

## POLICY RESEARCH WORKING PAPER

wps 1528

1528

# Developing Commercial Law in Transition Economies

## Examples from Hungary and Russia

*Cheryl W. Gray**Kathryn Hendley*

Three things are essential to implement decentralized legal frameworks in any setting: reasonable laws, adequate institutions, and market-oriented incentives. The problem in transition economies is that all three must to a large extent be built from scratch. The question to ask at any point in time is not whether there is "rule of law," but whether the country is moving in the right direction along all three dimensions.



## Summary findings

Implementing decentralized legal frameworks requires reasonable laws, adequate institutions, and market-oriented incentives. All three must exist together. Laws or institutions without each other or without a supportive framework of incentives are likely to lie dormant, while incentives by themselves will be frustrated without a reasonable legal framework and institutions to support and enforce them. Developing any of these elements is a major challenge, and progress along all three takes time.

In transition economies, not only must new laws be drafted (a daunting task yet perhaps the easiest of the three) but they must be accompanied by the growth of supportive institutions (including formal judicial institutions and the “watchdog” institutions that we almost take for granted in advanced market economies). And they must be accompanied by economic reforms — whether privatization (particularly with outside owners) or banking reforms — that separate actors from the state and reinforce market-based incentives.

Gray and Hendley use two case studies — Hungarian bankruptcy law and Russian company law — to illustrate the interaction of these three elements in practice. These

cases illustrate their general view that Central Europe is somewhat further along on all three dimensions than Russia. Russia is not advanced in the development of either laws or institutions, among other reasons because it lacks Hungary’s pre-war legacy of a legal tradition (Russia having never been a society or an economy ruled fundamentally by law) and because it launched economic reform much later. As for incentives, in both countries relevant actors exert weaker demand for proper implementation of the laws on the books — weaker demand that there be stable “rules of the game” — than one would expect in more mature market economies.

The cases belie any simplistic notion that the rule of law can be mechanically dictated from above. Top-down reform of bankruptcy law in Hungary appears to have been at least marginally successful in changing expectations and behavior, partly because it stimulated the growth of new supporting institutions. It might have been more successful if other areas of government policy had created more complementary incentives, particularly in banks. Top-down reform of company law in Russia has had little impact to date on either institutional development or firm behavior.

This paper — a product of the Transition Economics Division, Policy Research Department — was prepared for the John M. Olin Lecture Series at Harvard University. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Grace Evans, room N9-058, telephone 202-458-5783, fax 202-522-1151, Internet address [gevans@worldbank.org](mailto:gevans@worldbank.org). November 1995. (48 pages)

*The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.*

**DEVELOPING COMMERCIAL LAW IN TRANSITION ECONOMIES:  
EXAMPLES FROM HUNGARY AND RUSSIA**

by

**Cheryl W. Gray  
Principal Economist  
Policy Research Department  
World Bank**

and

**Kathryn Hendley  
Assistant Professor  
Law and Political Science  
University of Wisconsin**

**Paper prepared for the John M. Olin Lecture Series  
Harvard University**



## **Developing Commercial Law in Transition Economies:**

### **Examples from Hungary and Russia**

Cheryl W. Gray and Kathryn Hendley

The transition from plan to market in formerly socialist economies is perhaps most fundamentally a change in the role of the state. The state must withdraw from everyday control over most aspects of economic life, and the central economic controls associated with the state's central planning apparatus must be replaced by decentralized, objective rules of the game, i.e. the "rule of law". The patron-client networks and the resulting particularism that characterized economic relations under state socialism have to give way to relationships based on universalistic rules. The state's role must become facilitative. Its functions in this area are twofold: (1) to build a body of substantive law that is clear, transparent, feasible, efficient and stable, and (2) to create legal institutions with sufficient authority and independence to enforce these laws (even against the politically powerful).

