Comments

Edgardo Buscaglia: The paper by Florencio López-de-Silanes provides an extremely effective and well-conceived guide for academics and practitioners focused on fostering politically sustainable, efficiency-enhancing legal and judicial reforms. The piece also provides a survey of the most recent literature on best-practice judicial and legal reforms. Yet the list of factors enumerated in López-de-Silanes's paper is not comprehensive. The comments below build on previous research to identify additional necessary elements of legal and judicial reforms, as suggested by national experiences within the region.

The mix of increasing political democratization and the adoption of market reforms has created additional, but unfulfilled, demands for improvements in legal and judicial frameworks throughout the developing world, fostering the need for more effective private and public dispute resolution mechanisms.[1] Within this context, the political and economic forces preconditioning improvements in judicial performance clearly must be understood and accounted for. These preconditioning factors must be focused on the "right" kind of legal environment within which judicial efficiency-enhancing court rulings can later be enforced in an unbiased and transparent fashion.

International experience shows that the likelihood of successfully implementing the legal frameworks that the author has in mind depends not only on the institutional capabilities of enforcement that are rightly enumerated in López-de-Silanes's paper, but also on the political benefits and costs tacitly assessed by the main groups of political actors with the capacity to propose and implement the necessary reforms.[2] An effective design for legal and judicial reforms therefore cannot stop at taking into account the costs and benefits to society of enhancing the quality of the judiciary in general. Equally important are the changes in present and future individual benefits and costs as anticipated by public officials whose

1. Buscaglia (1998).
2. Buscaglia (2001).

perceived rents and power will be altered as a result of legal or judicial reforms that would limit their excessive discretion, enhance institutional transparency, and introduce impact-based government targets (that is, results-based management).

For example, previous studies of judicial reforms in Latin America argue that the institutional inertia surrounding the enactment of reform stems from the long-term nature of the reform benefits, such as increasing job stability, judicial independence, and professional prestige.[3] Contrast the long-term nature of those benefits with the short-term nature of the main costs of judicial reform to reformers (that is, the diminished capacity of politicians to bias or block court rulings, in particular, or law enforcement, in general). This contrast between the public officials' perceptions of their short-term costs and long-term benefits has proved to block judicial reforms and explains why court reforms, which eventually would benefit most segments of society, are often resisted and delayed.[4] In this context, court reforms promoting uniformity, transparency, and accountability in law enforcement would necessarily diminish the politicians' and court personnel's capacity to abuse their discretion, which translates into a loss of power and illicit rents in the short term. Reform sequencing, then, must ensure that short-term benefits to reformers compensate for the loss of discretionary powers previously enjoyed by public officials responsible for implementing the changes. That is, initial reforms should focus on the public officials' short-term benefits. In turn, court reform proposals generating longer-term benefits need to be implemented in the later stages of the reform process.

Unsurprisingly, periods of institutional crisis come hand in hand with a general consensus among public officials to reform the public sector. Within the judiciary, for example, a public sector crisis begins when backlogs, delays, and payoffs increase the public's cost of accessing the system to the extent that people restrict their demand for court services and question the legitimacy of judicial institutions. At that point, court officials increasingly embrace reforms in order to protect their institutional domain in the midst of public outcry.[5] The public agency would likely be willing to conduct deeper reforms during a crisis as long as reform proposals con-

3. Buscaglia, Dakolias, and Ratliff (1995).
4. Buscaglia, Dakolias, and Ratliff (1995).
5. Buscaglia, Dakolias, and Ratliff (1995, p. 35).

tain sources of short-term benefits, such as higher salaries, institutional independence, and increased budgets.

Developing countries that have undertaken significant, impact-oriented judicial reforms have all experienced a deep crisis in their court system, including Costa Rica, Ecuador, Hungary, and Singapore.[6] In each of these countries, additional short-term benefits accruing to high-ranking court personnel guaranteed the political support of key magistrates who were willing to discuss judicial reform proposals only after a deep crisis threatened their job stability.[7] Those benefits included generous early retirement packages, promotions for judges and support staff, new buildings, and expanded budgets.

