

## Transition or Development? Reassessing Priorities for Law Reform.

by Ioannis Glinavos

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Dr. Ioannis Glinavos, SOAS, University of London, [i.glinavos@soas.ac.uk](mailto:i.glinavos@soas.ac.uk)

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## **1. Introduction**

The modern literature on international development in conjunction with the rise of institutional economics has focused attention on the role of institutions in the operation of the economy and crucially on the function of law as setting a framework to market operations. An emerging consensus that views development as a legal in as much as an economic challenge is forcing us to reevaluate the relationship between law, regulation, state power and the market. Indeed, the greater the need for law, the larger the role of the state in the economy. The purpose of this article is to enquire into the implications the modern literature on economic development emanating from international institutions (primarily the World Bank and the International Monetary Fund) has for law reform and the role of the state in the economy. The main question asked is whether regulation has a uniform role in all reform contexts or whether there is a difference between the role of law in the transition to a market economy as opposed to the promotion of general development. This article suggests that there is indeed a difference between the role of law in transition as opposed to development that centres on the primacy of the state in the design for reform. While transition, it is suggested, requires a more limited role for law, development necessitates a more thorough involvement of the state in the reform process. This article offers some preliminary evidence to suggest that a minimal role for regulation focused on market promotion required by 'transition type' reforms is adopted across the board and applied indiscriminately to all development scenarios. This means that reform packages remain rather minimal in the involvement of the state and in the scope for law despite the input of institutional economics and the apparent enthusiasm for the promotion of the rule of law. The article concludes that once a distinction is drawn between the different designs needed for transition and development, it becomes evident that a larger role for law and state regulation is needed that goes beyond mere market promotion. The promotion of development which encompasses political, social and economic aspects therefore asks for a wider role for the state.

This article is divided in two main parts. The first part discusses the role of law in the transition to a market economy using as a main example the experience of post communism in Russia. The second part enquires into the wider role for law, beyond the establishment of sets of market fundamentals. By doing so the article offers an evaluation of the extent to which the role of the state in the regulation of the economy is changing in a 'Post-Washington Consensus'.

## 2. Transition

### 2.1 *The Policy Environment*

It is generally accepted that the policy priorities of early post communist governments in Eastern Europe in the 1990s reflected the main themes of what came to be known as the 'Washington Consensus'. Rooted in neoliberal ideas on the kind of economic management needed for development, the three tenets of the consensus - liberalisation, privatisation, stabilisation - were not merely a response to the particular economic problems faced by one region but a recipe for economic reform everywhere and at all times. In other words, the Consensus laid strong claim to universality and this is why, with minor variations, its central planks came to be exported around the world. Its reach extended from the stabilisation programs in Latin America, to the post communist transition reforms in Eastern Europe and the Soviet Union, to the austerity packages in Turkey, to deregulation and liberalisation in Western Europe, to development in Africa and to pro-market reform in China and the Far East.

By the mid nineties the basic tenets of the Consensus had come to be accepted as having equal application to any country seeking to reform its economy and gain access to world markets, signifying a global policy convergence part of the general phenomenon of so called 'globalisation'<sup>1</sup>. Underlying this claim to universality is the belief that the main tenets of the Washington Consensus are products of scientific enquiry devoid of political bias. In terms of economic policy, the Washington Consensus did not evolve from earlier development programmes but represented a radical departure from them. Until the early 1980s, economic policy was underlain by a body of ideas which placed the state at the centre of national economic development. The gradual acceptance of the neoliberal economic critique of state-

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<sup>1</sup> Neoliberal globalisation is a term that denotes the backlash against the social welfare state as developed from the end of the Second World War till the 1970s. It also represents a revival of individualistic liberalism and a return to 'laissez faire' as experienced in the first decades of the 20<sup>th</sup> century. This new theory of liberalism (neoliberalism) represents a return to the original liberal project of asserting society against the state, the market against planning and regulation, the right of the individual against authorities and collectives. In this, neoliberalism claims to follow the spirit of the American and French revolutions of the 18<sup>th</sup> century in emphasising liberty under the law. Unusually however, the neoliberal backlash against the welfare state and the dirigiste policies of the post war period has served to dismantle the network of social protection that is a direct descendant of liberal ideas encapsulated in the American Declaration of Independence and the Constitution, the Declaration of the Rights of Man and the spirit of the French Revolution. Inherent in these documents is the idea that people have fundamental human rights which extend to the assurance of their survival in the world. Battling against progressive state policies for the sake of individualism has the consequence of condemning those who are left on the sidelines to an existence that violates those basic rights. For authors like Milton Friedman however, individual liberty is more important than government acting in the general good. Friedman has actually defended the idea that government is usually contrary to the interests of the people. This is supported by authors like Robert Nozick who has made a strong case in favour of a minimal state. See Newman, P, Eatwell, J., Milgate, M. (2002) *New Palgrave Dictionary of Economics*, Palgrave Macmillan : entry 'liberalism'

led development, however, saw emphasis moved to a number of policy measures aimed at releasing the dynamic of the market. At the centre of the reform proposals associated with the Washington Consensus was the idea that the free market (not the state) should be the central instrument of economic policy and that the market (not the state) is the key mechanism for achieving growth and prosperity. Consequently, the market should be strengthened and the involvement of the state in 'self-regulating' market processes should be diminished. One of the main aims of reform efforts based on the Washington settlement was, therefore, the reduction of those parts of the economy occupied by the state; something that could be achieved, it was thought, by curbing government expenditure. Concurrently, the expansion of the market to ever growing areas of economic activity was actively pursued. In the dual process of state withdrawal and market expansion, fiscal discipline was seen as a precondition to macroeconomic stability. At the centre of the effort to expand the competence and reach of free markets according to the priorities of the Washington Consensus was the definition and maintenance of a robust system of private property rights. In order to extend the scope of markets and thereby reduce state involvement/interference in the economy, reform needed to be undertaken on the assumption that a stable and reliable system for defining and protecting private property rights was sponsored by the state.