What does it take to develop such "rule of law" in transition settings? Most observers and providers of technical assistance focus on the *supply* side, i.e. on what key laws and institutions have to be in place before decentralized markets can function. They recognize the importance of well-crafted legislation and institutions that facilitate efficient and largely self-enforcing economic outcomes. However, while a supply of key legislation is undoubtedly

critical, such supply is not enough on its own to ensure rule of law. There must also be a deep-seated *demand* for rule of law by existing or potential market players. What generates such demand? It springs from a desire for *stability* -- a desire for objective "rules of the game" that apply across the board rather than on a case-by-case basis (as was typical under socialism). This desire in turn will arise only if these players must truly depend on the market for survival; that is, if they no longer view the state as an assured safety net in times of trouble. State intervention can perhaps be conducted in an ad hoc fashion; widespread market interactions among strangers, in contrast, depend on reliable, objective rules to lower transaction costs. In sum, the withdrawal of the state may to a great extent be a *sine qua non* for the development of rule by law.

The goal of this paper is to illustrate the process and requirements for developing rule of law in transition economies. It focuses on a specific example of commercial law reform in each of two transition countries, Hungary and Russia. While each country's experience is in a narrow sense unique, in broader respects Hungary is quite representative of Central Europe, while Russia shares many characteristics with other former Soviet republics. While the key problems associated with transition in the two regions are similar in *kind*, the detailed comparison of Hungary and Russia underlies our belief that the problems of legal development in the two regions are different in *magnitude*, due to two factors: (1) different legacies and experiences under socialism, and (2) different degrees of state withdrawal from post-socialist economic activity. The shorter period of socialism in Central Europe, its presocialist legal and institutional legacy, and its closer links (even during socialism) with Western Europe ease the

task of developing rule of law. The legacy is particularly important; Hungary had a well-functioning legal system and rule of law before World War II, while Russia was never a society or economy ruled fundamentally by law. The highly instrumental use of law by the Communist Party elite during the Soviet period further eroded trust in law and legal institutions. Furthermore, Hungary's longer experience and greater progress to date in implementing economic reforms that separate private actors from the state help provide the incentives needed for rule of law to become reality.

The specific examples of legal reform addressed in this paper are somewhat different in the two countries. This reflects in part the different areas of concern that have highlighted the reform agenda in the two countries since 1992. In Russia the focus is on company law, which has been a primary means through which the Russian government has tried to change the behavior of ostensibly privatized firms. In Hungary the focus is on bankruptcy law, which has taken center stage as a means to change enterprise behavior in that country since the adoption of the transition world's most modern and aggressive bankruptcy law in late 1991. Thus, each specific area of law reflects a major initiative of that country in trying to change enterprise behavior in the past half-decade.<sup>1</sup> To what extent have these laws been followed in practice, and how effective have these initiatives been in changing behavior?

---

<sup>1</sup> Russia has hardly begun to implement bankruptcy law, and thus it does not provide a meaningful comparison of experience in this area to Hungary. Hungary adopted a new company law in 1988, but it was not accompanied by the same type of rapid privatization as in Russia, and thus it did not serve to the same extent as a tool of change.

## What is Required for Fundamental Legal Change?

The specific cases to be analyzed illustrate three interlocking requirements that are essential for decentralized legal frameworks to be implemented effectively in any setting -- reasonable laws, adequate institutions, and market-oriented incentives. All three must exist together, and in socialist economies must often be built from scratch. Developing any of the three is a major challenge, and progress along all three necessarily takes time. The question to ask at any point in time is not whether there is or is not "rule of law", but whether the country is moving in the right direction along these three dimensions.

### A Reasonable Legal Framework

The first necessary (but not sufficient) condition for the development of "rule of law" is a formal legal framework that:

- provides all players with clearly delineated rights and responsibilities, including clear norms of fiduciary duty;
- embodies market-friendly economic policies that are to a large extent "self-enforcing";
- has been internalized into local legal culture and understanding through an airing and acceptance by a basically democratic political process; and
- is reasonably well-known by the population, stable, and predictable in enforcement.