More generally, the balance between judicial accountability and judicial independence from other branches of the state is the necessary but not sufficient condition for achieving success in enforcing laws in the way that López-de-Silanes describes. This balance between judicial accountability and independence requires a basic prior consensus among the main political parties in each of the countries involved.[8] Policymakers must find a politically beneficial reason to assist the judiciary in the design of protective devices to safeguard their independence without going so far as to neutralize the incentives provided by a system of democratic accountability to be applied to judges. The cases of Costa Rica, Singapore, and to some degree Chile (within its commercial jurisdiction) all show that judiciaries can enhance their capacity to interpret laws with independence and autonomy only when the political concentrations of power within the legislative and executive branches tend to be relatively balanced in such a way that the alternation of power is a likely outcome of periodic elections. A balance of power among truly competing political forces creates an increased willingness among politicians to give up a good part of their political control of court adjudication in order to avoid a mutually assured destruction during the next electoral period, when the opposition may take over the reins of power. This sequential game between or among political parties operates as an insurance that guarantees an increased judicial independence.[9]

6. Buscaglia (2001).
7. Buscaglia (2001).
8. Buscaglia (2001, p. 67).
9. Buscaglia (1998, p. 478).

Additionally, a framework guiding policymakers during legal and judicial reforms must then first identify the main areas in which undue pressures are most likely to hamper the judges' capacity to adjudicate in an effective and unbiased manner. The identification of these areas must focus on the links between the judiciaries and other governmental and nongovernmental institutions without forgetting to review factors hampering independence within the judiciaries themselves. It would be naïve to think that constitutional provisions prescribing the separation of powers would be enough to guarantee the judicial independence required for the unbiased and transparent interpretation and enforcement of the law. In fact, constitutional provisions in this respect are not even a necessary condition for attaining judicial independence. Countries such as Israel, New Zealand, Sweden, and the United Kingdom, all of which have high levels of judicial independence, do not possess constitutionally entrenched judicial independence.

Once the political preconditions are present, policymakers must define the specific elements of judicial reform and design an implementation strategy. Case studies of Chile and Costa Rica in Latin America and of Singapore in Asia identify a number of technical areas that have proved most successful in enhancing productive economic interaction and access to justice.[10] These include the following:

—The implementation of policies introducing a much wider range of bottom-up, decentralized, and legally binding private mechanisms beyond the usual private and public mediation. These policies contemplate moving beyond the state's monopoly in supplying legally binding conflict resolution.

—Improved case-management measures applied to ordinary state civil and criminal courts with the purpose of enhancing the quality and quantity of services offered through dispute resolution mechanisms.

—The implementation of the necessary administrative (that is, personnel and budget-related) measures aimed at enhancing the quality and quantity of court services. These measures have an impact on the supply- and demand-related cost of dispute resolution.

—Specific reforms of the courts' organizational structure. This includes the introduction of improved information systems designed to serve the

10. Buscaglia (1997, p. 34).

needs of a more divided set of organizational roles for judicial personnel, lawyers, and litigants.

—The introduction of a hearing court fee system aimed at hampering frivolous (rent-seeking) litigation. Such systems have been used successfully in Singapore and Tanzania. The social impact of this policy includes improved access to justice by the poor segments of the population.

—The enhancement of the judiciary's capacity to review the consistency, coherence, and social desirability of its doctrines and jurisprudence as instilled in court rulings, by installing systems that prevent the abuse of judicial and procedural discretion (for example, effective cassation).

—Public sector, governance-related improvements in the links between the political arena and the judiciary. That is, judicial independence must be safeguarded to ensure the sustainability of judicial reforms.

Finally, developing countries importing foreign rules and standards into their private laws through either direct transplants or simple harmonizations must not only take into account the supply side's technical capacity to enforce the legal frameworks (this area is well covered by López-de-Silanes, as when he discusses the provision of enough trained prosecutors and judges), but must also consider the demand side's prospective level of voluntary compliance with these laws by citizens and firms. Both Cooter and Pistor, Raiser, and Gelfer show that the level of voluntary compliance with a formal law (that is, positive law) will be enhanced by the a priori compatibility between the informal norms and customs prevailing within a business community prior to the enactment, on the one hand, and the rules and standards formally instilled in the newly enacted legislation, on the other.[11] This compatibility between informal habits, customs, and norms and formal rules will diminish the costs of enforcing the newly enacted law, given the high levels of voluntary compliance.

Norman Loayza: Florencio López-de-Silanes's paper presents insightful reflections on the process of reform of legal structures and the judicial system. The author bases his conclusions on a broad sweep of the corporate finance literature, with particular attention to the abundant and influential research conducted by himself and his associates, Rafael La Porta, Andrei Schleifer, and Robert Vishny.

11. Cooter (1996); Pistor, Raiser, and Gelfer (2000).

The paper is written in a survey style, so its offering of original research is rather limited. This is not a weakness, however, because the author's objective for the paper is to be comprehensive and balanced. López-de-Silanes reviews the recent literature on the legal foundations of corporate finance, stock markets, and commercial banking in order to establish some guidelines for economic reform. In almost every section of the paper, the positive exposition of facts and findings is followed by normative conclusions on the direction of reforms in the legal and judicial systems.