## ***2.2 The Place of Law***

The adoption of the neoliberal perceptions of the Washington Consensus on the role of the state had specific consequences on the treatment of the role of law in the process of transition to a market economy. In Eastern Europe in the early 1990s and Russia in particular, theoretical discussions on the place of the state and law during transition from communism centred on the need to contain the reach of the state in order to facilitate the operation of the market and its rationality. Consequently, political interventions in economic processes should be kept to a minimum. From this perspective, the key roles for law were the definition, allocation and protection of private property and the enforcement of contractual agreements. Law was seen as having a key role to play as the guarantor of private property rights, for the market mechanisms and economic processes which lie at the heart of neoliberal theory are premised upon the existence of private property. In capitalism property forms shape the structure of the market because they are deemed to be essential to the operation of exchange and a necessary consequence of man's economic rationality. Neoliberalism actually sought to translate all human activity to transactions of property rights in order to facilitate market

exchange. Property of course can be a communal as well as a private good, but according to neoliberal theory it is only private property that is consonant with human nature because only private property can be readily exchanged in markets. Private property also corresponds to the 'so-called' individualistic nature of man and is the generator of human effort and the cause of human growth. Law makers during transition held the belief that individuals would rather invest their energies in something that belongs completely to them and not in something that they share with their neighbours. The explanation rests on the realization that in an imperfect world communal goods always run the risk of being taken by those who expend their energies not on production but on expropriation. The formulation of the so called 'tragedy of the commons' formed the basis of policy suggestions as for example in the work of Hernando de Soto and has remained a key feature of the understanding of the incentives created by property rights ever since<sup>2</sup>.

In focusing on the institution of private property, the neoliberal theories of transition combined two strands of traditional economic theory. Neoliberalism drew, on the one hand, from the Austrian economic tradition that views market individualism as the herald and prerequisite of individual freedom (Hayek, Ludwig von Mises, Schumpeter) and, on the other, from neoclassical economic tradition which emphasizes the function of markets in promoting economic efficiency (as, for example, in the Chicago School of Economics). For this reason, critics of neoliberal policies such as Ha-Joon Chang view contemporary neoliberal theory as an 'unholy alliance' between these two strands of liberal thought; with neoclassical economics providing the analytical tools and the Austrian-libertarian tradition providing the moral and political philosophy. The result of the combination of these two traditions is a shift in the perception of the state and of its relationship to the market. Neoliberalism represented a rejection of the treatment of the state as benevolent and as working in partnership with the market and adopted a perception of the state as rapacious and as in opposition to market. According to this latter conception, the state is no longer an impartial arbiter and social guardian, but an organisation catering to self interested politicians and bureaucrats acting in order to benefit various client groups<sup>3</sup>.

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<sup>2</sup> See WDR 2005 p. 9 (Verifying rights to land and other property)

<sup>3</sup> Chang Ha-Joon, Breaking the Mould An Institutionalist Political Economy Alternative to the Neoliberal Theory of the Market and the State (2002) Vol.26 Cambridge Journal of Economics 539-559 p.540

### ***2.2.1 Market as Freedom: the Role of Regulation***

The notion of incontestable private rights of property protected by law against both private and governmental interference as evidenced in the work of international financial institutions is indeed of pivotal significance to modern capitalism and is linked to the fundamental notions of individuality, democracy and freedom. The above notions are also fundamental to western liberal theory. As one of the greatest proponents of this liberal thought, Fredrich von Hayek delineated the implications of the principle of private property for state economic policy and for individual freedom. For Hayek<sup>4</sup> government regulation and laws that respect freedom need to be general and formal. He argued that the rule of law demands that the government is bound by fixed rules announced beforehand. By contrast, he claimed, economic planning is fundamentally contrary to the rule of law because of the ad hoc decision making power which is necessarily granted to planners. If the state wishes to abide by the rule of law it should confine itself to establishing rules applying to general types of situations and should allow individuals freedom to determine their actions in everything which depends on the circumstances of time and place. It is only respect for the rule of law and for government by fixed universal rules announced beforehand that provides legitimacy to the property structure.<sup>5</sup> In other words, property distributions which are the result of the application of general rules which comply with requirements of rule of law are, according to Hayek, 'just' both in a procedural and substantive sense. Putting to one side the question of the allocation of entitlements in society, Hayek claimed that the predictability of 'the rules of the game' and their strict application protect individual entitlements from all kinds of interference, including from the state. Hayek thus attempted to sidestep questions arising out of the (seemingly) substantive injustice of gross inequalities of wealth. In a similar fashion, borrowing from the Austrian tradition, neoliberal thought suggests that the distribution of wealth generated by unhindered market processes is inherently just, whatever its final form, because factors of production, including labour, receive their true worth reflecting what they actually contribute to production.

