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THE ROLE OF LAW IN
ECONOMIC DEVELOPMENT
IN CHINA AND RUSSIA



> THE ROLE OF LAW IN ECONOMIC DEVELOPMENT IN CHINA AND RUSSIA

Clifford Chance is supporting a research project which examines the role of law and legal institutions in economic development in Brazil, Russia, India and China. The project is being led by the Centre for Business Research at Cambridge University which brings together economists, lawyers and social scientists to study the role of legal institutions in economic growth, development and innovation.

Simon Deakin, Director of The Centre for Business Research (CBR) and Professor of Law at the Faculty of Law, University of Cambridge, and John Hamilton, former partner and now consultant with Clifford Chance and Senior Research Fellow at the CBR, spoke about their research and their findings on China and Russia at an event in London. In this extract they discuss the relative merits of common and civil law and benign authoritarianism and liberal democracies in the development of the rule of law and economies.

Simon Deakin

Our research project, supported by the Economic and Social Research Council, a government-funded body, is looking at a number of questions: What kind of legal system underpins a market economy; what are the principal features of law under a market system; how does the law contribute to the way the market works; what sort of legal order is needed to assist the transition from a socialist economy to a market one; and what is the current state of development of the legal and financial systems in BRIC countries? Our research involves large scale data analysis but we also carry out face-to-face interviews on the ground to get an up-to-date understanding of what's happening.

What the rule of law means

This year is the 800th anniversary of Magna Carta. It states: "To no one will we sell, to no one deny or defer justice or right." This seems so obvious that we almost take it for granted. But what exactly is the significance of an expression like that? Magna Carta means many things: subjecting the executive power to legal rules – in the sense of de-personalising the exercise of power, so even the monarch is subject to the principle of the equal applications of the law, "To no one will we deny or defer justice or right." However, the most interesting part of this clause is the first part - "To no one will we sell justice." This is a critical issue in many countries where justice is a commodity that can be bought or sold; where you may bribe or influence a judge and where you cannot expect the objective and transparent application of the rules that you thought were governing your exchange or relationship.

If justice is a commodity, then the rule of law doesn't function and that affects commerce, business and the wider society. Critically, the rule of law de-personalises trade, so that doing business is not just a matter of whom you know or who you can bribe. That system can't just be created overnight. It evolves and

depends upon a shared understanding that bribery is unacceptable.

I was at a conference in China recently and a Norwegian law professor said: “The whole point about the rule of law in Norway is that if you try to bribe a police officer you would be arrested. Nobody would think of bribing a police officer – it would just never occur to you.” However, there are countries where the only way to do business is to bribe. The question is how does the idea of it being wrong to bribe become standard behaviour? The more we reduce corruption the more transparent commerce becomes and the more successful the economy is.

There is a very strong correlation statistically between the absence of corruption and the presence of strong public institutions, democratic institutions and what we take to be the rule of law. Social science is very good at understanding how the rule of law works but it doesn't always have a good understanding of how to get there. In the 1990s there was a view that we had to liberalise, deregulate and privatise and make the market work by creating property rights and by reducing the role of the state. After the fall of the Berlin Wall, the economic philosophy of the University of Chicago was highly influential. It said “property rights are critical, the legal system is critical, the state must limit itself, the state can do some things but not others.” The Chicago School didn't just say, privatise and deregulate, it also said bargaining requires rules. It requires rules which tell us what our property rights are and courts which will enforce freely negotiated contracts.

Common law versus civil law

Another school of thought, which became popular in the 2000s, but now discredited, was that countries differ in their abilities to embed the rule of law, depending upon whether they have a common law or a civil law background. One idea, supported by the World Bank, was that English common law was more market friendly than French or German civil law. Economists at Harvard and elsewhere were crunching numbers and apparently discovering that French civil law, was too statist, too interventionist and that led to higher unemployment and more corruption. Common law, with its English tradition of independence, was associated with faster economic growth because there was more protection for contract rights and property rights. Now, 15 years or so on, there is really no economic evidence to support this claim. It has been shown that common law countries do not grow faster than civil law countries.