Marx or Weber?

Often in the paper the argument is made that a country's legal system determines economic outcomes. At the same time, the paper attempts to map a strategy for changes in the legal system. In the background there is a conflict regarding the preeminence of legal versus economic factors –does the legal system drive economic relations and performance, or is it the other way around? This question taps into a rich and old debate started in modern times by Max Weber and Karl Marx. According to Weber, the culture, ideology, and political institutions of a society determine its market forces and relationships. The legal system is a direct reflection of ideology and political institutions and thus takes preeminence over economic factors. Weber espouses this view in most of his work but nowhere more clearly than in *The Protestant Ethic and the Spirit of Capitalism*.[1] There he argues that capitalism, as an economic system, was first made possible by the change in people's mentality induced by the advent of protestant religions, most specifically Calvinism. Protestantism brought about a new appreciation of material possessions as exterior signs of God's blessings: people believed that by obtaining material wealth they would confirm that God had chosen them for salvation.

Karl Marx defends the opposite view. In the logic of historical materialism, a society's superstructure—that is, its culture and institutions—is derived from underlying economic relationships. For instance, according to Marx, the interpretation of Catholicism prevalent in medieval times, with its teachings of strict respect for social hierarchies, developed to support the economic system of feudalism. For Marx, the political, legal,

1. Weber ([1904] 1930).

and judicial systems are key elements of a society's superstructure and, therefore, are derived to protect the prevailing economic system, including its power and property structures.

López-de-Silanes and his associates propose an interesting and pragmatic solution to the debate. On the one hand, they argue convincingly that institutions, both the legal structure and the judicial system, determine economic outcomes. They find evidence that these institutions have a significant influence on a country's financial development at the macroeconomic level (that is, the banking sector and the stock market) and on corporate efficiency at the microeconomic level. On the other hand, given the need for policy advice, López-de-Silanes and earlier co-authors argue that if institutions are to be reformed, market forces must be considered. They thus argue that legal and judicial reform must contemplate, first, the incentive compatibility of the proposed structure, norms, and regulations and, second, the resource constraints in the implementation of the new policies. If economic incentives and resources are ignored, the process of reform is doomed to failure. In other words, López-de-Silanes and earlier co-authors are Weberian in their diagnosis of the existing situation but Marxian in their prescribed solution.

Given the broad nature of this paper, in terms of both analysis and recommendations, my comments also address general issues, which I present in the form of four questions.

Can the Legal Reform of Finance Occur in Isolation?

López-de-Silanes's paper addresses legal and judicial reform as it refers to the financial system. This is a small segment of legal reform in general, however, and legal reform is a small component of socioeconomic reform. It is difficult to conceive, for instance, procedural changes in the judicial system that apply only to financial cases. Likewise, it is difficult to imagine successful legal reform that is not accompanied by changes in the political system.

A single paper clearly cannot address the reform process in its entirety. However, it would be valuable to study the links between financial legal reform and institutional reform in general. For instance, where does legal reform fall in the sequence of overall institutional transformation? Are there any reform prerequisites for a successful change of legal and judicial

systems? To what extent can reform in these areas help consolidate reform on other fronts?

A recent example from the Latin American experience illustrates the importance of implementing additional reforms that support the legal reform process. One of the countries in the region that advanced the most in the last decade in terms of procedural improvements in the judicial system was Peru. It was also, however, one of the least advanced countries with regard to political rights. The lack of democratic checks and balances during Alberto Fujimori's near-dictatorship allowed the courts to serve the objectives of the party in power. Moreover, the courts were frequently controlled to facilitate the corrupt dealings of high-ranking public officials, mostly under the sinister hand of Vladimiro Montesinos. In short, the Peruvian courts became more efficient, but in many cases this efficiency served corrupt purposes. Once democratic rule was reestablished in the country, the areas that underwent the largest change were the legal and judicial systems, while public administration in economic areas, for instance, remained largely untouched. In this example, the attainment of political rights appears to be a prerequisite for any successful legal reform.

Can Legal Financial Reform Be Country Specific?

One of the distinctive features of López-de-Silanes's paper is its emphasis on the relation between law and enforcement. According to the author, a good law must be enforceable by the society in which it is enacted. A law can be perfect in theory, but if it cannot be enforced and will not be respected, then it accomplishes nothing. This emphasis may explain the title of the article. Aristotle said that politics is the art of the possible. If this dictum is applied to López-de-Silanes's paper, then "the politics of legal reform" becomes the art of implementing a reform that is enforceable and thus feasible.

