The Role of Law in Business Development

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Abstract

Part I of this Essay concerns the law of developing nations as it effects business growth. Part II describes the legal framework needed in developing nations. Part III talks about the legislative policies that should be adopted. Part IV is about the role of the World Bank in developing nations.
INTRODUCTION

As we approach the new century, our world is increasingly described as a global village and our times as the post-geography era. Political boundaries are becoming less of a barrier in the face of the explosive growth of global investment and trade. Almost a hundred investment laws and over a thousand bilateral investment treaties have extended to foreign investors, legal treatment equal, or similar to, that enjoyed by local investors. The right to national treatment is progressively finding its way to becoming part of customary international law. In these circumstances, it is no longer appropriate to speak of the need for a separate legal framework for international business distinct from that applicable to domestic business. What is needed is a legal framework that allows private business, regardless of whether it is domestic or foreign, to grow and prosper.

I. LAW AND DEVELOPMENT

I began working on development issues over thirty years ago. Ever since then, it has been clear to me that law plays a key role in the business development process in general and a pivotal role in the growth of private business in particular. Since the late 1960s, I have tried to articulate this role in my writings in a continued effort to enhance awareness of its relevance and importance. This, in fact, explains my association with the efforts which led to the establishment of the International Development Law Institute ("IDLI") in 1983 and my close association with that endeavor since that time.

In all countries, law, which is often used to maintain the
status quo, has also had an essential role in guiding and legitimizing the processes of change. It is the instrument for introducing orderly development and reconciling diverse interests. It took civil strife and economic failures in Africa, the collapse of dictatorships in Latin America, and, particularly, the transformation of Eastern and Central Europe, however, to bring this simple fact to the forefront of present-day development discussions.

As developing and transition countries began to move en masse towards market economies, they adopted strategies for the encouragement of local and foreign private investment. There is ample evidence that the establishment of the rule of law\(^1\) attracts private investment, to the extent that it creates a climate of stability and predictability, where business risks may be rationally assessed, property rights protected, and contractual obligations honored. More generally, experience supports the proposition that the rule of law is needed to give credibility to commitments on the part of the governments, and reliability and enforceability to applicable rules. This, in turn, leads to lower transaction costs, greater access to capital, and the maintenance of level playing fields. As a result of this experience, recent literature on economic development has placed greater emphasis on institutional economics, notably on preserving the quality of institu-

\(^1\) The "rule of law," sometimes called the "supremacy of law," has been understood to generally indicate that decisions should be made by the application of known principles or laws without the intervention of discretion in their application. See Black's Law Dictionary 1392 (6th ed. 1990). The "rule of law," in terms of constitutional law, was invoked by English writers as early as the 12th and 13th centuries to restrain the powers of monarchs, and was articulated in the Massachusetts Constitution. See Mass. Const. of 1780, Part the First, art. XXX, reprinted in Constitutions of the United States (Oceana Publications, Mar. 1992) (spelling out principle of separation of powers "to the end [the government] may be a government of laws, and not of men"). In modern constitutional law, the "rule of law" translates into the principles of law-abiding governmental powers, independent courts, transparency of legislation, and judicial review of the constitutionality of laws and other norms of lower order. See International Encyclopedia of the Social Sciences, Vol. 7, 304 (David L. Sills ed., 1972).

In my book, The World Bank in a Changing World, Vol.1, 85 (1991), Chapter 2 (The World bank and "governance" Issues in Its Borrowing Members), I defined the rule of law, for purposes of the World Bank's work on governance issues, to mean "a system of law, [which] assumes that: a) there is a set of rules which are known in advance, b) such rules are actually in force, c) mechanisms exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures, d) conflicts in the application of rules can be resolved through binding decisions of an independent judicial or arbitral body, and e) there are known procedures for amending the rules when they no longer serve their purpose."
tions through the establishment and maintenance of an appro-
priate and workable legal framework.

Such a framework has also proven to be critical to protect-
ing the environment and natural resources, a fundamental ele-
ment in sustainable development. In the process of achieving
economic development or expanding private business, countries
often deplete their natural resources. Environmentally sustaina-
ble development, however, may be achieved through enactment
of rigorous regulatory regimes, the clarification of property
rights, the establishment of monitoring institutions staffed with
well-trained professionals, and the building up of appropriate in-
ternational law regimes.

