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The Politics of Legal Reform

As more countries make the transition to market economies, the focus of the public policy debate has broadened from macroeconomic stability to the design of institutions that sustain growth. This paper focuses on the development of financial institutions such as banks and stock exchanges, the construction of the legal infrastructure supporting business, and the creation of regulatory mechanisms in line with best world practice. As a result of both the ever-increasing interconnections among financial markets and the waves of international turmoil in the last decade, such as the tequila crisis, the Asian crisis, and the Russian crisis, policymakers are reaching a consensus that the reform of financial institutions is an essential component of reform. Continuing academic research showing that the institutions of corporate governance, in particular law and the quality of its enforcement, are relevant for the development of financial markets and economic growth has backed up this belief.

Despite this consensus and the efforts of several international institutions to promote legal reform, many forces still oppose reform, and little agreement has been reached as to what constitutes feasible legal reforms. This paper first identifies the forces for and against legal reform and reviews their role in episodes of reform. Opponents of reform include managers and families in control of firms, labor, and sometimes politicians themselves. On the other side, the main forces facilitating reform include the opening up of economies and the increased interconnectedness of financial markets, which allows investors from all over the world to vote with their feet when investor protection is not part of the agenda. The primary lesson of this analysis is that the design of reforms needs to reflect

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the reality of local forces that may oppose reform and work on mechanisms to appease those interests.

The second goal of the paper is to identify what constitutes feasible legal reforms. There is no one-size-fits-all set of good laws and regulatory mechanisms. More important, rules that work in developed countries might not succeed in developing countries that are struggling with poor judicial systems and lack of rule of law. The divide between developed and developing economies is more pronounced at the level of enforcement than in the laws themselves. Reforming bankruptcy and corporate law must be undertaken in the local enforcement context. Complementary market-based mechanisms and judicial reforms that build further consensus on reform and enforcement are needed for long-term success.

If legal reform is to succeed, the commonly advocated principles of corporate governance in the international community need to be brought down to the local political and judicial realities of each country. A lot of work needs to be done to translate international corporate governance initiatives and principles into clear and enforceable rights for creditors and shareholders. This does not mean that legal reform is country specific, but it does suggest that blindly copying a list of investor rights or transplanting rules is not likely to succeed.

The organization of the paper is as follows. The following section briefly reviews the importance of investor protection and corporate governance for the development of capital markets and economic growth. This section also evaluates whether developing countries and emerging economies have systematically weaker investor protection embedded in their laws and enforcement than do developed countries, that is, whether developing nations face a legal trap. While the results show little evidence of a legal trap, they confirm that disclosure standards and legal enforcement are systematically lower in less developed countries. These facts have two implications for legal reform. First, blindly copying the laws from developed countries and providing rights to creditors and shareholders will not necessarily work in developing countries. Second, reform needs to be in accordance with the local legal system.

The next section of the paper reviews current theory on the politics of legal reform, describing the forces for and against it and what this implies for legal reform. The paper then attempts to translate the challenges imposed by the political and judicial local realities into a feasible reform of creditor and shareholder rights, respectively. The first part of this sec-

tion analyzes the avenues open for reforming bankruptcy law and emphasizes the need to create venues that allow market forces to play a larger role. The second part studies current proposals for corporate law reform and argues for translating them into feasible reforms. I also urge the establishment of complementary market-based mechanisms that tie higher valuations to higher investor protections to foster a corporate culture of legal protection to shareholders. Each subsection provides some lessons and suggestions for reform.

Since one of the main challenges for successful legal reform is the judicial system, the paper subsequently undertakes a comprehensive analysis of the available evidence on judicial reform itself and makes some recommendations for the structure of future reforms in developing countries. The final section concludes with some general comments.

Investor Protection

The development of stable capital markets and financial institutions helps firms gain access to the external funding needed to undertake investments. Securing access to external funds is essential for local firms, particularly in countries that have opened up to international trade. Without these funds, local firms may not be able to undertake the appropriate investments and reach the scale needed to compete internationally. The development of capital markets that help entrepreneurs access external funds crucially depends on the legal institutions that support these markets. These institutions, mainly laws and their enforcement, are intimately linked to corporate governance. Corporate governance is the set of mechanisms, again including law and its enforcement, that ensures that those who supply a firm with finance get a return on their investments. The main concern of corporate governance is that the returns owed to security holders (shareholders and creditors) are not stolen or expropriated.

The legal approach of corporate governance argues that agency relationships in the firm are the main source of expropriation by managers and controlling shareholders. This approach helps explain why some countries have much larger capital markets than others. Legal protection for investors and legal enforcement differ enormously from country to country. Recent research by La Porta, López-de-Silanes, Shleifer, and Vishny shows that these differences are largely explained by the legal origin of

commercial laws.[1] The commercial legal systems of most countries derive from relatively few legal families, including the English (common law), the French, and the German, with the latter two derived from Roman law. These systems spread throughout the world in the nineteenth century through conquest, colonization, and voluntary adoption. England, its former colonies, and other countries in Africa and Southeast Asia employ the common law system. France, other European countries conquered by Napoleon, and their colonies follow the French civil law tradition. Germany, Germanic countries in Europe, and a number of countries in East Asia are part of the German civil law tradition. Finally, the Scandinavian countries form their own tradition. In related papers, La Porta and others show that laws and their enforcement do matter: controlling for other factors, countries with higher investor protection, mostly those influenced by English common law, offer entrepreneurs better terms of external finance and thus have both more highly valued and broader capital markets.[2] Legal families originated before financial markets developed, and legal origins are highly correlated with the content of the law. It is therefore unlikely that laws were written primarily in response to market pressures. Instead, legal families appear to shape legal rules, which in turn influence financial markets.[3]

Extensive expropriation severely undermines the effectiveness of a financial system. Potential investors, fearful of expropriation, are unlikely to finance even the most attractive investment if they believe their return is likely to be expropriated. Clearly, weak legal institutions lead to few projects being financed. The projects most likely to be financed are those of firms with sufficient internal funds to make the investment. Overall, too few projects are financed and not necessarily those that are the most beneficial to society, from a welfare perspective. Productivity and economic growth thus suffer when investment is insufficient and misallocated.

1. La Porta and others (1998).

2. La Porta, López-de-Silanes, and Shleifer (1999); La Porta and others (1997, 2000, 2002).

3. The legal origin of commercial laws, which could be argued to be an exogenous variable, is a powerful explanatory variable of the development of capital markets. The laws of the mother countries, such as England or France, probably emerged as a result of the interplay of the ideology and institutions of those countries. The laws may well reflect the economic and political forces at play in eighteenth century England or early nineteenth century France, but not necessarily those of the countries where these laws were imposed through colonization or other means over the following two hundred years.

Investor protection also influences the real economy through its effect on financial markets. Extensive literature provides a wealth of evidence on the link between financial development and economic growth.[4] Some of these papers show that the association between external finance and growth holds even at the industry level, while other authors demonstrate that an exogenous component of financial market development, obtained by using legal origin as an instrument, predicts economic growth. In particular, financial development can accelerate economic growth in three ways. First, financial development can enhance savings by raising opportunities. Second, it can channel these savings into real investment and thereby foster capital accumulation. Third, to the extent that financiers exercise control over the investment decisions of entrepreneurs, financial development improves the efficiency of resource allocation, as capital flows toward more productive uses. All three channels can, in principle, have important effects on development.

Another body of research suggests that improved resource allocation is an important consequence of financial development, and that investor protection contributes to the growth of productivity and output through this channel.[5]

Conversely, weak legal institutions make recovery from economic crises more difficult. Weak protection of investor rights does not make shocks more likely, but it does enlarge the negative effect of shocks on the overall economy. Institutions thus matter for a particular aspect of volatility after collapses, as the evidence from the 1997–98 Asian crisis shows.[6]

Investor Protection and Per Capita Income: Is There a Legal Trap?

As explained in the previous section, an increasing number of academic papers are exploring the ramifications of investor protection, leading to widespread concern that income levels mostly explain different degrees of

4. Demirguc-Kunt and Maksimovic (1998); King and Levine (1993); Levine and Zervos (1998); Rajan and Zingales (1998); Levine (1999); Carlin and Mayer (1999).

5. Beck, Levine, and Loayza (2000) find that banking sector development exerts a large impact on total factor productivity growth and a less obvious impact on private savings and capital accumulation. Wurgler (2000) finds that investment across industries is more in line with industry-related growth opportunities in financially developed countries than in financially undeveloped countries.

6. Johnson and others (2000) analyze the depreciation of currencies and the decline of the stock markets in twenty-five emerging markets during the Asian crisis of 1997–98. Their results show that investor protection indexes, especially measures of the quality of law

investor protection. Do less developed countries have systematically worse legal protections than rich countries? If this is true, then poor countries could be stuck in a bad equilibrium of inadequate legal protection and scarce external finance, which stunts their growth and therefore keeps them poor and reinforces their inadequate legal protection. If, on the other hand, per capita income is not a critical determinant of effective legal protection, then countries can grow out of the trap, even if poor laws slow down financing and investment.

Tables 1 and 2 sort countries by per capita income into the bottom 50 percent and the top 50 percent and then compare the means of some investor protections, the judiciary system, and the size, activity, and concentration of the financial market variables across per capita income groups. The data show indices of key legal rules on the rights of investors and creditors, on the quality of law enforcement, and the breadth and depth of financial markets for forty-nine countries with publicly traded firms. The sample comes from La Porta and others.[7] Rules protecting investors come from different sources, including company laws and bankruptcy laws. Though there are many potentially measurable differences among countries in their company and bankruptcy laws, La Porta and others focus exclusively on the basic rules that scholars believe are essential to corporate governance, especially those that can be interpreted as pro-investor.[8] Variables on enforcement in the judiciary come from various sources, including Business International Corporation and the PRS Group's International Country Risk Guide. The authors construct variables on the size of financial markets using data from Moody's Investor Services, World-Scope, and several country sources.

Shareholders have residual rights over the firm's cash flows, and their right to vote is their main source of power. The shareholder rights index measures how strongly corporate law protects shareholders' voting rights and the rights that support voting mechanisms—and thus how strongly it protects minority shareholders against expropriation by controlling shareholders. The index covers the right of shareholders to receive advance notice of shareholder meetings, to vote by mail, to participate in the meetings, to elect directors who represent their views, to subscribe to new

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enforcement, are powerful predictors of the extent of stock market declines and exchange rate depreciations during the crisis.