This is by no means an easy first requirement, especially given the wide range and scope of the policy debate, the intense political pressures, the shortage of experience with market



mechanisms, the limited analytical skills and the fragility if not the absence of democratic institutions typical of transition settings. While getting the economic signals "right" is itself an enormous challenge, perhaps even more difficult is defining principles of individual responsibility, particularly for those acting in a fiduciary capacity for others. The socialist system undermined the mutual trust among the people that is so essential for decentralized markets to function, and the state, acting through new laws and institutions, must now undertake the formidable task of reinstating that trust and of convincing individuals that it will also be governed by law. Unfortunately, the failure of this first step may have systemic costs beyond mistakes in individual laws themselves. When laws are passed with major inconsistencies, uncertainties, economic flaws, or clear avenues for abuse by some at the expense of others, these new laws can act to deepen public mistrust in law even further.

What are the possible sources for transition countries to turn to in formulating substantive legal frameworks? Essentially there are two options: (1) "home-grown" law (either from "first principles" or from old pre-war legislation), as has typically been true of most of the legislation adopted since the late 1980s in Central and Eastern Europe;<sup>2</sup> or (2) legislation transplanted in part or in whole from advanced market economies. Although imported laws have the benefit of supplying "pre-tested" models, they are inherently risky, because they do not grow out of local legal culture and so may not take root when transplanted without having undergone an internal process of formulation and drafting. An intermediate model--borrowing general ideas from "best practice" models abroad, but then internalizing them through a thorough process of

---

<sup>2</sup> For specific examples, see Gray and Associates (1993).

indigenous legal drafting and political debate -- is probably optimal in most cases.

### Supportive Institutions

A second necessary (but still insufficient) condition for the development of "rule of law" is the existence of institutions capable of supporting the legal framework and enforcing it at the margin. Even if the formal body of laws is economically sound and potentially self-enforcing to a large extent, it may well lie dormant without basic institutional support.

The first obvious supporting institution is the court system. For an individual or the state, taking action to enforce a law is often time-consuming and costly, particularly when information is scarce. The potential end result must make it worth the effort. In particular, there must be some assurance that the court (or other legal institution involved) has the power and capacity to decide the substantive question objectively and enforce the judgment. These assurances were absent under state socialism. The administrative-command system led to a general marginalization of law within the economy, and formal judicial institutions atrophied in the economic sphere. Managers tended to turn to ministerial or party officials if a trading partner reneged, rather than pursuing legal remedies. This was a pragmatic approach. Appealing to the bureaucracy solved their problem in that the ministry or the party had the power to order, for example, that key inputs be delivered. As a rule, the courts could only award money damages and fines. In a non-monetized economy, such remedies were cold comfort to enterprise managers seeking to fulfill the plan. With the transition to the market, the remedial role of the state bureaucracy must be supplanted by arm's-length dispute resolution and

enforcement institutions.

While formal legal institutions such as judges, prosecutors, arbitrators, and court functionaries (including, for example, bailiffs and bankruptcy trustees) are of course the primary law interpreters and enforcers, the list of institutions needed to undergird the rule of law in any country goes well beyond them. For arm's-length legal norms to be useable by market participants in everyday commerce, perhaps the *most* important institutions are those that produce and distribute information and monitor those participants, i.e. the "watchdog" institutions such as accountants, credit rating services, securities regulators, the private bar and investigators (including the press). These institutions provide the information that is absolutely critical for laws to be enforced (whether "self-enforced" by the participants themselves or enforced by formal institutions) and thus for economic policies to have their intended effects.