It is now commonly recognized that rapid growth requires a
number of conditions that are not always of a strictly economic
or financial character. Relevant factors include defining the role
of the State and the nature and limits of its intervention, achiev-
ing good governance, improving the performance of the public
sector, supporting civil society, developing an appropriate envi-
ronment for the growth of the private sector, as well as emphasizing
shared values and influencing individual and group behaviors in a manner conducive to economic and social develop-
ment. These factors can hardly be defined, let alone
implemented and sustained, in a society regulated by an inade-
quate or obsolete legal system or deprived of well-functioning
institutions for the administration of applicable rules and the
settlement of disputes arising in their application.

Typically, reform, which aims at developing a business-
friendly legal framework at the national level, addresses two fun-
damental processes. The first process is the review of legal rules,
starting with the constitution and including legislation, adminis-
trative decrees, and orders. This process should ensure that the
contents of the rules incorporated in these instruments respond
to genuine social needs, reflect a pre-existing or emerging public
opinion, are based on adequate data and studies, and result
from some form of participation, especially by those likely to be
affected by them. The second is the enforcement of legal rules,
regardless of their content. Without the first process, law is not
likely to be sound or useful; without the second it is not law.

If either of these processes is flawed, confidence in the legal
system will suffer and the broader processes of economic and
social development will be negatively affected in a number of ways. The effects of a flawed legal system on the business environment may be found in many areas which are only too familiar to businessmen. Here are some examples of what usually happens in the absence of appropriate and enforced legal rules:

- **The effects on contracts**: Respect for contractual obligations will be left entirely to the good will of the contracting parties, agreements will be binding only to the extent their beneficiaries have effective power to make them so, and resorting to extra-legal means will become an ordinary method of enforcement.

- **The effect on property rights**: Individuals and corporations will tend to acquire only the assets over which they can maintain effective property rights. Many will prefer to liquidate their assets and keep them in the form of deposits or portfolio investments abroad, putting pressure on the value of the local currency.

- **Effect on corporations**: Most companies will take the form of closed corporations where shares are held by reliable friends and relatives, thus barring the formation of large domestic joint-stock companies and depriving ordinary citizens of opportunities to own stock portfolios.

- **Effect on the banking system**: Banks will lend only to those who can offer real assets as collateral, or to those who have effective, namely political, power in the society, thus limiting the growth of the banking sector and of new investment while reinforcing the concentration of wealth. Debt recovery will become a major problem for banks, threatening their very existence. Both the banking system and the capital market will not properly function in the absence of an adequate regulatory framework strictly supervised by efficient agencies. Furthermore, different types of financial mechanisms will emerge, promising quick and lucrative returns, but ending in failures which may affect the economy as a whole.

- **Effect on the transfer of technology**: The inflow of foreign direct investment, which normally introduces more modern technology, will slow down. Weak protection of intellectual property rights will stifle invention and the development of new ideas.

- **Effect on transaction costs**: Enterprises will avoid competitive bidding as a normal method of procurement, preferring to
deal with familiar and reliable sources. They will also tend to seek favors from public officials through illegal means.

- **Effect on ongoing legislation and regulation:** Weak or ineffective laws usually lead to the enactment of further laws and regulations. An over-regulated economy undermines new investment, increases the cost of existing ones, and leads to the spread of corruption. The multiplication of laws and regulations also reduces their quality and the chances of their enforcement. The absence of judicial review, or its high cost, and delays in the administration of justice add to the negative impact.

- **Effect on the extent of criminal offenses in the economic sphere:** Weak, ineffective, or excessive laws lead to tax evasion, smuggling, and the growth of organized crime.