One possible implication of the enforceability requisite is that legal financial reform must be country specific. Is this a good policy recommendation? On the one hand, this appears to be good advice given that, first, countries have quite different legal traditions and, second, their enforcement systems vary considerably among them. For example, it would seem difficult to reproduce a legal framework taken from a common law country into a civil and penal code country. Likewise, it would make

little sense to apply the strict regulatory framework of an industrialized country in developing countries, which generally lack the corresponding enforcement mechanisms. On the other hand, country specificity may not be good policy advice if the country in question is undergoing a process of globalization. Financial and trade openness requires the harmonization of legal codes, tax regimes, and enforcement mechanisms.

There is no general solution as to how country specific (or global) legal reform should be. In the areas least affected by globalization, legal and judicial reform can be adapted to the nature of the country. In areas in which international openness is significant, however, the strategy should give precedence to global solutions. This entails treating the enforcement system not as a given constraint, but as a focus area for reform: as certain laws become global, their enforcement standards must do the same. For example, if a firm in the airline industry hopes to expand to international markets, it cannot be subject to a regulatory framework that is dependent on the level of development of the country of origin. Given that failures in this type of industry are extremely costly and competition is international, adherence to the world's safest and most efficient standards is the only sensible strategy. A similar, though less dramatic, argument can be made for all industries whose capital or product markets depend crucially on international conditions. Given the sharp increase in international financial flows, foreign direct investment, and multinational corporate operations, I believe that financial legal reforms should be global rather than country specific.

Should the Protection of Investor Rights Be the Cornerstone of Financial Legal Reform?

A recurring theme in López-de-Silanes's past work (with his eminent coauthors) is the lack of protection of investor rights as the main cause of financial underdevelopment. At a basic level the argument is clear and compelling: if the law does not effectively and strongly protect the rights of investors in a country, then they will channel their savings either to investment opportunities elsewhere in the world or to activities that they can supervise directly. The local financial system loses its ability to act as an intermediary of financial services and products and, as a result, becomes inefficiently small and costly.

The lack of protection for creditors and shareholders is most probably an important reason behind the underdevelopment of the banking and stock market activities of many countries around the world. But is it the only cause? A small and costly financial system could also result from monopolistic behavior on the part of large investors (such as banks). In this case, it is not the rights of the investors that are unprotected; rather, it is the rights of the consumers of financial products that are violated by monopoly pricing and reduced services.

It is difficult to think of banks as defenseless. Although the law may handcuff large institutions in particular circumstances, being powerless is generally a characteristic of small players. People who deposit their savings in banks or who borrow money from them are most likely to be exploited by banks. In this case it is not an inappropriate legal protection of creditors' rights in general that is causing an insufficient development of the financial system, but the market structure and the lack of competition.

There are solutions to being small and powerless. Some of these may indeed lie with the legal and judicial systems, as López-de-Silanes argues for the case of investor rights. Other solutions may arise naturally as small players join forces to establish a stronger presence in the market, as in the case of mutual funds for small shareholders. If financial underdevelopment is caused by the lack of protection of small market players, it may be misguided to focus exclusively on the rights of creditors and investors and more appropriate to also consider the rights of consumers of financial services. Including the latter would open a second front of legal reform, to which López-de-Silanes and earlier co-authors could direct their research energies. This second front is the removal of legal obstacles for market competition.

Who Should Be in Charge of Judicial Reform?

As López-de-Silanes points out, judicial reform should improve the functioning of the courts along three broad dimensions: accuracy, cost, and speed. These objectives compete with each other, however, when resources are limited. The policymaker must therefore find the right balance in the trade-off between them.

López-de-Silanes provides some useful insights as to how this trade-off is different in developing and developed countries. For instance, he writes

that poor countries should concentrate on simple rules that are easy to enforce, even if accuracy suffers somehow in the process. This analysis has other practical implications that López-de-Silanes could further explore. Who should be in charge of judicial reform? Different specialists tend to emphasize the aspects of reform that they either value the most or are best trained to address. Thus, whereas lawyers would emphasize the importance of arriving at accurate judicial decisions, public administrators would concentrate on the expediency of sentence delivery and execution, and economists would worry about making the process cost-effective. In most cases in the past, lawyers and judges have planned and implemented reform, however, this difficult task should be the responsibility of multi-disciplinary teams.

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