1) Collecting and allocating financial (accumulated and current) savings (competition)

(2) Monitoring and disciplining the user of savings (controls) including management of risk.

(3) Running the payment system.

Source: Rybczynski, T. 1993, Innovative Activity and Venture Financing: Access to Markets and Opportunities in Japan, the U.S. and Europe, Chapter 3 in Day-Eliasson-Wihlborg (eds.) *The Markets for Innovation Ownership and Control,* IUI and North Holland.

Table 5 What Is Needed to Persuade Foreign Investors?

1. Private Investment

2. Public

   a) investment

   b) aid

3. Insurance

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