Early yet careful attention to institutional needs is warranted, because institutional development is reinforcing, as each successful case of law enforcement and information provision creates a demonstration effect that builds overall trust in the legal process. Institutions do not arise in a vacuum but are themselves shaped by the substance of the new transition-era laws and by the institutional legacies of state socialism.<sup>3</sup> The state creates formal legal institutions through enabling legislation. In doing so, the goal should be to develop institutions that are generally autonomous from the day-to-day political process of government and able to operate unobtrusively. The state continues to be involved, in that it provides financial support and lends its legitimacy to these institutions (which can be important when enforcing judgments

---

<sup>3</sup> For further discussion of the Leninist legacy and the path-dependent nature of the transition to the market, see respectively Jowitt (1992) and Stark (1992).

against the political or economic elite). As to the "watchdog" institutions that facilitate both official and self-enforcement, the state's role is more limited, both in terms of their creation and operation. Indeed, if such institutions are to be successful, they must arise from societal demand rather than being imposed from above by bureaucrats.

### Market-Based Incentives

Finally, a third necessary condition for rule of law to develop in any country is a set of incentives for individual market participants themselves that motivates them to take full advantage both of the rights granted by the formal legal framework and of the information and enforcement capacity provided by supportive institutions. Once again, the role of the state is critical. As noted earlier, parties will have strong incentives to take advantage of legal rights and abide by legal responsibilities primarily to the extent they depend on the market -- and their reputation in it -- for survival. For example, banks and other creditors may not avail themselves of the rights provided under bankruptcy laws unless they are convinced that state bail-outs are not likely to be available and thus that aggressive debt collection is necessary for survival. Similarly, managers in private firms may be tempted to ignore shareholder protections and other checks and balances laid out under corporate law unless their access to inputs and their ability to sell products and raise capital depends on a law-abiding reputation. If they can raise capital by turning to the government or state banking system for subsidies, or if they have a monopoly position in the market (either as output seller or as input purchaser), why worry about reputation in private markets?

In sum, market-oriented incentives complement market-oriented laws and institutions. All three are -- for better or worse -- inextricably interlinked. One cannot proceed far without the others, and all three are essential for the development of rule by law.

### Hungary's Experience with Bankruptcy Reform

To translate the rather abstract discussion above into real-world relevance, let us take as a first example the case of bankruptcy reform in Hungary. We look in turn at the pros and cons of the formal law, the state of institutional support for such law, and the incentives of the parties supposedly affected by the law's provisions.

#### The Legal Framework: Hungary's Bankruptcy Legislation

Hungary's experience with bankruptcy reform since 1992 is unique among the transitional economies. Hungary adopted a tough new bankruptcy law in late 1991 that took effect January 1, 1992. The law required managers of all firms with arrears over 90 days to any creditor to file for either reorganization or liquidation within 8 days (the so-called "automatic trigger") and provided a rather sympathetic framework for them to do so.<sup>4</sup> The law immediately resulted in a wave of filings, with some 3500 filings in April, 1992, alone (90 days after the law took effect). From 1992 through 1994 over 25,000 cases were filed under the law, a level far beyond

---

<sup>4</sup> For purposes of this paper, we use the term "bankruptcy" for the entire framework and "reorganization" and "liquidation" for the two specific procedures provided in the law. This differs from the specific Hungarian terminology, which used the term "bankruptcy" to refer to the specific reorganization procedure rather than the broader overall framework.

the expectations of policy makers when the law was adopted.

The Hungarian law provides a modern and quite reasonable economic and legal framework for judicially-directed reorganization and liquidation. It is similar in structure to the U.S. bankruptcy regime, as policy makers imported contemporary thinking from advanced market economies while attempting to tailor it to Hungarian conditions. Under the law debtor firms may file for either reorganization or liquidation, while creditors may file only for liquidation of the debtor firm. If a debtor files for reorganization, incumbent managers may stay in place and have three months to present a reorganization plan to creditors, who then negotiate and vote to accept or reject it. If either party files for liquidation, a liquidator is appointed once the court reviews and decides to proceed with the case. The liquidator is supposed to notify creditors, draw up a list of assets, sell the assets, and divide the proceeds among creditors in order of priority (with liquidation costs first, followed by creditors secured by mortgage, other creditors, and equity holders, in that order). The entire liquidation process is supposed to be completed within two years. The law sets compensation levels for liquidators and trustees, and regulations adopted concurrently with the law provide an annual licensing procedure for liquidators, with minimum capital and professional requirements.