7. La Porta and others (1997, 1998).

8. La Porta and others (1998).

TABLE 1. Development and Investor Protection

Country[a]	*Shareholder rights*	*Creditor rights*	*Efficiency of judicial system*	*Rule of law*	*Rating on accounting standards*
Less developed					
Kenya	3	4	5.75	5.42	n.a.
India	5	4	8.00	4.17	5.70
Nigeria	3	4	7.25	2.73	5.90
Pakistan	5	4	5.00	3.03	n.a.
Zimbabwe	3	4	7.50	3.68	n.a.
Sri Lanka	3	3	7.00	1.90	n.a.
Egypt	2	4	6.50	4.16	24.00
Indonesia	2	4	2.50	3.98	n.a.
Philippines	3	0	4.75	2.73	6.50
Jordan	1	n.a.	8.66	4.35	n.a.
Ecuador	2	4	6.25	6.67	n.a.
Colombia	3	0	7.25	2.08	5.00
Peru	3	0	6.75	2.50	3.80
Thailand	2	3	3.25	6.25	6.40
Venezuela	1	n.a.	6.50	6.37	4.00
Brazil	3	1	5.75	6.32	5.40
Turkey	2	2	4.00	5.18	5.10
South Africa	5	3	6.00	4.42	7.00
Malaysia	4	4	9.00	6.78	7.60
Chile	5	2	7.25	7.02	5.20
Mexico	1	0	6.00	5.35	6.00
Uruguay	2	2	6.50	5.00	3.10
Argentina	4	1	6.00	5.35	4.50
Greece	2	1	7.00	6.18	5.50
South Korea	2	3	6.00	5.35	6.20
Average	2.84	2.48	6.26	4.68	5.29
Median	3.00	3.00	6.50	5.00	5.45
More developed					
Portugal	3	1	5.50	8.68	3.60
Taiwan	3	2	6.75	8.51	6.50
New Zealand	4	3	10.00	10.00	7.00
Ireland	4	1	8.75	7.80	n.a.
Spain	4	2	6.25	7.80	6.40
Israel	3	4	10.00	4.82	6.40
Australia	4	1	10.00	10.00	7.50
Hong Kong	5	4	10.00	8.22	6.90
United Kingdom	5	4	10.00	8.57	7.80
Finland	3	1	10.00	10.00	7.70
Italy	1	2	6.75	8.33	6.20
Singapore	4	4	10.00	8.57	7.80
Canada	5	1	9.25	10.00	7.40

(*continued*)

TABLE 1. Continued

Country	Shareholder rights	Creditor rights	Efficiency of judicial system	Rule of law	Rating on accounting standards
Netherlands	2	2	10.00	10.00	6.40
Belgium	0	2	9.50	10.00	6.10
France	3	0	8.00	8.98	6.90
Austria	2	3	9.50	10.00	5.40
Germany	1	3	9.00	9.23	6.20
Sweden	3	2	10.00	10.00	8.30
United States	5	1	10.00	10.00	7.10
Norway	4	2	10.00	10.00	7.40
Denmark	2	3	10.00	10.00	6.20
Japan	4	2	10.00	8.98	6.50
Switzerland	2	1	10.00	10.00	6.80
Average	3.17	2.13	9.14	9.10	6.72
Median	3.00	2.00	10.00	9.62	6.80
Total average	3.00	2.30	7.67	6.85	6.09
Total median	3.00	2.00	7.25	6.78	6.40
Less vs. more developed mean (*t* statistic)	−0.87	0.88	−6.89*	−11.07*	−3.94*
Less vs. more developed median (*z* statistic)	−1.09	0.99	−4.93*	−5.78*	−3.58*

Source: La Porta and others (1997, 1998).

a. Countries are sorted by levels of GNP per capita in 1999: countries below the median GNP per capita of the sample are classified as less developed and those above the median are classified as more developed. See appendix for a description of the variables.

* Statistically significant at the 1 percent level.

issues of securities on the same terms as controlling shareholders, to call extraordinary shareholder meetings, and to sue directors for suspected wrongdoing, including expropriation. A country scores one point on the index for each pro-investor right granted by its corporate law.

The more developed countries—with an average index of 3.17—provide somewhat better shareholder protection than less developed countries (average index 2.84). But this is not the case for creditor rights. The index of creditor protection, based on bankruptcy law, measures the ability of creditors to use the law to force companies to meet their credit commitments. The index scores creditor rights in both reorganization and liquidation, in part because almost all countries rely, to some extent, on both procedures. The creditor rights assessed are those of senior secured creditors, in part because they account for much of the debt in the world. Creditor protections largely relate to bankruptcy procedures. These include the creditors' right to take possession of collateral, to protect their

seniority, and to decide whether to fire management. They also include measures that make it harder for firms to seek court protection in reorganization without creditors' consent. Like the shareholder rights index, the creditor rights index includes one point for each pro-investor right granted by law. On average, there is no evidence that more developed countries offer creditors stronger legal protection than do less developed countries. The average creditor rights score for developed countries is 2.13, compared with 2.48 for developing countries.

Although corporate and bankruptcy laws thus differ a great deal across countries at different development levels, there is no clear-cut evidence that developing countries are trapped by their laws. The laws in developed countries are more favorable to shareholders, but creditors are not better protected in either group of countries. Still, shareholders do better in some countries than in others. What explains these differences? Legal rules are only part of the story on investor protection. Enforcement of the law is just as important, if not more so. Good laws that are not enforced cannot be effective. Strong enforcement can compensate for weak rules, however, and an efficient judiciary system can redress management expropriation, thereby protecting investors despite bad laws.

An index measuring the efficiency of the judicial system serves as a proxy for the quality of enforcement. This index shows significant differences across groups of countries with different income levels. Table 1 shows that the mean score for the efficiency of the judicial system across developing countries is 6.26, compared with 9.14 in developed countries. Similarly, the index measuring the prevalence of the rule of law, which serves as a proxy for the tradition and respect of the law, suggests that developing countries lag behind considerably in the quality of enforcement: the average for developing countries is a mere 4.68, versus 9.10 in developed countries. Even if investor protection might not be all that different across nations, the quality of enforcement, and the legal tradition, is significantly weaker in the poorer countries of the world. In contrast with legal rules, which do not appear to depend on a country's level of development, the quality of enforcement is markedly better in wealthier economies.

Another index measures the quality of accounting standards for publicly traded firms. Disclosure and accounting standards, usually imposed by securities exchanges, are central to corporate governance. They provide investors with the information they need to exercise their rights and allow

courts to resolve disputes among investors. In this respect, developing countries once again show lower levels of disclosure and accounting standards, scoring 5.29 compared with 6.72 in developed countries.

Overall, table 1 shows that shareholder and creditor rights do not systematically depend on the level of per capita income. Table 1 suggests that creditor rights are somewhat stronger in developing countries. The relatively antimanagement stance of poor countries' bankruptcy laws may be dictated by efficiency: unless creditors get their hands on the assets fast, these assets are likely to disappear. Another possibility is that management lobbying has succeeded in emasculating creditor rights in richer countries. The aggressive promanagement stance of the U.S. bankruptcy law is consistent with both of these interpretations. In any case, there is no evidence that poor countries have weaker creditor rights.

The efficiency of the judicial system and rule of law both increase substantially with the level of income. In fact, per capita gross national product (GNP) alone explains over half of the variation in enforcement measures. The quality of accounting standards also rises sharply with per capita income, although fewer observations are available for the poorer countries. The picture is thus very different for law enforcement than it is for legal rules.

As for the size of capital markets, the evidence runs in favor of developed countries, which generally have bigger stock markets with considerably more publicly traded domestic firms, more active capital markets with firms seeking funds more often, and broader debt markets. Table 2 presents results for a list of variables on the ownership of the three largest shareholders in the average domestic firm, the number of initial public offerings (IPOs), the number of listed domestic firms, and the size of the debt market for a cross sample of countries. First, ownership concentration in financial markets is negatively and significantly correlated with income levels. Measures on the ownership of the three largest shareholders in the average domestic listed firm are lower for developed countries (0.46) than for developing ones (0.52). The test for the difference in means is significant at standard levels (*t* statistic of 3.43). Second, the number of IPOs or seasoned equity offerings in the local stock market is considerably lower in developing countries than in developed ones. On average, only 0.34 firms per million inhabitants go public in the developing world, compared with 1.02 firms in the developed world. Third, the number of publicly traded domestic firms per million inhabitants in the

TABLE 2. Development and Capital Markets

Country[a]	*Ownership of three largest shareholders*	*IPOs per million inhabitants*	*Domestic firms per million inhabitants*	*Debt/GNP*
Less developed				
Kenya	n.a.	n.a.	2.24	n.a.
India	0.40	n.a.	1.69	n.a.
Nigeria	0.40	1.24	7.80	0.29
Pakistan	0.37	n.a.	5.89	0.27
Zimbabwe	0.55	n.a.	5.82	n.a.
Sri Lanka	0.60	0.11	11.94	0.25
Egypt	0.62	n.a.	12.50	n.a.
Indonesia	0.58	0.11	1.16	0.42
Philippines	0.57	0.28	2.91	0.27
Jordan	n.a.	n.a.	23.75	0.70
Ecuador	n.a.	0.09	13.18	n.a.
Colombia	0.63	0.06	3.14	0.19
Peru	0.56	0.13	9.48	0.10
Thailand	0.47	0.57	6.71	0.93
Venezuela	0.51	0.00	4.29	0.10
Brazil	0.57	0.00	3.49	0.39
Turkey	0.59	0.05	2.93	0.15
South Africa	0.52	0.05	16.00	0.60
Malaysia	0.54	2.89	25.16	0.84
Chile	0.45	0.36	19.93	0.63
Mexico	0.64	0.03	2.29	0.47
Uruguay	n.a.	0.00	7.00	0.26
Argentina	0.53	0.21	4.59	0.19
Greece	0.67	0.30	21.60	0.23
South Korea	0.23	0.02	15.89	0.74
Average	0.52	0.34	9.25	0.40
Median	0.55	0.11	6.71	0.28
More developed				
Portugal	0.52	0.50	19.50	0.64
Taiwan	0.18	0.00	14.23	
New Zealand	0.48	0.67	69.00	0.90
Ireland	0.39	0.75	20.00	0.38
Spain	0.51	0.08	9.72	0.75
Israel	0.51	1.80	127.60	0.66
Australia	0.28	n.a.	63.56	0.76
Hong Kong	0.19	2.02	88.17	n.a.
United Kingdom	0.54	5.17	35.69	1.13
Finland	0.37	0.60	13.00	0.75
Italy	0.58	0.32	3.91	0.55
Singapore	0.49	5.67	80.00	0.93
Canada	0.40	4.93	40.86	0.72
Netherlands	0.39	0.67	21.13	1.08

(*continued*)

TABLE 2. Continued

Country	*Ownership of three largest shareholders*	*IPOs per million inhabitants*	*Domestic firms per million inhabitants*	*Debt/GNP*
Belgium	0.54	0.30	15.50	0.38
France	0.34	0.18	8.05	0.96
Austria	0.58	0.25	13.88	0.79
Germany	0.48	0.09	5.15	1.12
Sweden	0.20	3.11	30.12	0.81
United States	0.28	1.67	12.67	0.55
Norway	0.36	4.50	33.00	0.64
Denmark	0.45	1.80	50.40	0.34
Japan	0.18	0.26	17.78	1.22
Switzerland	0.41	0.00	33.86	n.a.
Average	0.40	1.60	34.45	0.76
Median	0.41	0.67	20.57	0.75
Total average	0.46	1.02	21.59	0.59
Total median	0.49	0.30	13.18	0.63
Less vs. more developed mean (*t* statistic)	3.43*	−2.81*	−3.95*	−4.58*
Less vs. more developed median (*z* statistic)	3.29*	−3.32*	−4.06*	−3.78*

Source: La Porta and others (1997, 1998).

a. Countries are sorted by levels of GNP per capita in 1999: countries below the median GNP per capita of the sample are classified as less developed and those above the median are classified as more developed. See appendix for a description of the variables.