However, back in the 2000s the World Bank adopted this approach and began to rank countries by ease of doing business. The assumption was that a heavy state gets in the way of business. Iceland, Denmark, Norway and Estonia, were all ranked highly, Germany crept in at number 20 and France was nowhere to be seen. The rankings became increasingly influential. The view was that to create a market economy



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you needed to deregulate, to privatise and to create property rights and it led to dozens of laws being changed across the world. It is quite easy to do at one level – pass a few laws and move up the rankings - because the World Bank wasn't basing its rankings on what was actually happening but on what the law said.

China

Another view is that China has grown so quickly precisely because it doesn't have a Western-style legal system. The people who argue this would say that China didn't have Western-style property rights and didn't have until recently, constitutional protection for property. How then do we explain China's very rapid economic growth? Maybe the absence of law is actually a good thing in emerging markets. Yet another view is that authoritarian politics - a benign dictator and the absence of democracy can be good for economic growth. If you think about China, it's clear that it hasn't had a Western style legal system and yet has enjoyed tremendous growth since the 1990s. Many people think this is due to an alternative to the rule of law called '*guanxi*' - trust and the personal relationships which are central to Chinese culture. Family is important, culture is important but contract and law are not. However, there is a dark side to '*guanxi*' - it is closely connected to corruption in China which oils the wheels of commerce. This is the dark side of trust where the costs of trust outweigh the benefits and it is becoming a major issue in China. In our research we have hypothesised that it's very important for economic development to move beyond the simple reliance on trust and personal exchange, to impersonal exchange. Thus we are sceptical of the claim that China's growth

depends, at least going forward, on the absence of the rule of law. We see elements of a rule of law starting to slowly emerge.

Russia

John Hamilton

I'm going to explore the Russian reforms of the 1990s and the steps taken to build a market economy and the lessons learned. Neoclassical economics dominated thinking on Russia in this period. The law was seen as something that was supposed to adjust to accommodate economic change. This was accompanied by the belief that a free market system supported by appropriate legal rules leads to a more efficient allocation of resources than any alternative system. The priority was to get the economy right and liberalise prices, and the reform of institutions was regarded as more challenging and a longer term project.

An early study by the economist Robert Shiller concluded that people who had lived under a communist regime were capable of responding to incentives in just the same way as people had spent all their lives in capitalist societies. The study also showed that Russian respondents had lower expectations about the honesty of businessmen and the security of property from state expropriation.



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Simon Deakin

The reformers were no doubt comforted by the idea that the laws of economics are universal. Lawrence Summers, chief economist at the World Bank, said in 1991: “The laws of economics are like the laws of engineering. One set works everywhere.” There was a belief that the creation of private property would create a demand for law and institutional reform. Alternative views, of which there were a number, were essentially disregarded.

The first wave of mass Russian privatisations took place from 1992 to 1994. Shares in state industries, energy and the financial sector were issued to the people free of charge but were transferable and had a face value of ten thousand roubles (roughly twenty dollars at the time). Many people had no real sense of what they were worth and sold them on quickly and therefore got no personal benefit from privatisation. The shares ended up in the hands of a small group of wealthy individuals. In addition, in 1996, President Yeltsin funded his re-election campaign through a small number of individuals who lent money to the state in exchange for shares in state owned industries. If the loans were repaid, the shares were returned. If not, the lenders were entitled to sell the shares and keep 30% of any upside. Inevitably the loans weren't repaid and state assets were transferred at an under-value.

As a result, ownership of former state industries, energy and the financial sector has ended up in the hands of a small group of individuals – a situation which continues. This has a negative effect on the demand for law since people with political and/or economic power don't need the

law and those that do need it have no influence. It seems the reformers would have been comforted by some version of the so-called ‘*Coase theorem*’ according to which, in a world of zero transaction costs, as long as legal rights are assigned, it doesn't really matter (from the point of view of efficiency) who acquires them. However, the concentration of ownership also led to a sense of alienation among much of the population.