II. **LEGAL FRAMEWORK**

Nothing in what has been said so far suggests that law, in itself, is necessarily a progressive force. Rather, the role of law may be reactionary, progressive, or neutral depending on the manner in which it is used, the interests it aims to serve, and the way it interacts with the entire range of other factors affecting individuals' choices. It is important to note, however, that law, though normally a reflection of the prevailing realities of a given society, can also be used as a proactive instrument to promote development and, thus, influence and change the very realities it is supposed to reflect.²

The question of how law may be utilized to achieve economic revival in the short run and sustainable development in the long run addresses the key concept of the legal framework both on national and international levels. In contrast with the usual conceptualization, such a framework consists of more than just the applicable legal rules. The framework can be defined in

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² See, e.g., Lawrence M. Friedman, *Legal Rules and the Process of Social Change*, 19 STANFORD L. REV. 786, 791 (1967); Robert B. Seidman, *The State, Law and Development* 77, 462-72 (1978) (arguing that adequate model of law can contribute to process of development; for such process of transformation, it is necessary to focus on law-making and law-implementing processes rather than thinking of law as being static and independent from society); P. Bondzi-Simpson, *Dilemmas of Development through Law*, in *The Law and Economic Development in the Third World* 45 (P. Bondzi-Simpson ed., 1992); See also World Bank Legal Department, *The Role of Law in Private Sector Development - Implications for the Bank's Private Sector Action Program* (Discussion Paper, 1989) (showing importance of having appropriate legal system properly administered and enforced for creating environment conducive to business development).
terms of a system based on three pillars.3

The first pillar represents the legally binding rules. Such rules are not only known in advance. They are actually enforced by the State on all relevant parties, and are subject to modification pursuant only to previously known procedures.

The second pillar consists of appropriate processes through which such rules are made, and through which they are either enforced in practice or are deviated from when necessary. The appropriateness of such processes will obviously differ according to the circumstances of each country. Legal processes will normally succeed, however, to the extent that they are not arbitrary, are based on a system of consultation with the people affected by the rules, and are realistic in their reliance on existing institutions.

The third pillar of the legal framework consists of well-functioning public institutions that are staffed by trained and motivated individuals, are transparent and accountable to citizens, are bound by and adhere to regulations, and apply such regulations without arbitrariness or corruption. An efficient and fair judicial system serves as the final arbiter of a functioning legal system. The absence of efficient institutions for the enforcement of rules and the resolution of conflicts reflects on the previous elements of “rules” and “processes.” Such absence may call for placing greater emphasis, when new rules are being enacted, on those which need a minimum degree of government or court intervention, until appropriate institution building takes place. By this, I mean rules that rely more on self-enforcing mechanisms rather than on official acts. Examples of such rules in corporate law include provisions which require detailed public disclosure of relevant information, periodic auditing by internal and external auditors, the representation of minority shareholders in the boards of joint-stock companies, or of consumers in the boards of public utilities and the passage of important decisions by special majorities in these boards.

The judiciary plays a particularly important role in a system based on the rule of law. This role is complemented by the busi-

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ness-oriented alternative mechanism for dispute resolution, notably mediation, conciliation, and arbitration. As it must by now be clear, law is not merely a collection of written laws and regulations. It also includes the manner in which these rules are actually implemented by government agencies and applied and interpreted by judges and arbitrators. Without having to conceive of law necessarily as “the prophecies of what the courts will do in fact,” one can readily recognize that a well-functioning judiciary, in which judges apply the law in a fair, even, and predictable manner, and without undue delays or unaffordable costs, is part and parcel of a functioning system of law. Moreover, such a system of law requires that rules be interpreted, applied, and, where authorized, departed from according to established procedures. It also requires that respect for rules be ensured in the final analysis by the force of the State and that an independent body exist to resolve disputes. The judiciary may also identify inconsistencies of the rules with the basic law or the constitution. It serves as the final institution to monitor and address allegations of corruption, arbitrariness, and lack of accountability by other branches of government. Together, these elements help create an effective competitive system and an atmosphere of social peace in which business can flourish.

Our understanding of the legal framework with its three abovementioned pillars is not limited to the formal legal system. In all societies, informal rules of custom and usage play an important role. This is particularly true when law enforcement is weak and corruption is wide-spread. In such situations, formal law may be readily replaced by informal rules which receive greater compliance in practice. Reform of the legal framework cannot therefore serve its purpose if it does not pay adequate attention to the issues of enforcement, compliance, and effectiveness. The concern with processes and institutions may help address these issues. Equally important is the content and fairness of the formal rules and the extent and quality of state intervention under them.