* Statistically significant at the 1 percent level.

average developing country is merely nine, compared with an overwhelming twenty-two in the developed world. Finally, the size of debt markets—measured by the ratio of the total bank debt of the private sector and outstanding nonfinancial bonds to GNP—shows that wealthier countries hold an edge in the level of financial development. On average, the size of debt markets to the economy is 0.76 percent in developed countries and 0.40 percent in developing ones.

The data thus provide no evidence of a legal trap in terms of laws on the books, but developed and developing nations demonstrate marked differences in terms of enforcement measures and accounting standards. In the end, and partly as a result of poor investor protection, developing countries have smaller stock and debt markets. One interpretation of these findings is that the legal rules in developing countries are not "the right ones" because they are not designed for inefficient judicial systems. The implication of this view is that legal reform needs to ensure that rules are redesigned taking into account the low efficiency of the judicial sys-

tem. Another interpretation of these findings is that low judicial efficiency renders “the right rule” unenforceable. The implication is that legal reform needs to be complemented with judicial reform. The rest of the paper adopts the view that both of these arguments apply, and successful legal reform in developing countries therefore needs to take both into account.

The Forces of Legal Reform

For most developing countries, improving investor protection would require rather radical changes in the legal system. Securities, corporate, and bankruptcy laws would generally need to be amended, and the regulatory and judicial mechanisms for enforcing shareholder and creditor rights would require radical improvement. However, there is no particular list of legal protections for investors, emerging from international best practice or from the list of rights included in the indices in table 1, that is either necessary or sufficient for such reforms. The evidence presented above suggests that the country’s judicial system plays a key role in shaping investor rights.

Effective legal reform faces tremendous political obstacles. Perhaps the most important objections come from the controlling shareholders at the top of large corporations. From their perspective, an improvement in the rights of outside investors is first and foremost a reduction in the value of control, particularly as the opportunities to unlawfully seize the assets deteriorate. This is the case despite the fact that the total value of these firms increases in response to legal reform, as expropriation declines and investors finance new projects under more attractive terms.

The elimination of self-dealing transactions and restrained competition are perhaps further reasons why the insiders of major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, the existing firms finance their own investment projects through internal cash flows, as well as through relationships with captive or closely tied banks. In Mexico, for example, the lion’s share of credit goes to the few largest firms: 18 percent of all private claims in the Mexican economy go to the twenty largest private firms listed on the stock exchange. This number is twice as high as the world mean and almost three times as high as in the United States or Canada. As in many other

developing countries, most of the Mexican loans come in the form of related lending, that is, loans to owners of the bank.[9] Consequently, the large firms get not only the financing they need, but also the political influence that comes with the access to such finance. They are also protected from competition that would arise if smaller firms could raise external capital. When new entrepreneurs have good projects, they often have to turn to the existing firms for finance. Poor corporate governance not only grants the insiders secure finance, but also ensures relatively secure politics and markets.

Opposition from labor interests may supplement the opposition to reform. After all, these interests also receive rents from the existing arrangements, for example when managers invest in large plants that are irrelevant and employ large numbers of people. The losers in the existing arrangements are the new entrepreneurs who cannot raise external funds to finance new investment, together with the segments of the labor force that do not have access to the privileged jobs. Objections from labor groups make it more difficult to pass reform legislation. Successful reforms have occurred only when the special interests could be destroyed or appeased. In this respect, corporate governance reform is no different from most other reforms in developing or developed countries.[10]

Although difficult, reform has taken place in several countries, such as the United States in 1933–34, Japan after World War II, Chile in the 1980s, and, more recently, Germany, Korea, and Poland. These examples not only illustrate the possibility of legal reform in the area of investor protection, but also point to the substantial political difficulties. Even so, countervailing political interests are on the rise as well, including foreign (institutional) shareholders and creditors who are insisting on their rights as investors. In some countries, these outside investors are beginning to have significant influence. Their influence becomes particularly great in times of financial crisis, such as that experienced in the emerging world in 1997–98, when companies and the insiders who ran them were desperately in need of funds. Thailand has recently introduced a new bankruptcy law, and outside investors in Korea have successfully sued the directors who act against their interests. It remains to be seen how far these efforts will go.

9. La Porta, López-de-Silanes, and Zamarripa (2003).
10. Hirschman (1963).

What can policymakers do to foster better investor protection? Capital market reforms are at work in many countries, and some of these efforts have had important effects on investor protection and the financing of firms. Some mechanisms adopted in developed economies might be appropriate for developing countries, but others might not, given the current enforcement environment of some nations. Unfortunately, the general understanding of the principles behind the reform of investor protection remains limited. There is no checklist of what needs to be done. However, the available evidence indicates that to foster financial markets in developing countries, reforms must meet three tentative principles. First, the enforcement of legal rules must be deeply connected with the rules themselves. Second—and potentially more controversial—government regulation of financial markets should be considered when court enforcement of private contracts or even of government laws is not reliable. Third, because legal reform is slow and complicated, complementary market-based mechanisms must be adopted, as they can help create the necessary pressures for implementing reforms. The next section applies these principles and the reality of the politics of legal reform to develop some ideas for the feasible reform of bankruptcy and corporate law.

Feasible Legal Reform

The implications of the previous two sections are very important for the design of feasible legal reform. In the last decade, the reform of corporate governance has preoccupied policymakers all over the world, from western and eastern Europe to Latin America and Asia. Their proposals to improve governance are wide-ranging. The Cadbury Committee focuses on boards of directors, while the European Corporate Governance Network stresses improved disclosure. In the aftermath of the emerging-markets crisis, several Latin American and Asian countries are reforming regulations covering bankruptcy, disclosure, and several other aspects of governance, yet their progress has fallen short of expectations. The failure of legal reform is frequently due to the underestimation of the politics behind it and the strong opposition that these changes might encounter in the process of approval, as this section illustrates.

In the last five years, several international organizations and groups of countries have come up with codes of best corporate governance prac-

tices to protect shareholders and creditors, such as the OECD Principles of Corporate Governance put out by the Organization for Economic Cooperation and Development and the World Bank's various initiatives on corporate governance and insolvency. The main lesson of table 1 is not that developing countries need to copy laws from developed countries, but that although governance systems might appear to be similar across groups, they may not work in the same way. Differences in effectiveness may stem from the varying degrees of judicial efficiency across groups. If so, the design of laws that are actually enforceable will be a challenge in most of the developing countries, particularly those with a history of poor enforcement of rules and laws. Blindly copying principles or inserting some investors' rights into the laws of developing countries is not likely to lead to effective legal reform.

Feasible Bankruptcy Law Reform

In the absence of a bankruptcy law, creditors may engage in a socially wasteful race to be the first to seize their collateral or to obtain judgment against the debtor. This may lead to the disbursement of the debtor's assets and to a loss of value to all creditors when the assets are worth more as a whole than in parts. For this reason, it is in the creditors' collective interest that the disposition of the debtor's assets be carried out in an orderly manner.

Several international organizations, such as the OECD, the World Bank, and other regional development banks, have started to develop a joint insolvency initiative to be used as a reference for countries undertaking reform of their bankruptcy laws. This initiative seeks to design efficient legal and regulatory mechanisms and to deal with unusual cases such as bankruptcies of state-owned enterprises and banks. More time is needed, however, to develop a real understanding of the particularities of the many different insolvency procedures in place around the world.

Regardless of the existing techniques, a good bankruptcy procedure not only ensures the orderly disposition of the debtor's assets, but by protecting creditor rights, it also meets the following four conditions:

—It aims to achieve an outcome that maximizes the total value of the proceeds received by the existing claimants. Clearly, all creditors would benefit if the bankruptcy procedure could be modified so as to deliver a higher expected ex post value of the firm.

—It is neither too soft on "bad" companies nor too hard on "good" firms. Debt can serve an important role in disciplining management by, for example, limiting their discretion to engage in wasteful projects. Accordingly, a good bankruptcy procedure should preserve the ex ante bonding role of debt by penalizing managers adequately in bankruptcy states. Even economically viable firms run into financial distress, however, and bankruptcy law should provide a way to preserve them.

—It maintains the absolute priority of claims. That is, the most senior creditors should be paid off before anything is given to the next most senior creditors and so on. There are two basic reasons for this. First, senior creditors would be reluctant to lend if the previously contracted structure of debt priority is violated within the framework of the bankruptcy procedure. Second, having different rules for dealing with creditors inside and outside of bankruptcy can result in perverse incentives, with some creditors wasting resources to try to induce management to either forestall or precipitate bankruptcy.

—Finally, a good bankruptcy procedure minimizes the amount of discretion that the judiciary is able to exercise. For example, allowing judges to make business decisions may not be desirable if they do not have the qualifications or the appropriate incentives. In addition, discretion may facilitate corruption.

The two basic procedures for addressing problems of financial distress are cash auctions and structured bargaining. Cash auction or liquidation procedures are most widespread. Virtually every country in the world has this type of procedure. A cash auction involves closing down the firm's operations and appointing a trustee or receiver to organize a cash auction of the firm's assets. The firm may be sold as a going concern or piecemeal. The receipts from the auction are distributed among claimants according to absolute priority.