### ***2.2.2 Market as Efficiency: the Role of Property Rights***

Having established that a limited state is the herald of freedom, neoliberal thinkers during post communist transition convinced policy makers that laws that guaranteed private property rights were the only incentive necessary for the efficient operation of the free market. Indeed,

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<sup>4</sup> See Hayek, F. (1944) *The Road to Serfdom*, G. Routledge & sons, London

<sup>5</sup> Hayek, F. *The Road to Serfdom* p.80

the widespread revival of Smithian theories of economic development, and the belief in the centrality of property rights and of unregulated markets, has in recent years had wide-ranging effects on economic policy across the globe, especially with reference to developing countries. Neoliberalism, with its revival of the 'laissez faire' theories of the late nineteenth century, purported to offer not only a comprehensive account of how to achieve growth but of how to organise human relationships in general. With its advocacy of policies aimed at rolling back the state and freeing the market (through measures such as the privatisation of state enterprises), its influence has been enormous. The spread of market solutions to all kinds of problems, as a result, is evident in the domestic and international sphere - from the privatisation of public utilities to the deregulation of financial flows.

The reform program pressed upon Russia and other states in transition from communism, as well as to states seeking to implement a comprehensive development plan, stems from a belief in the autonomous economic rationality of the market first outlined by Smith and in the consonance of this rationality with human nature. This theoretical framework presupposes certain truths which if taken at face value lead to the specific policy proposals that have helped shape the programs of economic reform followed during the 1980s in Latin America and in Eastern Europe in the 1990s. The core of these programmes has been the creation of new markets and the removal of impediments to the operation of existing ones. American advisors of a neoliberal persuasion played a key role in the design of these reform programmes. Particularly influential were those attracted to the economic analyses of law associated with the University of Chicago. The source of the ideas explaining the process of rational choice and its intersection with social development in the Economic Analysis of Law (EAL) and the expression it found at the Chicago School of Economics can again be traced to 19<sup>th</sup> century 'laissez faire' economics founded by Adam Smith. While for the theorists of the classical 'laissez faire' tradition, questions as to distribution of wealth are seen as essentially irrelevant to economics (they are, rather, political questions), the Economic Analysis of Law reintroduced certain political factors into economic policy, albeit with a limited ambit.

The new field of research into 'Law and Economics' began to develop at a crucial moment in the development of neoclassical economics. From a discipline that at its inception barely recognised the importance of distributional issues, claiming that they were part of the sphere of politics rather than of economic 'science', a consensus emerged within neoclassical

economics that distribution matters<sup>6</sup>. EAL sought to apply the tools of microeconomic theory to the analysis of legal rules and institutions. Ronald Coase, Guido Calabresi and Richard Posner are generally identified as its leading proponents. The starting point of both the classical and the EAL positions is a conception of man as a self interested individual. According to the thinkers of the EAL however, law is a means of shaping individual behaviour so that it benefits the community, thus maximising market efficiency and wealth. In the spirit of connecting society to the economic interests of individuals, Ronald Coase brought together law and economics by studying legal mechanisms to minimize transaction costs. His main thesis (known as the Coase Theorem) is that in a fictional world where there are no transaction costs, the initial allocation of legal entitlements is irrelevant to their final allocation. Through contractual mechanisms, rights will reach those who value them most.

The capacity of the market to ensure that assets will eventually be possessed by those who value them most (commonly described as the operation of the invisible hand of the market), ensures production with maximum efficiency. If initially rights are allocated to inefficient producers, Coase suggested, competitive pressure will lead to them being sold or transferred to those who will use them efficiently. The lesson of this process for legal reform is that impediments to the operation of market mechanisms ought to be removed, thereby reducing transaction costs as much as possible. Contractual mechanisms should be allowed to reallocate rights. Of course, the definition and allocation (whatever form it takes) of private property rights is the basis of this process<sup>7</sup>. It follows that one of the key functions of law (and law reform) is to define and allocate private property rights and to provide mechanisms whereby they can be traded. From this perspective, law is less a mechanism for ensuring social justice and more a mechanism for facilitating the emergence and smooth operation of market relations.

Richard Posner, one of the most influential figures of the Chicago School of Economics and one of the founding fathers of contemporary law and economics further defined the role law

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<sup>6</sup> Hackney, J. Law and neoclassical economics theory: a critical history of the distribution/efficiency debate (2003) 32 *Journal of Socio-Economics*, p. 362

<sup>7</sup> A note needs to be made here that the preceding comments represent a 'light' version of the Coase theorem. Further in his analysis Coase (drawing a distinction between the fictional world of zero transaction costs, and reality) attributes importance to distribution and equality of wealth in society because it affects access to productive resources. However, the interpretation of his theorem in the context of 'constructing' capitalism ignored issues of distribution. It focused solely in creating of private property rights and in the 'technical' capacity to exchange them without addressing the need for adequate distribution of capital to various economic actors.

should play in the economy by discussing methods of dealing with transaction costs<sup>8</sup>. His contribution to the debate has been the application of individualistic economic theory to the substance of common law doctrines such as negligence, contract and criminal law<sup>9</sup>. Posner argued that in circumstances where high transaction costs are prevalent and permanent, the role of law reform is to re-allocate legal rights to those who value them most, thus reproducing the outcome that market processes would reach were they able to operate freely. In this way, law energises individual economic agents into responding to economic incentives. From this perspective, for example, the vesting of control rights over former state-owned enterprises in the ex communist countries in the managers of those enterprises represents the (re) allocation of property rights to those who will make best use of them, thereby promoting restructuring and greater efficiency<sup>10</sup>.

Consequently, drawing from the two traditions mentioned above, the policy suggestions of the Washington Consensus applied during post communist transition offered a version of law reform that saw law as the facilitator and servant of economics and the state as the limited guardian of the greatest incentive mechanism known to man: private property rights.