III. LEGISLATIVE POLICY

For a legal and regulatory framework in the broad sense already described (i.e., formal and informal binding rules, processes, and institutions) to serve the purposes of private busi-
ness growth, it must ensure free competition. This is not, however, enough. Such a framework must also provide two other key elements. It must allow prices to reflect the relative scarcity of goods, and wages to reflect the real value of labor. In other words, it must price work and its products according to rational economic criteria. In addition, it must protect and enforce property rights and contracts. Without these features, the investment climate would lose its most important positive aspects, namely, competition in a level playing field and the ability of investors to predict the future. These matters should not be unduly confused with the very important need to protect the poor. Such protection should always be pursued, but through other means which do not undermine economic nationality such as a comprehensive social security network, procedures for income redistribution, and provision by the State of essential social services.

Contrary to what many believe, the protection of competition, contracts, and private property is particularly essential for the growth of small business. Individuals with little property and without political connections or influence would otherwise face tremendous difficulties in entering the market or staying there. Conversely, such protection promotes the accumulation of physical and human capital. It lowers transaction costs and helps create a better distribution of income and wealth. Above all, it gives investors and consumers alike a sense of security and confidence in the system that is badly needed for commitment of long term capital.

Legislative policy must, of course, be consistent with economic and social policies. Its role is to translate these policies into rules and procedures and to ensure their consistency and efficiency in serving their targets. Experience shows that successful legislative policies are based on the presumption of permissibility. That is, they assume that prohibitions, limitations, and approvals should be the exception rather than the rule. Interestingly, this simple presumption prevailed in the laws of nineteenth century Europe and earlier in Islamic shari'a.4 It has

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4. Based primarily on the Quran and the traditions of the Prophet Mohammed, Islamic law, or shari'a as developed through the ages by Islamic scholars who recognized that restrictions are the exception from the general rule of permissiveness (ibahah) and should be based on an explicit text or extended by analogy to cases having the same cause of prohibition or the regulated by an explicit text. See Bassam Tibi, *Islamic Law/
been largely ignored, however, in most of the twentieth century.

The principle of permissiveness not only makes good economics, it also makes good law. Furthermore, it respects human dignity. It assumes goodness in people and relies, in cases of violation of established rules, more on ex post enforceable sanctions than on the prior approval of every possible act by all sorts of government bureaucrats. By keeping the limits to a reasonable level dictated by the exigencies of what is truly in the public interest, the state reduces the opportunities of corruption and ensures the effectiveness of the limits it introduces. Such effectiveness is often lost in systems based on the presumption of prohibition and burdened with excessive constraints. Allowing market forces to work, while addressing market failures and excesses, and intervening to protect the poor, enables the state to follow successful legislative policies in support of private sector development.

The presumption of permissiveness does not mean, however, that business transactions and the provision of public services by private enterprises should be left unregulated. This could only lead to the stifling of competition and would allow the forces of monopoly to exploit the market and its consumers. Regulation, it should be emphasized, is not the enemy of competition. Rather, its enemy is excessive state intervention and the application of different rules to competitors in the same field. Also, competition is not a substitute for appropriate regulation. If regulation is done right, competition would in fact be its first beneficiary. What is needed, therefore, are regulations which aim at clearly agreed economic and social objectives, continuously serve these objectives, avoid excesses and arbitrariness, and prevent the concentration of the market in a few hands. This obviously requires a large measure of participation in rule-making and a high capacity to apply the rules. It also requires, to the extent possible, stability in the rules.

IV. CONCLUDING REMARKS - WORLD BANK EFFORTS

It may be appropriate to conclude these remarks by referring briefly to what the World Bank ("Bank" or "World Bank") is doing to improve the enabling environment for private business.