Structured bargaining or reorganization encourages creditors and shareholders to bargain about the future of the company. Under the judge's supervision, claimants develop a plan to liquidate or reorganize the firm and to divide its value among them. The plan is implemented if it receives approval by a suitable majority of each claimant class.

In practice, both types of procedures have serious problems. Under perfect and complete capital markets, cash auction or liquidation procedures sell the firm to the highest bidder and guarantee an efficient outcome. If capital markets are not efficient, however, the best managers may not be

able to raise the cash necessary to buy the firm. Capital market imperfections may have dire consequences if firms are inefficiently dismantled and their assets sold off cheaply at fire sale prices. A well-functioning structured bargaining procedure, in turn, requires a sophisticated legal system. In practice, bargaining procedures have been criticized for being time-consuming, involving significant legal and administrative costs, causing considerable loss in company value, being relatively soft on management, and allowing the judge abusive powers. Although these difficulties could be addressed through legal reform, any structured bargaining process entails two inherent problems. First, it is difficult to know what fraction of the firm should be allocated to each class of claimants because there is no objective valuation for the restructured firm. Second, and more important, structured bargaining processes address two questions simultaneously: who should get what and what should be done with the firm. The coupling of these issues introduces conflicts of interest and may cause assets to be put to other than their most productive use. For example, a senior creditor may press for a speedy liquidation (since he or she will then be paid off for sure), whereas junior claimants may encourage protracted bargaining (since they enjoy the upside of any changes in the firm's value, but not the downside).

In general, improving bankruptcy procedures is more difficult than improving shareholder rights because unlike the different noncontrolling shareholders, different types of creditors have different objectives. Senior creditors, especially secured senior creditors, prefer the rapid liquidation of bankrupt firms. Junior creditors and shareholders, whose claims are less secure, may prefer more orderly liquidation or even reorganization. These conflicts have pushed most countries to opt for slow, reorganization-focused bankruptcy schemes rather than liquidations.[11]

Further problems may arise when a bankruptcy procedure is applied in a developing country. Since capital markets in emerging economies are less developed, the deficiencies outlined for liquidation procedures may be severe. The effectiveness of court procedures is often impaired by the low efficiency of the judicial system and widespread corruption common in emerging markets.[12] In some of these nations, court procedures are slow not only as a result of less efficient courts, but also because the law is

11. Hart (1999).
12. Knack and Keefer (1995).

underdeveloped and vague. Many countries have poor systems for registering property, which leads to long and uncertain bankruptcy procedures because title to property is difficult to ascertain. Finally, the deficient accounting standards that characterize the financial reporting of companies in emerging economies make it harder to sort out the claims and determine whether bond covenants have been breached.[13]

The practical consequence of such deficiencies is that creditors in countries like Indonesia, Mexico, Thailand, and Russia are only able to recoup a very small fraction of their claims at the end of a very long procedure; consequently, those countries have very small debt markets.[14] Given the high costs of the present procedures, court-sanctioned reorganizations are rare, as firms typically prefer informal solutions to their financial problems. In some countries, personal property is commonly used as collateral in commercial transactions because it is not subject to the provisions of bankruptcy law and therefore can be seized more easily. Personal property can back only so much debt, however. In addition, although out-of-court settlements can be an effective means of coping with financial distress, the bargaining position of creditors is compromised by the lack of an effective collective procedure. In some cases, the parties may not achieve an out-of-court settlement, particularly if there are many creditors.[15]

The ramifications of this scenario become evident during a corporate debt crisis such as those that occurred recently in East Asia, Mexico, and Russia. In the aftermath of these crises, investors cried for better creditor rights, which caused some countries to modify the procedural features of their existing court-run bankruptcy and reorganization laws. These reforms did little, however, to change the situation for investors. Courts are frequently reluctant to play too active a role in matters as political and complicated as the closure or liquidation of companies. Several East Asian countries reformed their bankruptcy laws following the Asian crisis, for example, yet few companies have been taken through the bankruptcy process to date, largely because courts are politicized and not ready to

13. See CIFAR (1994).

14. The resolution of a bankruptcy procedure may take anywhere from three to seven years in countries like Mexico and Peru and even decades in Thailand.

15. In a study of the companies listed on the New York and American stock exchanges that were in severe financial distress in 1978–87, Gilson, Kose, and Kang (1990) find that workouts fail more than 50 percent of the time and are more likely to fail the larger the number of creditors.

adopt the new procedures. They tend to throw out most creditor applications on technicalities, especially when the case involves powerful borrowers.

The recent reform of Mexico's bankruptcy law illustrates how politics can oppose reform. As in the case of Indonesia, Mexico's reform was judicial based, so it raised many political issues in congress. Most experts in the country felt that their bankruptcy law was outdated, inefficient, and very costly. In the words of Domínguez del Río, one of the most respected corporate lawyers in Mexico, "As a legal process, Mexico's bankruptcy law has proved to be full of defects, confusing, and inept. . . . [and] it is unable to deal in an orderly fashion with a kind of litigation that needs speed and clarity to prevent irreversibly wasting the firm's assets." According to a Mexican Supreme Court judge, "Mexico's bankruptcy law is enough to cause anybody related to the bankruptcy process to lose their mind—including judges, lawyers, debtors, creditors, and all those who have the misfortune of having to read, understand, or interpret the complex, tortuous, and poorly written text of the law."[16] Consequently, the government stepped up efforts to change bankruptcy law following the tequila crisis in 1994.

Court-intensive bankruptcy procedures can impose substantial deadweight losses, since assets are dissipated throughout the process and out-of-court settlements are expensive. Particularly in emerging markets, the deadweight loss associated with bad bankruptcy procedures can be significant and may prevent solvent firms from undertaking projects with a positive net present value (NPV). Therefore, the search for alternative bankruptcy procedures to reduce reliance on the judiciary may have particular appeal in developing countries.

In the absence of a well-functioning judicial process, as in most emerging markets, the following two alternative reorganization procedures may be worth considering. First, creditors, or more specifically secured creditors, could be given the right to appoint an administrative receiver in charge of both running the firm in default and disposing of its assets (either piecemeal or as an ongoing operation). This method parallels the United Kingdom's administration procedure. Once the firm's assets have been sold off, the receiver distributes the proceeds in accordance with absolute priority, marking the end of the process. The advantage of this mecha-

16. López-de-Silanes (2000).

nism is that it can be implemented quickly, thereby minimizing the firm's loss of value. In addition, the immediate transfer of control to creditors minimizes intervention from the court, whose main role is to police the procedure to prevent fraud. The main disadvantage is that creditor-appointed receivers will not necessarily be interested in maximizing the firm's value. Not only may they favor some creditors over others, but they may also fail to act in the interest of shareholders when the firm is still economically viable.

A second departure from court-intensive procedures is to leave the decision to restructure or liquidate to market forces. Introducing market forces into bankruptcy proceedings requires steps akin to those of a privatization. Hart and others develop such a bankruptcy procedure based on auctions.[17] Specifically, both firm insiders and outsiders are invited to place cash and noncash offers for the bankrupt firm's assets. The assets are thus auctioned off to the highest bidder, and the proceedings are used to cancel existing claims according to absolute priority. Although the firm is stripped of its assets in preparation for the auction, claimants retain control and cash flow rights (bankruptcy rights) over the firm's assets. The holders of bankruptcy rights choose among the competing bids and retain all the proceeds from the auction. To eliminate conflicts of interest among different classes of claimants, this procedure transforms the capital structure of the firm into an all-equity firm through a mechanism that preserves absolute priority of claims: all debts are canceled, all bankruptcy rights are allocated to the most senior class of claimants, and more junior classes are allowed to acquire these rights if and only if they are willing to retire all senior claims to them.[18]

The introduction of market forces into bankruptcy through this procedure has several advantages. First, because firm insiders and outsiders can make offers in cash and noncash securities for the firm as a whole or for

17. Hart and others (1997).

18. A potential drawback of this mechanism is that capital market imperfections may preclude junior claimants from exercising their right to buy bankruptcy rights from senior creditors. In such cases, this procedure delivers allocative efficiency but not a fair outcome, as senior creditors benefit at the expense of other classes of claimants. As shown in Hart and others (1997), however, the basic procedure can be enhanced to avoid liquidity constraints through the introduction of an outside market for bankruptcy rights. A public cash auction for bankruptcy rights may be organized to sell all bankruptcy rights that could not be assigned to claimants and to purchase bankruptcy rights held by claimants if outside investors are willing to offer a price such that the holders' claims are paid in full.

parts of it, the firm's assets are likely to be put to their most productive use.[19] Second, the procedure eliminates conflicts between different classes of claimants regarding the future of the firm since all holders of bankruptcy rights are equal and have only one objective: to maximize the value of the firm. Third, while increasing creditor rights, the procedure allows for debtor protection by giving shareholders and management the opportunity to bid for the firm, including via reorganization proposals, and by allowing them first priority in exercising their right to acquire the bankruptcy rights from creditors.[20] Fourth, the procedure is simple and quick; it therefore reduces uncertainty and minimizes the loss of value (through financial distress and the depletion of assets) that usually follows the declaration of bankruptcy and reorganization. The preservation of the firm's value increases the probability of a successful reorganization and is translated into higher cash flows for the claimants entitled to the assets. Finally, the procedure minimizes the reliance on and room for discretion of the judicial system, yet it achieves a fair outcome in terms of absolute priority.[21]

Improving creditor rights is a sound strategy for developing credit markets. Unfortunately, reforming creditor rights can be politically treacherous. Extending improved creditor rights to preexisting credits is likely to cause wealth transfers from debtors to creditors. In addition, banks may not be interested in facilitating bankruptcy reform if it means having to specify the value of bad loans in their portfolio and, as a result, to inject fresh capital into their operations. Bankruptcy reform may be further complicated by the need to reach a compromise between the conflicting interests of secured and unsecured creditors.[22] When these parties have strong political allies, the introduction of new procedures can face insurmountable opposition. In Mexico, the authorities struggled for several years to introduce procedures based on market forces, like those described above.

19. A related advantage of allowing outside bids for the firm is that it reduces the probability of strategic behavior on the part of debtors by making it harder for them to declare bankruptcy and buy the firm cheap.

20. This preferential treatment protects shareholders when the cause of financial difficulties is bad luck and not poor management performance.

21. An additional advantage of this procedure over existing options is that contentious claims need not impede the reorganization process. This feature makes the proposal particularly attractive for emerging markets with poor property registration or lengthy court proceedings.