According to a number of studies, privatisation did not really improve the overall performance of former state enterprises. Some performed better, but others did not. Following privatisation there were also issues around corporate governance. In the now defunct Yukos Oil company, for example, minority shareholders were eliminated. Tactics included preventing minority shareholders from attending shareholder meetings and other flagrant abuses of shareholder rights. We should perhaps not be surprised by this – if you can achieve your economic ends by circumventing the legal rules in an environment in which there is not redress then why wouldn't you do so?

Milton Friedman of the University of Chicago said in 2002: “Russia is privatised but in a way that created private monopolies – private centralised economic controls that replaced government's centralised controls. It turns out that the rule of law is probably more basic than privatisation. Privatisation is meaningless if you don't have the rule of law. What does it mean to privatise if you do not have security of property or if you can't use your property as you want to?”

This is interesting coming from Milton Friedman who was of course one of the best known

proponents of the free market. Neoclassical economics, with its emphasis on private property and private contracting, does assume an important role for law in the protection of property rights. However it may also be antagonistic to the rule of law as we have just seen unless we implicitly assume somewhat unrealistically that economic interest is pursued only by comparatively gentlemanly means.

The chaos generated by the reforms in the 1990s and the lack of adequate democratic institutions in Russia helped to pave the way for the return of the state as a stabilising influence.

What has changed since the 1990s?

There is a great deal of new legislation coming out in Russia and the civil code has undergone a major overhaul to make it more market friendly. Initially, Russia drew inspiration for its legislation from other legal systems and engaged foreign legal experts to help with the drafting process. These days there is very little of that and the level of legal drafting is poor generally. Agencies such as the tax authorities can be predatory, but it does mean that people are learning compliance even if they are learning the hard way.

Russia has never been a rule of law state. The manner in which the reforms were conducted may have been a missed opportunity. Attitudes to law have improved but the legal environment is not always a congenial one for doing business and the main threat is now from the state. Corruption unfortunately goes right to the top but the courts are generally less corrupt than

they used to be. The gap between the formal and informal rules and practices is wider in Russia than in many other countries but there is a formalistic side to Russian culture and people do document their deals.

Views from the ground

As part of our research we have talked to business people, lawyers and where available, regulators, lawmakers and policy makers in Russia and China. Here are some responses from China:

“The market rules and *guanxi* rules are two different systems.”

“There is less and less chance to make certain money through *guanxi*. In five years the market will have competed away from *guanxi*.”

“More and more people are now beginning to see that the key factor is how the company performs, not personal contacts.”

“*Guanxi* will continue to be important if the government plays a role in allocating assets.”

We also carried out a series of one on one interviews in Russia and here are the responses



“Attitudes to law have improved in Russia but the legal environment is not always a congenial one for doing business and the main threat is now from the state.”

John Hamilton, Consultant, Clifford Chance

The rule of law

“The Russian leaders have declared they want to move to the rule of law but they would have to give up power. The strategy is to hang onto wealth.

“[Putin] plays with the letter of the law but not the essence.”

The State

“The state is just some people in power and their friends.”

“Russian society is a series of layers and the leaders can only touch the top layers.”

“Russian to Russian deals are frequently allocations under instructions from the state. It does not matter what you say (in the documents) as it has already been decided.”

Corruption

“The state is internally highly corrupt, even at the top, where there are a lot of very clever, powerful individuals, most whom loathe each other.”

“Ten years ago corruption in courts was huge. Today no one will make a judgment that would be absolutely illegal, at least not in Moscow.”

Property

“There is little respect for property and privatised property is seen as stolen not earned, meaning that it is not seen as fundamentally wrong if someone else takes it away.”

Attitudes to Law

“People need to learn how to use their rights to protect themselves. Law is like a hammer: it can

hit someone hard, but one can build a beautiful house using it.”