### ***2.3 The State in Transition***

The discussion above reveals that the consensus of opinion largely based on neoliberal ideas that crystallised in the Washington Consensus and dominated post communist transition in the 1990s saw the role of law during transition as having a very defined scope: to minimise state interference in the economy and create the background to free market exchange by instituting a framework of private property rights, rules of contract and mechanisms for enforcing contractual bargains. In order to achieve this the state had to increase the scope for markets to work efficiently by eliminating state-owned and legal monopolies, barriers to entry and exit such as unnecessary licenses, and other interventions into commercial decisions such as price controls (these simplification, liberalisation, and deregulation policies usually aimed to intensify market competition); and also to provide a market framework of policy, regulatory, and judicial functions to protect property rights, promote competition by controlling market abuses, carry out competitive procurement, and provide efficient services to the private sector such as registration, licensing, and a contractual system for economic transactions. The

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<sup>8</sup> Posner's writings have a close association with the normative economics of free market economists like Milton Friedman.

<sup>9</sup> Campbell, T. (2001) *Justice*, Second Edition, Macmillan Press, p. 134

<sup>10</sup> Deakin, S. *Law and Economics Chapter 3* in Thomas, P. (1996) *Legal Frontiers*, Dartmouth Publishing.

market framework in fact required that the state effectively set up a range of institutions for market supervision, adjudication, enforcement, licensing, and standard-setting, that are independent and do not require active involvement. The state in other words was supposed to create the mechanisms that allow the market to govern itself.

According to the theories explaining policy design for transition it is only on a secondary level, as attention moves from transition priorities to more general development concerns, that the state can expand its attention to social policies such as funding transfer payments that underpin the welfare state, educating, providing health services, financing universal service programs, and promoting safety, health, environmental quality, energy security, and other objectives that may not be properly valued in the market. Even in traditional public services, however, governments are advised to rely on private sector initiatives, while providing funding to deal with affordability concerns<sup>11</sup>.

To summarise therefore, during transition it is enough that the state deregulates and that law reform establishes the fundamentals of a free market.

### **3. Development**

The experience of early post communist transformation in countries like Russia has shown that even though 'transition type' reforms are one way of deconstructing planned economies, they are hardly adequate to deal with developmental concerns that extend beyond the establishment of the fundamentals of a market economy. Development evidently requires a different role for the state and a different function for law. But what should these roles be?

The latest World Development Reports (WDRs) produced by the World Bank highlight the role of institutions and legal mechanisms in enhancing educational opportunities (2007), promoting equality (2006) and promoting investment (2005). A common theme in these publications and in works produced by the IMF is the prominence of 'well designed' regulation in promoting an institutional environment conducive to growth. However, as noted in the 2005 United Nations Human Development Report (HDR) growth should not be treated

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<sup>11</sup> Jacobs, S. & Astrakhan, I. Effective and Sustainable Regulatory Reform, (2006)  
[www.regulatoryreform.com/documents/Evaluation-of-regulatory-guillotine-Jacobs-Jan-2006.doc](http://www.regulatoryreform.com/documents/Evaluation-of-regulatory-guillotine-Jacobs-Jan-2006.doc) p. 7

as being synonymous with development. The preoccupation with promoting market solutions to development challenges and the efforts to re-engineer state mechanisms along the lines of 'efficiency' with the aim of promoting growth cannot not the solution to the weaknesses of reform models applied in transition or a sufficient guarantee to the achievement of pro-poor outcomes (which seem to be the aim of much current work on development). The HDR finds that despite the focus of the World Bank on poverty and inequality, the choice of pro-growth policies is not necessarily pro-poor or certain to advance the Millenium Development Goals (MDGs) when the effects of growth are rising inequalities<sup>12</sup>. One of the main reasons for this is that extreme inequalities weaken political legitimacy and corrode institutions. Perhaps the explanation for the lack of progress in development outcomes is the fact that beyond the surface of 'reform rhetoric' the policies promoted are still closer to the 'transition' models, than the World Bank and the IMF would have us believe.

This article suggests that the reason why social and political problems cannot be adequately addressed by a market focused mindset of reform is the core misunderstanding in the design of reform programmes between the different needs of 'transition' as opposed to 'development'. The currently dominant interpretation of development does not allow, as the following discussion will show, the state to have an active role in promoting development and therefore limits institutional change to the core legal reforms needed for transition, failing to erect the market supporting framework that is necessary for wider development.

### ***3.1 Transition or Development?***

A starting point for a critique of the reform doctrine of the Washington Consensus and 'transition' type policies that informed reforms aiming to promote development at the end of the last century is the way advice on legal and economic reform under the auspices of mainstream neoliberal advice predominant in the early 1990s failed to differentiate between countries at different stages of economic development. Because of their belief in the universal applicability of their ideas, reform advisors (such as those advising the Russian government, Jeffrey Sachs and Andrei Schleifer most prominent among them) tended to lump all non free-market capitalist economies together, adopting a one-size-fits-all approach to reform. One result of this was their failure properly to distinguish the difference between development and

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<sup>12</sup> HDR 2005 p.53

transition, allowing advisors to reach the conclusion that the state ought to have the same limited role in economic life in both situations.

Even though the terms transition and development are sometimes used interchangeably in the literature, transition and development are distinguishable. In classical economics, economic development is sometimes reduced to a problem of capital accumulation<sup>13</sup>. From this perspective, developing countries are deemed to be characterized by excesses of unskilled labour and in some cases abundant natural resources, but by low endowments of capital. The relative absence of skilled labour is usually attributed to lack of education and learning opportunities among the general population. Developing countries are also commonly characterized by high population growth and a lack of technological development. Transitional economies, on the other hand, tend to share only some of these features. For example, a shortage of capital is not a major issue in countries like Russia and human capital is also relatively abundant as a result of relatively high levels of education and advanced levels of specialisation amongst the labour force. Population growth is also often very low and sometimes negative (mainly in the non-Islamic, post-communist states). At the same time, however, transitional countries exhibit a technological gap with the west in key consumer sectors and much of their capital is locked into poorly performing enterprises and antiquated infrastructure. To make matters worse, such dynamism as there is in the economy is often drained into underground activity in much the same way as corruption swallows resources in certain parts of Africa.