22. Hart (1999).

They encountered serious difficulties in passing bankruptcy law reform through a very divided congress, which represented the political interests of forces opposed to legal reforms. In fact, the congress removed basic features designed to solve many of the problems that plagued bankruptcy law. The same type of resistance in congress currently faces the new Philippine bankruptcy proposal.

The politics of legal reform may thus waste the very few chances a country has to substantially reform its legal institutions. To some extent, the presence of a large negative economic shock might serve as a catalyst for deep legal reform, as in the case of the 1998 reform of Colombia's bankruptcy law. Political expediency, as well as fairness, suggests that changes in creditor rights should apply only to new credits. Firms might even be allowed to opt into a more protective creditor regime by specifying irrevocably in their charters whether the new creditor-friendly rules apply in the event of financial distress. If the new set of rules for creditor protection is superior to the old one, firms should voluntarily adhere to higher standards of creditor protection, enticed by the prospect of lower interest rates.

Feasible Corporate Law Reform

As described earlier in the paper, the deepening of developing countries' financial markets must adhere to three basic principles, namely, the effective enforcement of legal rules, government regulation of financial markets in support of court enforcement of contracts and laws, and the adoption of complementary market-based mechanisms. These principles give rise to several policy recommendations for reforming corporate law. I classify these measures into two groups: (1) legal reforms that create rules to reduce the room for discretion and (2) mechanisms that allow market forces to create a culture of investor protection.

LEGAL REFORMS. The design of successful legal reforms for the protection of noncontrolling shareholders must take into account the weaknesses of the legal system of each country. This illustrates the first principle mentioned above: the enforcement of legal rules must be deeply connected with the rules themselves. The best reform strategy is not to create an ideal set of rules and then consider how to enforce them, but rather to enact rules that can be enforced within the existing enforcement structure.

As in the case of bankruptcy, the politics behind corporate law reform are very strong. Large private firms and labor unions often try to derail reforms before they get to the congress. Several Latin American countries are currently undergoing the painful process of negotiating reform. Although some of them have been able to pass corporate laws, the exact regulation of these principles in the commercial code needs to be clearly established if the ideas are ever going to benefit minority shareholders.

In the area of securities regulation, the main recommendation is to try to refocus regulation so that supervision is concentrated on intermediaries, rather than on issuers. This idea is sometimes credited to James Landis, a contributor to the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934. Landis reasoned that regulators alone could hardly monitor either the compliance of all listed firms with disclosure, reporting, and other rules or the trading practices of all market participants. Rather, the commission would regulate intermediaries, such as brokers, accounting firms, and investment advisors, who would, in turn, attempt to ensure compliance with regulatory requirements on the part of the issuers and the traders. Moreover, by maintaining substantial power over the intermediaries through its administrative relationships, including the power to issue and revoke licenses, the commission could force them to monitor market participants, as well.

A number of countries, including Germany and Poland, have introduced private intermediaries into the enforcement of securities regulations. Their success suggests that smarter regulations can improve the protection of investors, particularly in countries with relatively weak legal systems.

The successful regulation of the U.S. securities markets, the Polish financial markets, and the German Neuer Markt have a common element, namely, the regulatory insistence on extensive disclosure of financial information by the issuers. For improved disclosure standards to have an effect, however, securities regulations may need to be complemented with changes in the country's corporate laws to give shareholders the right to act on the information they receive. The right to act appears to be a key element of their protection.

The reform of corporate laws can take many forms. In some instances, it might require refining existing principles to make them more applicable. In others, it is necessary to create rights that are easily enforceable. Corporate law reform does not necessarily need to follow mechanisms of

Anglo-Saxon origin that rely heavily on the judicial system via derivative or class action suits. Depending on the state of their legal system, many developing nations may benefit from the application of more automatic principles, such as those in use in Chile.

The OECD initiative on corporate governance, like some of the initiatives from other international institutions, embraces some of the main principles that must be incorporated in the reform of corporate laws around the world. The following are some of the initiative's most useful recommendations:

—Protection of shareholder rights. Basic shareholder rights should include the right to secure methods of ownership registration; to convey or transfer shares; to obtain relevant information on the corporation on a timely and regular basis; to participate and vote in general shareholder meetings; to elect members of the board; and to share in the profits of the corporation. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules that govern general shareholder meetings, including voting procedures. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

—Equitable treatment of all shareholders. All shareholders of the same class should be treated equally. Insider trading and abusive self-dealing should be prohibited. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

—Timely and accurate disclosure and transparency. Disclosure should include, but not be limited to, material information on financial and operating results of the company; company objectives; major share ownership and voting rights; members of the board and key executives, and their remuneration; material foreseeable risk factors; material issues regarding employees and other stakeholders; and governance structures and policies. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and nonfinancial disclosure, and audit. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in

which financial statements have been prepared and presented. Channels for disseminating information should provide for fair, timely, and cost-efficient access to relevant information by users.

—The responsibilities of the board: monitoring and accountability. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and its shareholders. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly. The board should ensure compliance with applicable law and take into account the interests of stakeholders. The board should be able to exercise objective judgment on corporate affairs, independent from management. To fulfill their responsibilities, board members should have access to accurate, relevant, and timely information.

While these principles are undeniably important, close inspection reveals some basic concepts without which several of the outlined principles may be rendered weak or even useless. Most countries with poor shareholder protection lack two basic principles that have far-reaching ramifications. First, they need to develop an appropriate definition of a relationship and an interested or related party; without it, some of the recommendations on improved voting facilities or even disclosure are useless. Nothing much will change, for example, if the interested shareholders or directors can vote and approve by a majority certain transactions that are favorable to them but detrimental to the rest of the stakeholders. Second, the responsibilities and penalties for directors who violate their duties must be carefully outlined.

MARKET-BASED MECHANISMS. Legal reform may be slow and complex, particularly if it involves the amendment of national laws or drastic changes in legislation. Therefore, market-based mechanisms should be designed to temporarily substitute for or complement the reform of laws and regulations. These mechanisms should entail public measures that facilitate competition and ratings, giving firms that adhere to the measures access to capital at lower cost. The mechanisms also have the objective of extending and publicizing the concept of better corporate governance practices. The adoption of such measures could constitute a useful first step in the reform process, as they will foster the culture of respect for investor protection and establish the basis for the coming legal reform.

The first mechanism to consider is a local committee on best corporate governance practices. Several developing nations, such as Colombia,

Mexico, and Russia, have followed the example of Australia, England, and New Zealand in establishing a commission formed by members of both the private sector and government to review corporate practices and investor protection in the country. In each of these cases, the committee in charge of the analysis produced a document called a code of best practices, in which it detailed rules of good corporate governance and investor protection important to the country. These codes are mainly concerned with the organization of the board and special committees, but in some cases (probably as a result of the current lack of investor protection), the code also specifies shareholder protections. The adoption of the code's principles is usually voluntary, but the disclosure by each firm in the stock is compulsory.

The philosophical principle underlying these codes is that the disclosure of information about each firm's corporate governance practices and investor protections allows the market to perceive the differences among the policies of various companies. Information should enable shareholders to identify those firms that adhere to investor protections, which will then make the shareholders more willing to give those companies funds. Firms with better practices should find it easier and less expensive to access capital, as they provide a more certain environment for the investor. This code represents a substantial step forward in the creation of a culture of investor protection because it helps investors to recognize firms that have effective corporate governance mechanisms in place and to reward firms that offer better protection with higher valuation multiples or lower costs of capital. Furthermore, the code can trigger the modernization of a firm's investor protection because it offers an agenda of reforms that shareholders can submit to the board or present at the shareholders' meeting.[23]

Enhanced disclosure requirements may not be sufficient in countries with weak legal institutions or in which investors have very few rights and cannot demand changes. The second mechanism, therefore, is to restrict institutional investors to investments in companies that meet minimum corporate governance standards. These standards may be determined in relation to the code of best practices or by independent commissions. This recommendation is based on prudential considerations, as well as on the need to create an incentive for firms to agree on better investor protection. Chile, a civil law country, successfully implemented a similar program

23. For details on the case of Mexico, see López-de-Silanes (2000).

in which a commission identified a large list of minimum requirements that issuers of securities must meet in order to receive funds from institutional investors (Decree 3.500 in Chile).

Finally, the third mechanism involves improving the corporate governance practices of state-controlled enterprises. Despite widespread privatization, some countries still feature widespread state participation. These firms could set the example for private firms by adopting better investor protections.

Most state-run firms are large public utilities or companies dedicated to exploiting natural resources. External funding is just as important for these firms as it is for private concerns, as a result of substantially reduced government expenditures. They need higher levels of investment to meet the demand from the growing private sector. It therefore becomes imperative for them to find mechanisms for funding their projects through capital markets. The reform of corporate charters and improved board practices would also alleviate the government budget constraint. The adoption of the code of best practices by firms in the stock exchange can provide a quick and easy way for these state-controlled firms to transform themselves substantially and secure access to funds at better rates.

Although the market-based mechanisms outlined here may help foster the growth of external funding, they have important limitations since they reach only a small group of firms that are already in the stock market or that belong to the state. There are also limits on what can be obtained from improved disclosure and the voluntary adoption of higher investor protection standards. Even in the best-case scenario, firms might adopt improved protections with nonstandard contracts, but when violations occur, enforcement of those contracts may be difficult in the context of a weak legal system. Market-based mechanisms must therefore be backed up by deep legal reforms whose effects can reach all firms and be easily enforced as the standard in the country.

Reforming the Judiciary[24]

Legal rules are only one element of investor protection; the enforcement of these rules may be equally or even more important. If good laws are not

24. Botero and others (2001).

enforced, they cannot be effective. Likewise, investors may enjoy high levels of protection despite bad laws if an efficient judiciary system can redress expropriations by management. Strong legal enforcement can thus serve as a substitute for weak rules.

Copying principles from other countries' laws might not work. This failure could result, in part, from the fact that the procedures for applying law differ across nations. Djankov and others find that civil law countries have heavier regulation of dispute resolution for the same types of judicial actions than do countries following other legal traditions.[25] This provides an additional reason for complementing legal reform with judicial reform, if the former is to succeed. Judicial reforms that deal with the application of laws and reforms that establish or reinforce the independence of the courts from the executive power become a key ingredient of institutional reform.[26]

The judicial systems in most developing countries are perceived to be in crisis: cases take too long and cost too much, and the courts are littered with dishonest judges. Litigants are dissatisfied with the process, creditors never use bankruptcy laws, and shareholders feel it would be impossible to win a case against the controlling investor in a local court. Although there is little consensus on exactly what judicial efficiency means or how to measure it, people seem to agree that it is low. As a result, several countries have opted to implement judicial reform in the hope of improving investor protection and the efficiency of the judicial system.