“If you compare with, let us say, five years ago, the role of lawyers has become more significant. Now people tend to show a contract to a lawyer before the deal is done, rather than after.”

“Today legislation is business friendly.”

“Law is like water and business people are fish in this water. There are sharks, the water may get cold or too warm...”

Comparing Russia and China

John Hamilton

In China there is a stronger sense that things are evolving away from informal ways to a more market based system. Chinese bureaucracy seems to be more efficient in that there is a long tradition of bureaucracy in China which there isn't in Russia. The Chinese system is modernising more rapidly and is generally much more dynamic than Russia.

In Russia corruption is an enduring problem and the effectiveness of the state to get things done, as well as the viability of Russian business ventures abroad, is questionable. There are some positive developments but the pendulum has swung from a free for all form of capitalism with a weak state and



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virtually no rules, to a partially free economy and a strong state which exercises control over large sections of the economy either directly or informally to the detriment of market development. The idea of co-evolution between the law and the market and the emergence of the ideal self-limiting state still seems to be some way off.

Questions from the audience

How do you deal with the perception that it is not as easy as it was 20 or 25 years ago for Western researchers and lawyers to contribute to the reform drive in Russia and China?

Simon Deakin

I think that the 1990s were a period of Russia opening up to the rest of the world and at that point Western advisers had an enormous amount of influence. In retrospect maybe that influence wasn't always used very well. If we understood better our own system we could have given better advice to them. The models we had were how a market economy works but not how a market economy had come to exist and that's what was really needed. There are many factors which led to the return of more authoritative politics in Russia but undoubtedly one of them was the enormous instability in society accompanied the so-called pro market reforms of the 1990s.

In China we still don't see complete liberalisation at all of Chinese capital markets. The IPO market is very strictly controlled and we haven't seen mass privatisation of state enterprises. There is still a very strong party state in China but I think sometimes the Chinese party state is much less strong on the ground that in appears to us in the West.

It's never easy for academic researchers from abroad to work in these countries. And it is sometimes quite difficult for the researchers from those countries to do this sort of work. However, I think we do have a much better understanding of these countries than we did before and maybe a better understanding too of what the risk and costs are for the West. I think that the issue for us in the West is very much how to avoid a situation where we go backwards. We may think there are very many attractive features about Chinese economic growth but the absence of the rule of law doesn't strike me as being a very attractive feature and not one that we would wish to import.

John Hamilton:

I think we should add that the Russian interviews were carried out from September 2013 to 2014 and clearly there have been some quite significant geopolitical developments since then, the result of which, is a clamping down on freedom of expression, and increasingly one comes across some quite alarming attitudes being expressed by people. We are going to have to wait and see how things pan out before we can look forward to any real new developments concerning Russia and I think it would be a brave person to predict exactly how long that is going to take.

Is there any evidence to suggest that there is a correlation between natural resources or lack of and the speed and strength of development of the rule of law and economy in society?

John Hamilton:

There is some evidence for a negative correlation but that's not to say it's impossible to develop the rule of law in a resource rich

economy. England in the industrial revolution was a resource rich economy so we shouldn't assume that we cannot have an effective rule of law simply because a given state is well endowed. However, on the face of it that is part of the problem in Russia. Having said that, I think many developing countries are resource rich and they can use their resources to move from being low income countries to middle income countries. There is some evidence that it is very difficult to implant an effective state and the rule of law in a low income country but much easier in a middle income country. I think that the importance of natural resources in the very early stages of economic growth in low income countries can be positive but at some point the system has to make the transition to a reliance on institutions and not just on resources.

I wanted to contrast the reforms in Russia in the 1990s with those in Poland. We had some of the same advisors proposing the same legislative and economic changes and yet Poland was a success and Russia was not. What would you say were the intrinsic features of the Russian economy which made those reforms impossible there?

Simon Deakin

I think in Poland the reforms were more carefully planned and they were not as extreme. There is some academic evidence to suggest that the regulation of markets in Poland was much more effective from an early stage because they didn't believe in just de-regulating everything.

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