In certain important respects, some post-communist states more closely resemble developing rather than transitional economies. China, for example, has more in common with the rest of the developing world than it does with Russia. Chinese reform for instance could be seen as geared above all else to raising agricultural productivity in order to sustain an increasingly non-agricultural workforce and to finance a higher capital-labour ratio in the economy. In other words, it is suggested that Chinese reform is about changing a predominately rural, agrarian economy into an urban industrialized one. Transition in Russia, on the other hand, is not so much about industrialisation as about privatisation and the restructuring of existing industries, about reorganisation of the labour force and a strengthening of market forces. In

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<sup>13</sup> Slay, B. Development v. Transition, (July 2005) Vol.1 Development and Transition p.7

these respects, the role of the state is arguably different. Put simply, development may demand more active involvement by the state than does transition<sup>14</sup>.

Interestingly however, as in the nineties, advice on economic reform continues to largely ignore the differences between development and transition and offers the same package of macroeconomic stabilisation - low inflation, liberalisation and privatisation - regardless of the differing needs of countries in often radically disparate economic positions. What also seems rather bizarre in this context, is that the usual developmental advice offered under does not correspond to the historical experience of development in the western world. This is a point which has forcefully been made by many critics of the neoliberal inspired advice packages pushed by the IMF and the World Bank. Ha-Joon Chang for example has argued that the fiscal discipline and deregulatory reforms required of developing countries by the IMF deny them the economic tools that made infrastructure development and industrialisation available in the west<sup>15</sup>.

### ***3.2 A Larger Role for Law***

The realization that the type of social transformation taking place in countries emerging from communism like Russia in the 1990s required more than minimal legal and state intervention – and that securing the market fundamentals of property and contract was rather more demanding and complicated than initially realized - has gradually and significantly altered conceptions of the role of law in the process of transition and has changed the tools employed in the design of reform programmes. While previously reform choices were based on the standard list of policies of the Washington Consensus (macroeconomic stabilisation, privatisation, trade liberalisation, property rights) in the last few years the process of identifying priorities for reform has become much more context specific and is becoming more targeted<sup>16</sup>. This is assisted by the evidence from statistical data on investor preferences, business indicators and various industry analyses<sup>17</sup>.

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<sup>14</sup> Schelkle, W. Linking Economic Development and Transition (July 2005) Vol.1 Development and Transition p.12

<sup>15</sup> See Chang, HJ. (2002) *Kicking Away the Ladder: Development Strategy in Historical Perspective*, Anthem Press.

<sup>16</sup> Kikeri, S. Kenyon, T. Palmade, V. (2006) *Reforming the Investment Climate: Lessons for Practitioners*, World Bank Publications, p.17-18

<sup>17</sup> Hausmann, R. Rodrik, D, and Velasco, A. Getting the Diagnosis Right: A New Approach to Economic Reform. (March 2006) 43.1 *Finance and Development* 12-15, p.12

Along with institutions in general, law has become much more important in reforms (in the context of post communism called second generation reforms) aimed to promote development that have a wider ambit than the establishment of a market economy. Indeed, in many ways development is now being treated as a fundamentally legal/institutional reform project rather than a purely 'economic' one<sup>18</sup>. Responding to the widespread upheaval created by early transition policies, in the second generation reforms the role attributed to law is going well beyond fostering economic growth and is turning towards the achievement of social objectives. In many ways, legal reform in a general sense – encompassing respect for the rule of law, institutional creation and the recognition of individual rights - has come to be seen as absolutely central to the achievement of development itself. However, the perceived need to contain the reach of the state which is embedded in the neoliberal paradigm has led to the continuing promotion of the aims of transition type reform packages (like shock therapy in Russia) without fundamental changes to the basic institutional architecture or modifications to the substantive element of the core legal reform agenda (which remains focused on judicial and police reform). For example, while projects to promote the rule of law stress the commitment to equality, fairness, transparency, accountability, consistency and predictability, there is still a lack of specific means to achieve these objectives. As a result, it is clearly arguable that, lacking the capacity to promote substantive values, law is actually doing little more than legitimating de facto political and economic power<sup>19</sup>.

While there is recognition that development requires more law, there is still doubt as to what role the state should play. The persistent, neoliberal desire to set outer limits to legal regulation has shifted the focus away from the state to non-regulatory and so-called mixed modes of governance as far as the achievement of social objectives is concerned. This is reflected in the emphasis on NGOs, civil society and 'soft' forms of regulation. The encounter of the social and the economic in what is seen as a second generation of reforms is, therefore, marked not by a change of path but by a growing tension between an enlarged development agenda and preoccupation with market reform.

Considering the inability of 'transition type' priorities to cater for wider developmental concerns in countries like Russia, what future can there be for states wishing to move beyond

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<sup>18</sup> Rittich, K. The Future of Law and Development: Second Generation Reforms and the Incorporation of the Social (Fall, 2004) 26 Mich. J. Int'l L. p.206

<sup>19</sup> Toope, S. Legal and Judicial Reform through Development Assistance (2003) 48 McGill LJ p.368

transition and embrace development goals going further than the institution of a free market economy? Problems in designing effective reforms dealing successfully with incentives, information, and the structure of the economy are exceedingly difficult to address in a sustainable way. They require much more than marginal changes to a few procedures. This is especially true for developing countries which face a triple legacy of numerous interventions into business decisions from previous unsuccessful economic models, poor institutional capacities to implement reforms, and weak reform and corrective mechanisms to remedy problems. The resulting overly complex, multi-layered, arbitrary, and interventionist administrative and regulatory environments make it difficult to create a transparent and predictable business environment. Sustainable changes therefore require deeper institutional reforms<sup>20</sup>. One way to achieve this is to move beyond the preoccupation with property rights that characterised transition.