Judicial reform efforts, in both developed and developing countries, have been varied and have met with mixed success. Even so, they might be divided roughly into six classes: (1) reforms based on the enhancement of the managerial capabilities of the judiciary; (2) reforms based on incentives to judges; (3) reforms based on incentives to the parties and other actors of the judicial process; (4) reforms based on the structural modification of the judicial system; (5) reforms based on the modification of procedural rules; and (6) reforms based on the simplification of substantive rules. Four common threads link these legal reforms: the need to address the issue of incentives, increase accountability, institute competition and choice, and streamline procedures.

25. Djankov and others (2002).
26. See La Porta, López-de-Silanes, Pop-Eleches, and Shleifer (2002).

Addressing Incentives

Reforms that tinker around the edges without addressing the incentives of judicial actors—such as those that indiscriminately increase judicial budgets or salaries, or that institute a one-time "crash" program to reduce backlogs—are not likely to succeed. Judicial officials commonly complain that they have too few resources and are understaffed, but the evidence on the effectiveness of increased resources is mixed. In a study of ten countries across various regions of the world, Buscaglia and Dakolias find that the worst court performance is in countries that devote the largest proportions of their budget to raising salaries and increasing staff sizes.[27] Data from the Caribbean, Latin America, and the United States show no correlation between the overall level of resources and time to disposition.[28] Many reform efforts lump other initiatives together with funding increases.[29] These packages may work more because of the other initiatives than because of the increased funding, as occurred in Paraguay and Tanzania.[30] The poor result of reforms based solely on increased resources could be due to the fact that higher salaries and larger budgets are classic ways of providing short-term gains to participants as "payments" for allowing reform to happen.[31]

Studies in Latin America and Singapore find that introducing computer systems and other forms of mechanization helps shorten delays and reduce corruption.[32] This result probably does not stem directly from the increase in resources, however. Computer systems seem to work because they increase accountability. Funding increases can help alleviate temporary backlogs in systems that have made a serious effort to work better, but they may be useless when inefficiencies are large—and they may even have a

27. Buscaglia and Dakolias (1999).

28. Church and others (1978). See also Buscaglia and Ulen (1997); Buscaglia and Dakolias (1996); Dakolias (1996, 1999).

29. See, for example, Hendrix (2000) for Guatemala; Tarigo (1995) for Uruguay; Hong (1995) for Singapore; and Dakolias and Said (1999) for Peru.

30. In Tanzania, the Commercial Court is well funded because it gets its operating budget from filing fees. Furthermore, because the court does not have exclusive jurisdiction, its ability to collect fees depends on its ability to offer a better product for the filing party (mainly for the party who is interested in resolving the issue most quickly). In Paraguay, the number of judges was increased at the same time that oral proceedings were introduced.

31. Buscaglia, Dakolia, and Ratliff (1995).

32. Buscaglia and Ulen (1997); Buscaglia and Dakolias (1996, 1999); Dakolias (1999); Hong (1995).

negative effect to the extent that they draw resources away from fixing systemic problems. Crash programs to reduce backlogs, presumably through a large infusion of resources, have shown good results in the short term, but as with crash diets, the effects will be temporary if not accompanied by deeper change, as courts revert to their old, bad habits.[33]

Purely managerial reforms can work in extreme cases, such as when resource shortages are particularly acute (if the court has no paper, for example, as in Uganda), but this is not the norm. While managerial reforms can help judges who already want to change, these are often the judicial actors who need the least prodding. A major source of inefficiency in many judicial systems is judges' responsibility for administrative work, such as signing paychecks and ordering office supplies. Centralizing administrative work in a single office, with employees who have administrative training, increased efficiency in Colombian and Peruvian pilot courts and in the Guatemalan public ministry.[34] At the same time, such measures may decrease judicial independence, since they may subject judges' paychecks to the mercy of the government.

Some studies in Latin America, Singapore, and the United States suggest that case management reduces total case time, particularly when it stresses pretrial conferences, strict scheduling, and shortened discovery time cutoffs.[35] Case management can seriously backfire if poorly designed, however, as it did in the case of pretrial hearings in Japan.[36] In the hands of judges who already take judicial efficiency seriously, case management can bring effective pressure on litigants to get their act together, but it may not make recalcitrant judges reform because there is no easy way to test whether cases are being managed well.[37]

Increasing Accountability

Accountability increases judicial efficiency. In traditionally corrupt or repressive countries, juries can serve as a check on the behavior of judges, since overruling a jury is a visible and seemingly heavy-handed act. Imple-

33. Neubauer and others (1981).
34. Dakolias and Said (1999); Hendrix (2000).
35. Church and others (1978); Neubauer and others (1981); Hong (1995); Buscaglia and Ulen (1997).
36. Hasebe (1999).
37. Feeley (1983).

menting judicial databases that make cases easy to track and hard to manipulate or deliberately lose helps guard against sloppy procedures and corruption. Individual calendars make explicit the link between judges' case management habits and their reputation among the public and the political decisionmakers whose opinions they care about.[38] Some studies have found that the individual calendar reduces time to disposition, not only because the judges in charge are more familiar with their own cases, but also because they feel more accountable.[39] Another advantage of the individual calendar is that it allows measurement of judicial performance. The mere ability to generate accurate statistics, even without any enforcement mechanism, can reduce delays, since judges care about their own numbers. Such an effect has been reported in Colombia, Guatemala, and the United States, though in the last case some judges object to perceived threats to their independence.[40]

Not every measure that aims to increase accountability will succeed or even be beneficial if it does succeed. For instance, legislated time limits may seem like an obvious incentive-based scheme, but they are largely unenforceable. There is no objective way to determine whether a case is dragging on because of legitimate difficulties or because someone has fallen down on the job. Every legislated time limit that has been implemented has had exceptions and loopholes so broad that they can fit any case.[41] In Argentina and Bolivia, judges are given mandatory time limits, but these are rarely enforced.[42] Additionally, step-by-step regulation of the litigation seems merely to add rigidity to the procedure, limiting the space for case management techniques, reducing judges' accountability for the overall efficiency of the procedure, and leaving ample room for corruption.

38. Individual calendars are different from systems with master calendars, in which the court can assign different parts of a case to different judges. The master calendar has some advantages—a case can go on if a judge is sick or has a congested docket; judges can specialize in the procedural tasks they are good at—and some jurisdictions use it without too many problems. The system also has drawbacks, however—no judge becomes very familiar with the case; attorneys are able to shop the judges; different judges can rule inconsistently in the same case; and if a case takes a long time in a master calendar jurisdiction, it is hard to know on whom to pin the blame.

39. Church and others (1978); Neubauer and others (1981); Dakolias (1996).

40. Neubauer and others (1981); Dakolias and Said (1999); Hendrix (2000).

41. Feeley (1983).

42. Dakolias (1996).

Judges are not the only cause of delay, since cases are often desired and pursued by at least one of the parties.[43] Some reforms are therefore directed at the litigants, to give them incentives to expedite the process. Fee shifting schemes, such as "loser pays" rules, make frivolous litigants responsible for the burdens they place on hapless defendants, but they can actually encourage excessive legal costs. In cases in which both parties stand a fair chance of winning, each litigant may be encouraged to outspend his or her opponent in the hope of producing a marginally more persuasive case, thereby winning and paying nothing. Lawyers and attorneys have vigorously opposed such reforms in several countries, including Peru and Uruguay.

High legal costs for litigants reduce the legal system's subsidy of litigation, but at the cost of restricting access. One way of discouraging long litigation is to increase the direct costs to one or both of the parties. In Singapore, where the first day of trial is free and court fees increase progressively over subsequent days, 80 percent of cases take a single day for trial.[44] In Latin America, as well, higher direct costs decrease the duration of cases.[45] But the effects of such a system are mixed, since what it gains in speed it may sacrifice in access for poor people with cases too complex to solve in one day.

Because attorneys' fees constitute a large part of the costs of justice, it seems natural to apply incentives for the attorneys themselves. Direct fee regulation may reduce efficiency, however, since it restricts the supply of lawyers, whom people often believe they need.[46] Low fees may also lead claimants to hire an attorney even for minor controversies that could have been resolved by an arbitrator. The success of the Japanese judicial system is attributed, in part, to the absence of lawyers in 90 percent of summary court cases, which account for over 60 percent of all civil litigation in Japan.[47] Similarly, a low rate of lawyer involvement in lower-level courts

43. Feeley (1983); Church and others (1978).

44. Buscaglia and Dakolias (1996).

45. Buscaglia and Ulen (1997).

46. The Dutch and Japanese experiences indicate that deregulating the legal services market increases the supply of legal aid and decreases costs. Studies of legal advocacy by both lawyers and nonlawyers in the United States suggest that the decrease in costs is not necessarily associated with a decline in quality.

47. See Ogishi (1999). See also the *Japan Statistical Yearbook* (Japan Sorifu Tokeikyoku, 1999), which states that of the 456,000 civil and administrative litigation cases disposed of that year, 277,000 were disposed of in Summary Courts.

in England is associated with high levels of efficiency and litigant satisfaction: more than 80 percent of unrepresented English small claims litigants surveyed in a recent study said they would not have preferred representation.[48] Finally, reduced costs generally increase litigation, including both good claims and bad. In 1997, the United States had a filings-per-population rate of 34 percent, compared to 4 percent in Japan.[49]

Instituting Competition and Choice

The presence of competition and choice, in the form of alternatives to the standard legal system, tends to increase judicial efficiency. Creating or extending small claims courts, for example, is among the most praised of all judicial reforms.[50] In many countries, the use of small claims courts has substantially reduced times to disposition and expanded access to justice.[51] The increase in the small claims limit in Great Britain is vastly popular among litigants, though some of the enthusiasm may be driven by the decreased risk of small claims litigants who must neither pay their opponents' legal fees nor go up against defendants bankrolled by the government's generous legal aid system (in contrast to regular British courts).[52] Small claims courts are also popular in many other countries, including Japan and the United States.[53] The main criticisms of small claims courts are that they do not provide enough legal advice to pro se (or self-represented) litigants and that sometimes, as in Italy and Germany, they remain too formal in their procedures and thus do not fulfill their promise of reducing costs and delays.[54]

48. Baldwin (1997b).

49. There were 91 million cases filed in U.S. state courts, as reported by Ostrom and Kauder (1998). Total filings in Japan were 5,128,000, according to the *Japan Statistical Yearbook* (Japan Sorifu Tokeikyoku, 2000). The U.S. population is 270.3 million, while the Japanese population is 126.4 million (World Bank, 2000).