Under the first version of the law, a debtor firm filing for reorganization received automatic relief from debt service and asset foreclosures for the first three-month period (further extendible by one month), during which the reorganization plan was to be prepared. Unanimous approval by all creditors was required for the plan to be adopted; otherwise the case reverted automatically to liquidation. A firm with a successful plan could not file again for

reorganization for at least three years. Trustees and creditors' committees were not required in reorganization cases but could be organized at the discretion of creditors.

Numerous important changes were made to the law in September, 1993, drawing from the first one and a half years' experience with the 1991 law. The unanimous creditor approval requirement was considered too tough, so it was replaced by a requirement of creditor approval by one-half in number and two-thirds in value of outstanding claims. The automatic three-month stay on debt service was considered too generous and easy to abuse, and it was replaced by a discretionary stay that required the same level of creditor approval. Liquidators' compensation was considered too low and was increased. To stem the unanticipated flood of cases, both the "automatic trigger" and the automatic reversion of failed reorganizations to liquidation were eliminated. Finally, trustees were made mandatory in all reorganization cases.

In sum, while there were some design flaws in both the original and the amended bankruptcy laws,<sup>5</sup> the adoption of the 1991 law was a step forward in Hungary and provided a reasonably efficient economic framework for the reorganization or exit of problem firms. Was it implemented? Yes it was, due in large part to the powerful nudge provided by the automatic trigger. Was it implemented as it would have been in advanced market economies, or even as anticipated by its designers? No it was not, and to understand why one must turn to institutions and incentives.

### The Institutional Base: Hungary's Legal and Commercial Institutions

---

<sup>5</sup> For details, see Gray, Schlorke, and Szanyi (1995). For a somewhat different view, see Bonin and Schaffer (1994).

When the bankruptcy law was adopted in Hungary, the institutions needed to implement it were extremely weak. First, there were very few bankruptcy judges -- only 8 in the entire Budapest court<sup>6</sup> in mid-1992 (handling about 4000 cases) -- and even fewer with a clear understanding of the issues involved. Second, the professions that we tend to take for granted in advanced market economies and that are so critical in bankruptcy proceedings -- accountants, lawyers, appraisers, trustees -- were in their infancy. Third, banks and other creditors (including trade and government creditors) lacked employees trained in market-based financial analysis and workout negotiation techniques. Fourth, the economy lacked the institutions -- whether trained and motivated bank supervisors, wary depositors, or interested owners -- that markets depend on to oversee bank management and counteract fraud and inefficiency. Finally, financial and cost accounting systems were poorly developed within debtor enterprises themselves.

All of this institutional weakness added up to a huge asymmetry in access to information concerning debtor enterprises (such as their true profit-earning potential or the true extent and value of their assets). Creditors suffered from a vacuum of information (with little place to turn to reliably generate it), while only senior managers within the debtor firms had full access to this important information. This contrasts markedly with the situation in advanced market economies, where both judicial and "watchdog" institutions insure much broader access to relevant information in bankruptcy cases among both debtors and their various creditors. What happens when information is asymmetrically distributed? Those with access have greater

---

<sup>6</sup> Mizsei (1993).



opportunity to use the information for their own ends, as discussed further below.

### Demand for Law?: The Incentives Surrounding the Bankruptcy Process

Even with a well-designed law and sufficient information, would the Hungarian bankruptcy law have been implemented as intended by policy makers and as a similar law would be in advanced market economies? This depends in large part on the incentives of the various parties, which depend in turn on the extent of their independence from the state and thus their dependence on the market for survival. The major parties whose incentives matter in bankruptcy reorganizations are the debtors and their creditors. Added to this in liquidation cases are the liquidators themselves.