The focus on institutions and the rule of law that is viewed as an emerging 'Post Washington Consensus' could be interpreted as a return to the structuralist logic underlying the national developmentalism that preceded the neoliberal era. In contrast to the view that the state should play only a minimal role defining and protecting property rights and enforcing contracts, a Post Washington Consensus as proposed for example by Joseph Stiglitz<sup>21</sup> and as suggested by new thinking within the World Bank seems to see the state as having an important role in assisting the functioning of the market. The limited rediscovery of a role for the state in development policy does not, however, represent a return to the past, because the current debate contains a qualitatively different and more complex understanding of the role of state than that of the developmentalism of the 1950s. The emerging theory, building on the critique of the Washington Consensus, presents the state-market relationship not as a relationship of opposition (in which the market stands against the state, as in the shock therapy model applied in early transition in Russia) but as a dialectical relationship in which state and market are mutually supportive. In order to have a lasting effect, however, a genuine Post Washington Consensus needs to overcome the neoliberal assumptions that constrict the role of the state and public participation in economic decision making and to allow democratic politics to retake control of economic affairs. As Soederberg has noted, the current consensus seeks to fortify and thus legitimate the imperatives of free capital mobility by adopting a third way

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<sup>20</sup> Jacobs, S. & Astrakhan, I. Effective and Sustainable Regulatory Reform, (2006)

[www.regulatoryreform.com/documents/Evaluation-of-regulatory-guillotine-Jacobs-Jan-2006.doc](http://www.regulatoryreform.com/documents/Evaluation-of-regulatory-guillotine-Jacobs-Jan-2006.doc) p. 9

<sup>21</sup> See for example Stiglitz, J. Towards a New Paradigm for Development: Strategies, Policies and Processes (1998) Plebisch Lecture 19/10/98 [www.worldbank.org/html/extdr/extme/prebisch98.pdf](http://www.worldbank.org/html/extdr/extme/prebisch98.pdf)

compromise. This is not, however, sufficient to address the failures of the Washington Consensus<sup>22</sup>. The reinstatement of politics at the centre of development policy should be the natural conclusion of the processes of institutional and rule of law reform. This is necessary not least because the main problem of the post soviet reform effort and the legacy of failed reforms in Africa – the creation of non accountable, illegitimate elites – will otherwise remain unresolved.

It is clearly possible, however, that the revised rhetoric of the IMF and the World Bank on the role of law does not in reality represent genuine change. Even though a detailed critique of the failures of the Washington Consensus has been developing for at least the last 10 years, the adjustment and development programmes which are currently being promoted around the world continue to retain the theoretical assumptions of the ultra-neoliberal ‘big bang reform’ programmes of the early 1990s<sup>23</sup>. While there seems to be increased recognition of the fact that democratic regimes are essential to the development of transparent and accountable states, for the World Bank the market is still the ultimate good and it is through its promotion that economic and social rights are guaranteed<sup>24</sup>. In its attempt to depoliticize the economic decision making process and to restrict the domain of democracy – in order to foster the smooth and speedy implementation of market based economic reforms - the Washington Consensus had created conditions which encourage the spread of illiberal regimes; regimes characterized by widespread corruption and state failure. Moreover, the strategy of entrusting state functions to independent institutions renders those institutions vulnerable to private capture and increases the scope for corruption. In other words, state institutions that are at least open to democratic scrutiny and democratically accountable should act as a check on corruption – a check which may be much less strong in undemocratic states, even with the presence of ‘independent’ institutions.

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<sup>22</sup> Soederberg, S. The Emperor’s New Suit: The New International Financial Architecture as a Reinvention of the Washington Consensus (2001) 7 *Global Governance* 453 p.460

<sup>23</sup> For example one has reason to doubt the renewed dedication to eradicating poverty, when short term adjustment and regulatory reforms directly related to poverty and inequality are not included in the IMF standby programs for countries like Turkey and Argentina. On the contrary, the strict adherence to budget surpluses and suppression of social sector spending suggested do not assist in fighting poverty. See Ziya Önis and Fikret Senses Rethinking the Emerging Post-Washington Consensus (March 2005) Volume 36 Issue 2 *Development and Change* Page p.21

<sup>24</sup> Anghie, A. Time Present and Time Past: Globalization IFIs and the Third World (1999-2000) 32 *N.Y.U. J. Int’l L. & Pol.* 254

The comment above is not meant to deny that the problem of capture and corruption is very real in state administration, but at least a democratic state can have a direct link of legitimacy to the public which acts as a force against the corruption. There is a paradox in the focus on legitimacy and accountability present in World Bank publications like in the WDR 2006, as on the one hand the presence of a democratic and accountable state is seen as the basis for the legitimacy of institutions but on the other hand, these institutions are required to be immune from political influence. For example the report suggests that positive impacts of regulation are conditioned on the ability to insulate regulators from pressures coming from politicians and providers. Measures to strengthen the independence of the regulator are paramount, and this may require a separate agency with reliable and ringfenced funding and staffing. In short, regulators should be subject to substantive and procedural requirements that ensure integrity, independence, transparency, and accountability<sup>25</sup>. In a state whose political foundations lack legitimacy due to the lack of democratic participation, the link of an independent regulatory authority or independent judiciary or independent financial institutions like central banks to the public is more tenuous. While the public can affect state administration in various ways – not least through democratic selection processes – how can it influence an independent, permanent institution run by technocrats many of whom believe they are acting in a natural, scientific manner, and think they are entrusted with the application of science? In fact, despite the alleged aim of reducing corruption by distancing economic decision making from political control, the liberalisation process itself has in the past in countries like Russia helped to undermine the effectiveness of state institutions and has created a vacuum in which widespread corruption can flourish.