50. Varela and Mayani (2000) argue that in the Dominican Republic, all civil claims below D.R.$900 (U.S.$56) should be tried by a justice of the peace; this would account for 75 percent of all civil cases.

51. Bermudes (1999) argues that the introduction of small claims courts in Brazil in 1995 "succeeded in bringing justice closer to the Brazilian people [by allowing them to] litigate at a very low cost, in an informal manner, and see immediate results for their judicial initiative."

52. Baldwin (1997a).

53. Kojima (1990).

54. Baldwin (1997a); Varano (1997); Rohl (1990).

Specialized courts addressing a particular subject matter can also increase efficiency. Such courts have been set up for streamlined debt collection in several countries, including Germany, Japan, and the Netherlands.[55] The Netherlands also has a specialized court for divorce cases, which is considered inexpensive and easy to use; in the United States, judges who specialize in contested divorce trials tend to resolve cases faster.[56] Labor tribunals in Ecuador and the commercial court in Tanzania have similarly been associated with reduced times to disposition.[57] Many of these specialized courts emphasize arbitration and conciliation, so some of the positive results on specialized courts may stem from the effect of alternative dispute resolution and not from the specialized courts per se. Specialization is not only good for courts; the Guatemalan experience indicates that setting up specialized prosecution teams in the prosecutor's office can also lead to better-quality prosecutions.[58]

Alternative dispute resolution is also generally positive. As noted above, many successful small claims courts, specialized courts, and native justice courts incorporate a strong element of arbitration and conciliation, including the *kort geding* in the Netherlands; labor mediation in Ecuador; justices of the peace in Peru, the United States, and elsewhere; mediation centers in Latin America; and the *lok adalats* in India.[59] In Chile and Ecuador, the presence of alternative dispute resolution has reduced opportunities for corruption, since a judicial system in competition with other institutions is less able to extract rents from litigants.[60]

While no one questions the value of voluntary alternative dispute resolution, mandatory dispute resolution is another story. In the United States,

55. Blankenburg (1999); Rohl (1990); Kojima (1990).

56. Blankenburg (1999); Buscaglia and Dakolias (1996).

57. Dakolias (1996); Finnegan (2001).

58. Hendrix (2000). A note of caution is in order. Courts that specialize in native or so-called peasant justice are often criticized for not respecting human rights, as in Peru. Other courts, like the *nyaya panchayats* in India, are considered corrupt and riven by factionalism, though the experience with *lok adalats* has been more positive. The resistance committees in Uganda have had fewer problems. Specialized, informal courts are still agents of the state, and procedures are in place partly to guarantee fairness and equal treatment for all litigants. An excessive emphasis on procedure may undermine fairness, but so may excessive informality—although costs and delays may fall, the informal forum may be unaccountable. At the margin, however, formal judicial systems in developing countries seem to suffer more from an excess of formality than from its opposite.

59. Blankenburg (1999); Dakolias (1996); Brandt (1995); Hendrix (2000); Cranston (1986).

60. Buscaglia and Dakolias (1999).

the courts with the most intensive civil settlement efforts tend to have the slowest disposition times; neither processing time nor judicial productivity is improved by extensive settlement programs.[61] Referring cases to mandatory arbitration has no major effect on time to disposition, lawyer work hours, or lawyer satisfaction, and it has an inconclusive effect on attorneys' views of fairness.[62] In some mediation programs in Latin America and Japan, the mediator is also the judge, which may be procedurally unfair: the judge may railroad the parties into a settlement, and the parties are often afraid to be frank before the same official who will pass judgment on them later.[63]

Competition and choice seem to work at all levels. For example, sophisticated international commercial arbitration provides an expensive yet cost-effective alternative to court litigation for complex international transactions. Deregulation of legal services lets people prepare a case without relying on the expensive services of the legal monopoly.

Finally, the best alternative to the standard legal system is the opportunity not to have a dispute arise in the first place: the simplification of substantive rules lets people structure their behavior to reduce their chances of ever having to use the legal system. When the substantive rules are unclear, there may be a limit to how much judicial efficiency can be improved through procedural reform. For instance, when most land is untitled, land tenure is insecure because no one is sure how courts will rule on a contested claim. In that case, a land titling program, like the one undertaken in Peru, may increase judicial efficiency and also substantially increase economic activity and land values.[64] In the Dominican Republic, substantive changes in family and commercial law—to reduce gender bias in custody cases, modernize the commercial code, and implement more effective sanctions against fraudulent check writers—are a necessary condition for successful judicial reform.[65] Substantive complexity is generally associated with increased time to disposition.[66] Studies in the United States find that the types and complexity of cases are major con-

61. Buscaglia and Dakolias (1996); Church and others (1978).
62. Kakalik and others (1997).
63. Hasebe (1999); Dakolias (1996).
64. De Soto (1998).
65. Varela and Mayani (2000).
66. Buscaglia and Ulen (1997) make this point, but Church and others (1978) argue that substantive complexity is not as important as the "local legal culture."

tributing factors to civil and criminal trial length.[67] Studies in civil law countries suggest that this association is particularly important during the sentencing stage, when judges play a more active role and can't delegate their work to a clerk.[68] Substantive simplicity may also be driving many of the results in the small claims court studies.[69]

Streamlining Procedures

Streamlining procedures tend to increase judicial efficiency. In a cross-country study of 109 nations, Djankov and others find that countries with heavier regulation of dispute resolution in simple civil cases—such as the collection of a returned check or the eviction of a nonpaying tenant—have less efficient judicial systems.[70] Establishing simple procedures for simple cases improves the overall efficiency of the system by allowing the bulk of litigation to be resolved swiftly and inexpensively in one or two hearings, without further impact on upper judges' caseloads. Reforms of this sort have improved efficiency and access in countries with diverse legal traditions, including Brazil, England, Japan, Peru, Scotland, and the United States.

The predominance of written statements over oral representation is commonly associated with inefficiency in civil law countries, especially in Latin America.[71] Oral hearings are unimportant in these systems, and judges do not have direct contact with witnesses or other sources of evidence. This tends to be associated with a piecemeal trial, rather than one that is continuous in time. A move toward oral litigation has produced positive results in Paraguay, Uruguay, eighteenth-century Prussia, and possibly Italy.[72] Oral litigation is, of course, a dominant characteristic of small claims courts and specialized tribunals.[73]

Greater procedural complexity reduces transparency and accountability, which increases corrupt officials' ability to sell progress on the case.[74] Pro-

67. Sipes and others (1988) argue that "trial length for both civil and criminal trials varies greatly among states and within states. Factors contributing significantly to these variations are the types and complexity of cases and methods used to select juries."

68. Buscaglia and Dakolias (1996).

69. Baldwin (1997b).

70. Djankov and others (2002).

71. Véscovi (1996); Varano (1997).

72. Dakolias (1996); Tarigo (1995); Weill (1961); Varano (1997).

73. Baldwin (1997a); Blankenburg (1999).

74. Buscaglia and Dakolias (1999).

cedural simplification tends to decrease time and costs (for instance, the shortened time cutoff for discovery in the United States) and increase litigant satisfaction (for instance, the streamlined procedures of small claims courts in Great Britain and of justices of the peace in Peru, the United States, and elsewhere). The efficiency of small claims courts seems to be driven not so much by any structural difference between small claims courts and regular courts as by the simplicity of procedures. Indeed, English small claims courts are not a separate institution at all; county court procedures have merely been modified over the years to accommodate small claims.[75] The same is true in Scotland and several U.S. states.[76]

Not all streamlining efforts work, however. In the Dominican Republic, for instance, forms intended to simplify case filing procedures actually complicated the process.[77] Furthermore, streamlining costs and reducing the time to disposition are not the only legitimate goals of judiciary reform. Most procedures have been adopted because they were believed to improve accuracy, protect the accused, facilitate access, or otherwise further justice. In the United States, for instance, the Federal Rules of Civil Procedure seem to have increased costs without reducing delays, but they may have increased accuracy, which may or may not represent a net gain.[78] To the extent that reform focuses on speed and cheapness, it risks undermining some of the less measurable goals of procedure.

The simplification of lower court procedures has improved efficiency and access in countries with diverse legal traditions, such as Japan, Peru, and Scotland, but the overall impact of procedural simplification depends on how burdensome the procedures were before the reform. Reforms in completely clogged systems may bring about a large increase in filings in the short run, and in the long run they will be associated with improved service, greater litigant satisfaction, and improvements in access. But reforms to already simple procedures may have little impact or result in frivolous litigation. Many procedures exist for a reason, and to the extent that streamlining undermines valuable procedural rights, caution is required. In most countries, however, the dangers of oversimplification are more remote than the dangers of overproceduralization.

75. Baldwin (1997b).
76. Kelvie (1994); Mays (1995).
77. Varela and Mayani (2000).
78. Leubsdorf (1999).

Putting It Together

There is no one measure of judicial efficiency. Some aspects of judicial efficiency are not measurable at all, and the whole exercise is affected by value judgments about the nature of justice. Any conclusions must therefore be taken as tentative. Moreover, reformers should always ask themselves whether reforms from one country or legal system should be transplanted into another. The accuracy-speed-cost trade-off is quite different in the developing world than it is in developed countries. Complicated legal systems that work in rich countries, which have the resources and expertise necessary to handle such complexity, are unlikely to work in poorer countries without significant modification. Poor countries, or countries without a developed judicial tradition, should probably concentrate instead on instituting simple rules that are easy to enforce. The quest for a legal system that will do perfect substantive justice in infinite time and at infinite cost is a luxury that the poor can ill afford.

If the goal is accurate, cheap, and swift justice, infusions of money are probably not the answer, except in cases of egregious resource shortages or perverse allocations of workload. Limiting access is not the solution, either—a judicial system that denies people the right to sue will leave many wrongs unrighted and will create pervasive incentives for people to take justice into their own hands. Limiting access to the judicial system in order to solve structural inefficiencies is like fighting cancer with morphine. The pain of congestion diminishes, but it will inevitably resurge, and precious time will have been lost.