Debtors. Beginning with debtors, one can differentiate between owners and managers of debtor firms, whether public or private. To the extent that an owner owns 100 percent of the firm and is also the manager, the incentives of owners and managers are one and the same. If the owner-manager's ownership interest is less than 100 percent, or if the owner is not also the manager, the incentives of these two parties are likely to differ. Hungarian managers, like managers everywhere, are likely to obtain satisfaction from two sources -- the performance of their firms and their own personal economic remuneration. The mix between these objectives varies from manager to manager and firm to firm, but in most cases each plays some role. As is well-known in Western literature, agency costs (including managers' pursuit of personal agendas, even at the expense of shareholder value) are likely to be higher when shareholder monitoring is weak. For example, a manager of a state-owned firm may have a strong incentive

to "spontaneously privatize" the firm's assets,<sup>7</sup> particularly if those assets are readily transferable and if such transfer is unlikely to harm his or her reputation because the owner (i.e. the state) is either disinterested or uninformed. The manager of a private firm may face the same incentives to the extent there are many widely-dispersed owners without adequate incentive to monitor management. Similarly, a partial owner who manages a private firm may have an incentive to transfer assets of the enterprise to another firm more fully owned by that person. In any case, one common incentive of managers in many transition settings is to increase their ownership of valuable assets while decreasing their ownership of costly liabilities -- or to "privatize" assets and "socialize" liabilities.

In the Hungarian case, privatization has moved quite slowly, due in large part to the country's dedication to the sales approach and its eschewing of any form of mass privatization. Yet, unlike in Poland or the former Yugoslavia, Hungary's state-owned enterprises do not have a long tradition of worker activism and control. This, combined with the practical difficulties faced by Hungary's state asset management agencies in their attempts to monitor the activities within hundreds of individual firms, has essentially left managers in almost total control of state-owned firms, with little oversight by owners or workers.

Creditors. At the same time that some managers face strong incentives to divert assets of firms, many creditors in transition economies lack strong incentives to stop them. In Hungary the principal creditors are government agencies, trade creditors, and banks, each holding roughly

---

<sup>7</sup> "Assets" here should be read broadly to include valuable intangibles such as customer lists, service contracts, or the working time of productive employees.

equal proportions of the debt of the large problem enterprises.<sup>8</sup> The government creditors include the tax office, the social security service, and the customs office. These authorities were not known for active law enforcement and collection of arrears; in contrast, their legacy carried over from socialism was one of pervasive bargaining and redistribution from profitable and loss-making firms.<sup>9</sup> Habits and attitudes do not die easily. Although there is some evidence that budget pressures have made government creditors more vigilant, tax and social security arrears clearly continue to be a major source of financing for firms in financial distress.<sup>10</sup>

The incentives of trade creditors depend in large part on their links with the state, and these are changing quite rapidly with the growth of the private sector in Hungary. As with government debt, a significant portion of the debt to trade creditors consists of overdue receivables, many which arose in 1991 and 1992 when the enterprise sector in both countries was subject to serious demand and liquidity shocks. These shocks led to a network of inter-enterprise credits that itself undercut discipline due to the fear of "domino" bankruptcies if any one party attempted to collect debts. There is evidence, however, that trade creditors are slowly becoming more active in preventing the emergence of new overdue receivables by requiring payment in advance before goods are shipped to problem firms.

The third major category of creditor is banks. Credit from banks represents less than half the total liabilities of troubled firms in Hungary. Nonetheless, banks play an important if

---

<sup>8</sup> Baer and Gray (1996).

<sup>9</sup> Kornai and Matits (1984), Vodopivec (1994), Schaffer (1990).

