

## Law, Regulation and Enforcement

### *The Link between Law and Law Enforcement Institutions*

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The canonical approach to law reforms in the transition economies of Central and Eastern Europe has been that countries need first, “good law” and “good law enforcement institutions” (Worldbank 1996). Typically, “good law” took precedence over “good enforcement institutions”, because it was easier, cheaper and faster to design new laws than to reform judiciaries, build regulatory agencies, and train bailiffs. Only when it turned out that all the good new laws were not enforced effectively, did policy makers turn to the problem of enforcement. Separating law and legal design from law enforcement institutions, however, makes little sense (Stiglitz 1999).

First, laws that cannot be enforced have at best an educative function, in most cases will live a “shelf-life” and in worst cases will undermine the credibility of law as an effective governance device.

- The Asian *dragons* and *tigers* had Western style laws on the books at the outset of their dramatic growth period in the early 1960s. These laws, however, were superseded by administrative guidance (Pistor and Wellons 1999) and had little impact on the resolution of governance issues – and by implication on the economic success of these systems.
- The proposed “educative” function of Russia’s 1996 corporate law (Black, Kraakman, and Hay 1996) did not materialize in light of stronger economic and political factors that fueled systematic abuse of shareholder rights after a “good law” had been enacted (Black, Kraakman, and Tarassova 2000).
- Lack of *effective* governance can change the economic landscape. An example is the strong trend towards consolidation of ownership in transition economies at the expense of stock markets irrespective of the quality of the law on the books (Berglöf and Pajuste 2003; Pistor, Raiser, and Gelfer 2000).

Second, it is easier for law enforcement institutions to take over law making functions than for legislatures to participate in lawmaking activities. Moreover, complex governance issues require close cooperation between “regulators” and “the regulated”.

Thus, the starting point should be law enforcement, or more broadly, governance institutions, not law.

- Courts play an important lawmaking function across legal systems notwithstanding the fact that in civil law systems courts according to legal doctrine “interpret”, but do not make the law. Applying the law to specific cases, filling gaps, and using analogy are part of lawmaking functions (Merryman 1981).
- Administrative agencies and regulators can and do perform similar functions when they grant approvals or constrain specific behavior. Moreover, they can be delegated specific lawmaking powers to respond to changes in their area of competence (Kischel 1994).
- The increasingly complex task of governing economic activities and responding to changes in the environment have given rise to new governance systems that build on close cooperation between “regulators” and “the regulated” (Sabel and Zeitlin 2006).

Third, however much attention lawmakers pay to the design of “good laws”, in countries in the early stages of their legal development is inherently difficult to enforce – even controlling for the quality of law enforcement institutions. The reason is that law in these countries tends to be highly incomplete (Pistor and Xu 2003). In such a situation, the allocation of law enforcement and (residual) lawmaking functions becomes particularly important.

- Law is inherently incomplete – i.e. it is impossible for any lawmaker to anticipate all future contingencies and regulate them ex ante. New and untested law is particularly incomplete. Countries that have only recently embarked on law reforms – China, for example – have only begun the process of explaining, fine tuning, and adapting the principles enshrined in legislation to the real world (Pistor and Xu 2005).
- When law is highly incomplete it is unlikely to deter acts that may result harm to constituencies the law seeks to protect, i.e. legal governance is weakened. A good example is the massive transfer of investor protection law with little impact on financial market development, as much of this law had little deterrence effect (Pistor, Raiser, and Gelfer 2000).
- By allocating law enforcement and law making functions to institutions that are designed to take the initiative in making and enforcing law in response to changes in the market place, legal governance can be strengthened (Xu and Pistor 2006).

Fourth, legal governance is only one form of governance, and even in highly “legalized” economies, not the only one (Knight 1998). While there may be good reasons for strengthening legal governance institutions, it is preferable to rely on alternative governance mechanisms until they are built – and not to destroy them prematurely (Pildes 1996).

- Switching from one governance regime to another in a short period of time is not possible, as evidenced by the experience of transition economies (Elster, Offe, and Preuss 1998; Stark 1996).
- The experience of China's early stock market development suggests that such markets can be built in the absence of strong legal governance, if other governance systems are in place. The quota system, which relied on administrative governance at the local level subject to central supervision provided such a mechanism (Pistor and Xu 2005). The critical challenge China is facing now, is whether it can successfully "grow out" of this system (Naughton 1996). While this is not an easy task, the situation China is confronting today may still be superior to many other transition economies where stock markets failed to take off in the first place.

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