Reforms that increase accountability, institute competition and choice, and streamline procedures show promise. Accountability deters sloppy or corrupt judicial actors ex ante, and it allows the public or the legislature to punish them ex post. Countries with a repressive history or whose judicial systems suffer credibility problems may do well to establish mechanisms such as juries, good information systems, individual calendars for judges, individualized statistics on clearance rates and times to disposition, and alternative avenues of litigation that establish competition and choice. In addition, countries should promote voluntary alternative dispute resolution and criminal plea bargaining; set up specialized courts with nonexclusive jurisdiction, such as small claims courts or commercial courts in many countries; deregulate their legal services, for instance by allowing mediators and others to compete with lawyers; and simplify their

substantive legal rules to reduce the need to use the legal system in the first place.[79]

Finally, judicial procedures should be streamlined, provided that fundamental procedural rights are not violated. Evidence suggests that the simplification and streamlining of procedures—especially in lower-level courts—allocates resources better, increases access, and improves overall efficiency. In particular, simple cases may be solved quickly and cheaply in one or two hearings with direct examination of the evidence, while complex litigation is handled at higher levels within a reasonable time and at a reasonable cost.[80] To facilitate simplification, judicial sectors should be given more leeway to innovate and experiment with different procedural requirements; countries with a heavy emphasis on writing should move toward oral hearings; the role of specialized courts and small-claims courts should be expanded; and the number of procedural steps should generally be reduced.

The impact of all the judicial reforms described in this section is likely to depend on the degree of judicial independence. The equality of subjects before the law and the impartial administration of justice by the courts are key elements for restricting the sovereign's power. Parliament or congress makes the laws, but judges need to enforce them without interference. To that end, the sovereign—even a democratically elected one—must be restrained. Judicial independence is especially important for financial development and other measures of economic freedom, such as the level of regulation surrounding the start-up of a business.[81]

79. For interesting case studies involving small claims courts, see Baldwin (1997a, 1997b); Kojima (1990); and Rohl (1990). For a case study involving a commercial court, see Finnegan (2001). For case studies involving the deregulation of legal services, see Kritzer (1997) and the discussions in Blankenburg (1999) and Kojima (1990).

80. For interesting case studies involving procedural simplification, see the discussions in Baldwin (1997b), Hendrix (2000), Leubsdorf (1999), and many others.

81. See La Porta, López-de-Silanes, Pop-Eleches, and Shleifer (2002), who collect information on a variety of constitutional arrangements in seventy-one countries to measure the prevention of arbitrary action by the government and the separation of powers between the creators and the administrators of the law. For a detailed description of the regulation of entry across countries, see Djankov and others (2002).

Conclusions

The legal environment, as described by both legal rules and their enforcement, matters for the size and extent of a country's capital markets. Some countries offer investors a rather unattractive legal environment in terms of shareholder and creditor rights, as well as the quality of enforcement. As a result, credit markets in these countries are exceedingly small, and stock markets are both small and very narrow. The immediate reaction to the evidence here is to call for an overhaul of the judiciary system and undertake legal reform. However, the politics of legal reform are difficult.

Although legal reform, in general, appears to enjoy international support, it is seldom completed on time or achieved on optimal terms. The overall benefits of reform might be sizable for society, but numerous political forces seek to limit the efforts to conduct radical overhauls of corporate governance and laws. Opponents of reform have many faces and varied interests, including entrenched politicians, insiders from large corporations, distressed financial institutions, workers, and political parties representing these interests in congress. Corporate governance reform is likely to cause wealth transfers from controlling investors and rent-seeking third parties to creditors and minority shareholders, leading the affected parties to fight to maintain the status quo. Against these forces, the increased interconnectedness of financial markets and the larger role of international investors act as catalysts for reforms that promote convergence in governance practices across markets, as firms compete for the funds they need to meet the challenges brought by a more open economy with increased competition. The politics of legal reform are difficult, but not insurmountable. Those countries that have successfully engaged in legal reform have taken account of the local political reality and designed the changes to appease the opposing forces.

Unfortunately, the challenges for successful legal reform do not end there. As some of the examples reviewed here show, getting reforms through the political process might not give positive results if the reforms do not overcome deficiencies in the country's judiciary. Changing the judicial system is a slow process, and judicial reform must therefore begin early on. In this effort, two basic issues must be addressed at the outset, as they affect other judicial reforms. First, the regulation of dispute resolution in courts should be reduced. As explained in Djankov and others, courts in countries with heavy regulation of civil procedures take significantly

longer to solve disputes than courts in countries with lighter regulation, and the participants of the system perceive the outcomes as unfair and inefficient.[82] Second, as the cross-country data on constitutional rules show, institutions of judicial independence are strong predictors of financial development and economic freedom.[83] Because improving the efficiency of the judicial system and asserting the rule of law are slow processes, it is important to incorporate those constraints into the policy design. The general, and sometimes vague, principles of corporate governance need to be translated into feasible reforms that can be implemented and, most important, that can be enforced by the judicial system of each country. Successful reforms take time to permeate through the courts. The design of bankruptcy and corporate law reform must therefore find creative avenues for avoiding existing enforcement problems.

In bankruptcy law, the reform of creditor rights needs to be grounded on those rights that can be enforced. Even if reorganization procedures were optimal, they probably would not work well in countries with slow and ineffective judicial systems. Mechanisms that allow the interplay of market forces, such as those described in this paper, may be particularly appropriate in countries with weak judicial systems. The success of the escrow systems in several developing countries illustrates the practical importance of creating out-of-court mechanisms for dealing with financial distress. However, these mechanisms are only a partial solution. More extensive legal reform is likely to be necessary to allow for broad access to credit.

Measures that promote the interplay of market forces as incentives to those in charge and that reinforce suitable informal norms and customs prevailing within the business community are essential for corporate and securities law reform. In principle, some mechanisms—such as giving shareholders the right to a quick redress, allowing them to make their views known to other investors, and increasing voting facilities—could work powerfully even in an environment in which other shareholder rights are missing or in which courts do not function well. With regard to securities exchanges, it is easier to supervise the financial intermediaries that bring securities to the markets than to control each individual issuer; reform should therefore contemplate mechanisms that make agents

82. Djankov and others (2002).
83. La Porta, López-de-Silanes, Pop-Eleches, and Shleifer (2002).

responsible for the actions of their clients. Again, all reforms should be complemented with market-based mechanisms that allow market participants to award higher valuations to those firms that improve investor protection. Successful efforts in this area include local codes of best practices that force firms to reveal their corporate governance mechanisms and prudential measures that restrict institutional investors to investments in companies that meet minimum investor protection standards.

Improving corporate governance should be at the top of the policy agenda if developing countries are to embark on a self-sustainable path of long-term development. Institution building is a critical part of the success of a market economy. Reforming institutions to allow for a deepening of financial markets is key to ensuring business growth. However, it is essential to recognize the perils of blindly transplanting rules or applying a list of investor rights without regard for the legal realities and financial structure of the country. The design of feasible legal reform must incorporate judicial reform as well as rules that take into account the status of the local legal enforcement.

The benefits of improved investor protection on the overall economy, as well as on facilitating monitoring by capital markets and lending institutions, justify taking steps toward improving corporate governance. The available empirical evidence suggests that enhancing corporate governance will likely result in larger capital markets, reduced output volatility, and faster growth. Macroeconomic management will need to pay increasing attention to the development of the institutional infrastructure that will support large and stable private capital inflows.

This paper argues that effective legal reform needs to include changes in several specific areas of investor protection laws, including corporate law, securities laws, and bankruptcy laws, as well as changes in the more general area of judicial reform. Undertaking such reforms is economically and politically costly, and some priorities may need to be set according to the forces of the status quo in each of these areas in each country. Although a priority list is hard to come by, judicial reform and securing judicial independence should be high on the list of reforms because of their impact on other areas beyond the functioning of capital markets and because those reforms take time to implement. Additionally, facilitating the flow of dispute resolutions would provide more security for small financial transactions, such as the cashing of a supplier's check when the

supplier defaults. This, in turn, should be reflected in an increase in trade credit and interfirm financing, complementing reforms that directly affect the development of capital markets.

Appendix: Description of Variables

The table in this appendix describes the variables collected for the forty-nine countries included in tables 1 and 2. The first column gives the name of the variable. The second column describes the variable and gives the range of possible values. The third column provides the sources from which the variable was collected.

TABLE A1. Variables Used in Tables 1 and 2

Variable	*Description*	*Source*
Shareholder rights	An index aggregating the shareholder rights, which are labeled as anti-director rights. The index is formed by adding 1 when (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the general shareholders' meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an extraordinary shareholders' meeting is less than or equal to 10 percent (the sample median); or (6) shareholders have preemptive rights that can only be waived by a shareholders' vote. The index ranges from 0 to 6.	Company law or commercial code
Creditor rights	An index aggregating different creditor rights. The index is formed by adding 1 when (1) the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); (3) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; or (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from 0 to 4.	Bankruptcy and reorganization laws
Efficiency of judicial system	Assessment of the efficiency and integrity of the legal environment as it affects business, particularly foreign firms, is taken from the country-risk rating agency, Business International Corporation. The index "may be taken to represent investors' assessments of conditions in the country in question." Average for 1980–83. Scale of 0 to 10, with lower scores indicating lower efficiency levels.	Business International Corporation
Rule of law	Assessment of the law and order tradition in the country, published in the *International Country Risk Guide*. Average of the months of April and October in the monthly index between 1982 and 1995. Scale of 0 to 10, with lower scores indicating less tradition for law and order. (The scale has been changed from the original range of 0 to 6.)	PRS Group, *International Country Risk Guide*
Accounting standards	Index created by examining and rating firms' 1990 annual reports based on their inclusion or omission of ninety items. These items fall into seven categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data, and special items). At least three firms in each country were studied. The firms represent a cross-section of various industry groups, with 70 percent industrial firms and 30 percent financial firms.	Center for International Financial Analysis Research (CIFAR), *International Accounting and Auditing Trends*

(*continued*)

TABLE A1. Continued

Variable	*Description*	*Source*
Ownership of three largest private firms	The average percentage of common shares owned by the three largest shareholders in the ten largest nonfinancial, privately owned, domestic firms in a given country. A firm is considered privately owned if the state is not a known shareholder.	Moody's Investor Services; CIFAR; Thomson Financial Extel Survey; WorldScope; 20-Fs; various country sources
IPOs per million inhabitants	Ratio of the number of initial public offerings of equity in a given country to its population (in millions) for the period of July 1995 to June 1996.	Securities Data Corporation; *AsiaMoney*; *LatinFinance*; Financial Times, *Guide to World Equity Markets*; World Bank, *World Development Report*
Domestic firms per million inhabitants	Ratio of the number of domestic firms listed in a given country to its population (in millions) in 1994.	International Finance Corporation, *Emerging Stock Markets Factbook*; World Bank, 1996, *World Development Report*
Debt/GNP	Ratio of the sum of bank debt of the private sector and outstanding nonfinancial bonds to GNP in 1994, or last available.	International Monetary Fund, *International Financial Statistics*; Euromoney, *World Bondmarket Factbook*