Through its adjustment loans, the Bank supports borrowing countries in their efforts to improve their macro-economic and micro-economic frameworks, to liberalize their trade and investment regimes, to privatize public enterprises, and to strengthen their financial sectors, including in particular, banking institutions and the capital market.\(^5\) In addition, the Bank offers loans to finance legal and judicial reform projects\(^6\) and has even given grants\(^7\) for the initial studies needed for this purpose. The Bank's experience in financing legal reform, though still limited, has already yielded some useful lessons.\(^8\) Perhaps the most important lesson is that such reform should be comprehensive in scope. It should not be limited to the enactment of new legislation and regulations. It must also include a series of the processes through which existing rule have been made and applied and cover the institutions which apply these rules, including, of course, the judiciary. The contents and direction of a country's legal reform should be the responsibility of the country itself, not that of its foreign donors, and must conform with the country's needs, its social norms, and other special characteristics. It follows that local lawyers, possibly with the help of foreign advisors, should be in charge of the process. Wholesale

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5. Since the early 1980s, the Bank has been supporting economic policy reform through adjustment loans. These loans finance general imports by the borrower in the context of a reform program agreed upon with the Bank. In certain cases, the Bank recognized that in order for economic policy reforms to be sustainable, adjustment programs need to include modifications in the institutional frameworks. Changes in the legal and regulatory frameworks of particular sectors of the economy thus figure prominently under the Bank's more recent adjustment loans.


7. The Bank has provided grants from its Institutional Development Fund ("IDF"), established in 1992 and financed through transfers from the Bank's net income, to finance detailed legal work or in-depth studies of certain issues of particular concern, including studies of the administration of justice in a certain borrowing country. Examples include grants for assistance in the drafting of cultural property protection legislation in Albania, anti-trust and anti-dumping legislation in Egypt, value-added tax legislation in India, the review of commercial, financial, and investment laws and regulations and the training of judges in Lebanon, as well as a "diagnostic study" of the judiciary in Argentina, Ecuador and Peru.

8. See The World Bank and Legal Technical Assistance, supra note 6 (describing some of Bank's initial lessons).
importation and transplantation of legal systems may, therefore, be inappropriate. Comparative law experience constitutes a useful source of guidance and the model laws prepared by various international agencies, such as the United Nations Commission on International Trade Law,9 ("UNCITRAL"), and the International Institute for the Unification of Private Law,10 ("UNIDROIT"), can be of great help. It is important, however, not to adopt such model laws without first adapting them to the national legal system and the particular requirements of the society concerned. Social customs and usage should thus be taken into account, but a new law need not always reflect preexisting traditions; it may indeed be designed to change such traditions because of their perceived negative effects on the country’s development. Laws of this latter type, however, must be cautiously preceded by adequate sociological studies and should reflect a strong public conviction in favor of the change. Without careful preparation, such laws may not survive or may simply be ignored in practice.

World Bank experience in financing legal reform also highlights the importance of participation of both the local legal and business communities in the design and details of the reform process. Quite often, it has also been useful to establish a central legal reform unit which reports to the head of government and thus, effectively coordinates the varied demands of various internal sectors and external donors. Finally, strengthening legal education and providing continuous training to lawyers and judges have proven to be important elements in a successful legal reform.

The World Bank’s assistance to private business takes other forms as well. In addition to the loans and guarantees provided by the Bank to private enterprises with the guarantee of the host


government and those provided, without government guarantee by the International Finance Corporation, a World Bank affiliate, another World Bank affiliate, the Multilateral Investment Guarantee Agency11 ("MIGA"), provides insurance to foreign investors against non-commercial risks. A further affiliated institution, the International Center for Settlement of Investment Disputes12 ("ICSID"), provides facilities for the conciliation and arbitration of disputes between states and foreign investors. Moreover, in 1992, the World Bank issued a collection of Guidelines for the treatment of foreign investment.13 The Development Committee, in which all Bank member countries are represented, unanimously endorsed these Guidelines.14 Since their adoption, they have influenced subsequent legislation and treaties providing favorable treatment to foreign and local investors alike. They are paving the way for current efforts outside the World Bank to formulate a multilateral convention on the treatment of foreign investment, an effort which has proven unworkable in the past. The World Bank's efforts to improve the legal framework for private business in its borrowing member countries is expected to continue with the increasing realization of the relevance and importance of the role of law, and institutional reform, in general, in the development process.

14. The 24 member Development Committee is a joint committee of the Board of Governors of the World Bank and the International Monetary Fund. It reviews the transfer of resources to developing countries, exchanges views, and makes suggestions on issues of economic and social development.