The contradiction between improving political institutions and removing the tools through which politics can influence economics is not only evident in the WDRs. Various assessments of reform policies perpetuate the confusion. For example it is common to see as ‘lessons of reform’ suggestions that investment climate reforms, more cross-cutting and continuous than one-off events, call for special efforts to make the reforms permanent, insulate the process from political and bureaucratic interference, and ensure transparency and accountability<sup>26</sup>. At the same time one reads that getting the reform process right is just as important as ensuring sound policy content : paying attention to the way in which reforms are initiated and carried

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<sup>25</sup> WDR 2006 p. 174

<sup>26</sup> Kikeri, S. Kenyon, T. Palmade, V. (2006) Reforming the Investment Climate: Lessons for Practitioners, World Bank Publications, p.5

out builds the legitimacy, support, and ownership needed to achieve policies and outcomes that are both desirable and sustainable<sup>27</sup>. However, it is not easy to promote democratic accountability and at the same time promote depoliticisation and institutional independence..

In a model of development that seeks to separate the economy from politics, legal reforms pursuing accountability through institutional independence and depoliticisation are unlikely to further democracy. Perhaps the question of what type of legal reform supports the evolution of accountable regimes ultimately depends on what one understands by accountability and democracy<sup>28</sup>. If the aim of reform is to create a democratic regime of limited scope that operates within a strict framework of capitalist institutions, the current policy revisions described as the emerging Post Washington Consensus can succeed. If, on the other hand, one takes an extended view of what democracy entails – that it should allow the public to challenge all aspects of economic policy - then the Post Washington Consensus is seriously curtailing popular choice and is, democratically speaking, seriously deficient.

### ***3.3 A Larger Role for the State?***

From 1997 onwards the World Bank claims to have largely abandoned its original minimalist conception of regulation, which was in accordance with the tenets of the Washington Consensus, where state involvement in the economy was seen as impeding efficient transactions and impairing the extent and quality of investment. It began instead to recognize the existence of a variety of what it called distortions, externalities and market failures, and on this basis accepted in principle the need for intervention and regulatory action. Hence, the widespread criticism (by Stiglitz, for example) of the privatisations carried out in an institutional vacuum in post communist Russia and the criminal takeover of the economy that resulted<sup>29</sup>. However, the Bank, like other international financial institutions, still maintains its original position that the state ought to intervene as little as possible in the market and that market inefficiencies are more easily dealt with than state capture and corruption. This view serves to place limits on both the reach and purposes of legal reform, as the presumption of government failure often undercuts the case for state intervention even where it might otherwise be warranted in order to enhance efficiency.

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<sup>27</sup> Kikeri, S. Kenyon, T. Palmade, V. (2006) *Reforming the Investment Climate: Lessons for Practitioners*, World Bank Publications, p.6

<sup>28</sup> Pastor, M. & Wise, C. *The Politics of Second Generation Reform* (1999) 10.3 *Journal of Democracy* pp34-48

<sup>29</sup> See Chapter 5 Stiglitz, J. (2002) *Globalization and its Discontents*, Penguin; and Chapter 9 Stiglitz, J. (2003) *The Roaring Nineties*, Penguin.

The IMF in its 2005 World Economic Outlook publication offered the realisation that economic institutions are closely related to political institutions and argued that political institutions shape the incentives of the political executive and determine the distribution of political power, which includes the ability to shape economic institutions and the distribution of resources. In turn, economic institutions, by determining the relative affluence of various groups of society, also help shape political institutions. This leads the IMF to two broad conclusions : first that good economic institutions are most likely to flourish in a “rent-free” environment in which small groups are not able to take advantage of; and second that good economic institutions are likely to be accompanied by good political institutions (on the assumption that if political power is broadly shared and subject to checks and balances, there is much less risk that those with political power will take advantage of their position to extract rents themselves)<sup>30</sup>. However, this sort of leap from good economic institutions to good political institutions is not possible because the means employed to promote better economic institutions (independent, apolitical institutions that control norm marking and the implementation of market friendly regulations) prohibit political normalisation, by undermining legitimacy through the isolation of economic management from the democratically expressed political choices of the public.

Consequently, even though there appears to be a shift between ‘transition type’ priorities and development promoting reforms in attitudes towards the role of law, the shift is limited by a continuing skepticism about the state’s capacity to intervene effectively and a continuing belief that state interventions should be kept to a minimum. This trend is present in all WDRs despite growing emphasis on what might be called ‘social issues’. After all, the position of international organisations still is that growth is more likely to result from deregulation and liberalisation that encourage foreign investment rather than from government sponsored development policies, despite evidence to the contrary<sup>31</sup>.

The main preoccupation of international institutions remains, therefore, to sustain market friendly reforms. It is at this point that a fundamental rift between market promotion and democratic development becomes apparent. If in a democratic society the public has the power through the electoral process to challenge all aspects of economic organisation and

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<sup>30</sup> World Economic Outlook 2005, p. 126

<sup>31</sup> Rittich, K. The Future of Law and Development p. 210

policy, then the reform process could in principle be modified or, indeed, be reversed by the election of governments with less faith in markets or, indeed, radical anti-market governments. The only way to avert this danger and cement the reforms is by limiting the reach of the political process; by immunising the economy from political interventions. One of the ways this is achieved is via efforts to decommission the political arms of the State in an expanding zone of policy and regulatory activities<sup>32</sup>. This trend does not square with the World Bank's objectives of increasing accountability and legitimacy in an effort to promote equality and achieve pro-poor development outcomes.

This process has been described as involving the constitutionalization of reform and operates by placing market norms beyond the reach of political institutions<sup>33</sup>. This is achieved by placing the sanctity of property and contract, together with definitions of human rights that include the unassailability of individual rights, in constitutional structures that are impossible or near-impossible to amend. The protective framework is then completed by the subsequent creation of politically independent courts that can overturn government legislation that violates those rights. This legal/institutional framework safeguarded by a bench educated to reach pro-market 'efficient' outcomes means that state policies with social objectives and redistributive aims are very difficult to implement if they offend the basic pro-market politico-economic status quo<sup>34</sup>. In short, the ideological and methodological straightjacket of neoliberalism is leading to the adoption of a policies and, more importantly, to a framework of rights which will make it very difficult to broaden the development/transition agenda to include social and distributive concerns.

#### 4. Conclusion

The state envisaged by the World Bank and the IMF currently is neither the minimal 'transition type' state nor the protective or regulatory state of the pre-neoliberal era, but an 'enabling state' that aims through 'good governance' to protect existing private rights which, it is said, will ensure the continued existence of a framework in which markets can flourish. It is possible, then, to conclude that despite the apparent inclusion of social objectives and some commitment to greater citizen participation in the development process, and despite *some*

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<sup>32</sup> Rittich, K. The Future of Law and Development p. 216

<sup>33</sup> See Teivanen, T. (2002) Enter Economism-Exit Politics, Zed Books

<sup>34</sup> Aman, A. (2004) The Democracy Deficit, Taming Globalization through Law Reform, New York University Press. Also see on the judicialization of politics Hirschl, R. The Political Origins of the New Constitutionalism (2004) Vol.11.1 Indiana Journal of Global Legal Studies 71-108

change in the proposed role of the state (it is for example now recognized that the protection of the property rights created in early transition reforms require greater state intervention) the proposed role of the state has not fundamentally changed from that posited by the Washington Consensus<sup>35</sup>. Further evidence to this are offered by the fact that international codes and standard setting by international financial institutions (which are aimed primarily at securing the continued integrity of intangible financial property forms) take place in an environment well removed from democratic scrutiny. In such a way (despite proclamations to the contrary) economic reality is constructed in a manner aimed to ensure the dominance of neoliberal principles as the only viable option to achieve development<sup>36</sup>. The continuation of 'controlled state' development policies (dictated by the closed mindset propagated by the Washington Consensus and maintained by the current rule of law/institutional reform proposals) poses therefore a great danger to the political and economic progress of states on the path to development.

The neoliberal mindset has survived the disastrous legacy of neoliberal transition, and currently operates so as to close off policy options for development. This led Ugo Mattei to claim that the discursive practices branded 'democracy and the rule of law' serve to form a reactive legal philosophy that outlaws redistribution of wealth based on social solidarity<sup>37</sup>, and it is exactly redistribution of wealth that is needed according to the 2005 HDR to achieve progress towards the MDGs. As it has been noted above, the institutional variant of plans for development drawn by international financial institutions for the new century aims to safeguard the gains of the market transition process (by limiting the right of political processes to alter economic conditions) and aims to secure not merely market friendly reform programmes but property rights - especially financial property rights. Not least through the marketing of 'independent' courts and institutions, the sanctity of property and contract is put before social justice and equality. The current deregulatory trend observed in the subcontracting of government functions to private and quazi-state agencies beyond the control of democratic politics is an extension of the idea of private government inherent in the concept of sacred property rights. As Robert Hale observed<sup>38</sup>, legal rights to the possession,

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<sup>35</sup> Rittich, K. The Future of Law and Development: Second Generation Reforms and the Incorporation of the Social (Fall, 2004) 26 Mich. J. Int'l L. p234

<sup>36</sup> Soederberg, S. The Emperor's New Suit: The New International Financial Architecture as a Reinvention of the Washington Consensus (2001) 7 Global Governance 453 p.460

<sup>37</sup> Mattei, U. A Theory of Imperial Law: A Study on US Hegemony and the Latin Resistance (2003) 10 Ind.J.Global Legal Studies 383

<sup>38</sup> Hale, RL. Law Making by Unofficial Minorities (1920) 20 Col LR 603

use and exchange value of property are best described as delegations of public authority to private individuals and unofficial minorities. Because the legally constituted coercive power of the state both defines and enforces property rights, individuals are as subject to coercive power in non regulatory laissez-faire regimes as in controlled state-managed ones. The only difference is in the source of coercion, coming from (state-backed) private power in the first instance and (direct) state/public power in the latter case. This led Hale to conclude that the public-private and state-market dichotomies that have characterized theoretical analysis at the end of the nineteenth and at the start of the twentieth century need to be abandoned<sup>39</sup>. Of course, far from being surpassed these dichotomies are still going strong in the twenty first century and continue to determine policy responses to issues of development. And, as this article has demonstrated, a 'transition mindset' of reform continues to determine the content of development promotion projects despite the move of theory towards a greater acceptance of the role of law and state.

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<sup>39</sup> Ireland, P. Property and Contract in Contemporary Corporate Theory p.491