<sup>10</sup> Bonin and Schaffer (1994).

not pivotal role among creditors in maintaining borrower discipline and forcing workouts or liquidations in problem firms. Banks are the only source of financing available now to most Hungarian firms, apart from self-financing and temporary involuntary financing from government, trading partners, and employees through arrears. In advanced market economies banks are clearly key players in bankruptcy processes.

Yet the incentives of large state-owned Hungarian banks in the early 1990s have been complex and confused. As in most transition economies, many of the state-owned commercial banks in Hungary were insolvent by 1992 when evaluated using internationally accepted accounting principles. These insolvencies resulted from several causes, including bad loans inherited from the socialist "monobank", transition-induced defaults on existing loans, and defaults on new credits extended after the onset of relative price reform.<sup>11</sup> As in many other countries, Hungary moved to reinvigorate existing banks via recapitalization. A one-time recapitalization may be needed early in the transition to establish viable institutions, given the undercapitalized state of most commercial banks when initially separated from the monobank. However, growing experience from around the world is showing that recapitalization is itself a risky undertaking, particularly if undertaken repeatedly. If it leads bank managers to believe that future losses will also be offset by the government, it can encourage fraud and moral hazard and further undercut the incentives of banks to expend time and energy pursuing delinquent borrowers.<sup>12</sup> Hungarian banks were effectively recapitalized four times between

---

<sup>11</sup> Indeed, while some of the problem was inherited from the breakup of socialism, much of it arose from lending made during the 1990-1991 period. Abel (1994) provides supportive data for Budapest Bank.

<sup>12</sup> For further discussion, see Baer and Gray (1996).

1991 and 1994, with a total value of some \$3.4 billion -- equivalent to about 9% of 1993 GDP. Yet little else was done to create strong market-based incentives within banks. The government did not carry out independent, in-depth portfolio or operations reviews before the recapitalizations or implement performance-oriented management contracts. Managers did not have strong and clear incentives to undertake actions that would increase the value of the banks they managed. The government failed to formulate a clear plan for state-bank privatization, although two banks (the foreign trade bank and Budapest Bank) have recently attempted to privatize (the first successfully, the second not yet so) largely on their own initiative. Most observers agree that banking supervision has been weak. In sum, banks have continued to rely on government support, and this has arguably undercut their aggressive pursuit of debt collection.

#### The Outcome: Rule of Law?

To what extent is Hungary's bankruptcy experience evidence of the development of "rule of law"? In other words, to what extent did the introduction of a new bankruptcy law in Hungary change the behavior of those ostensibly subject to it, and in ways envisioned in the law? The evidence is mixed. On the one hand, the automatic trigger unequivocally resulted in an enormous wave of filings, as managers evidently took seriously the civil penalties they could personally incur if they failed to file. Furthermore, evidence gathered from a recent survey of 117 bankruptcy cases filed in 1992 and 1993<sup>13</sup> indicates that the rough outlines of the

---

<sup>13</sup> See Gray, Schlorke, and Szanyi (1995).

mandated legal procedures were more or less followed. Debtors filing for reorganization did benefit (until September 1993) from automatic stays on debt service and collateral foreclosure, and they did generally put forward reorganization plans within the 3-4 month period provided in the law. The cases of firms whose plans were not approved reverted automatically to liquidation. In liquidation cases there is clear evidence that appointed liquidators maintained strong control over the liquidation process and made at least partial attempts to fulfill their legal duties and requirements.

More important than adherence to process, however, is the fact that bankruptcy outcomes appear broadly to follow some degree of economic logic. Of the 117 firms surveyed, those that successfully emerged from reorganization were on average less heavily indebted and had better profit performance (i.e. smaller losses) than either those that filed in reorganization (and thus reverted to liquidation) or those that avoided reorganization altogether and filed directly for liquidation. The achievement of a roughly logical economic outcome can arguably be considered a real success, given the newness of the process and the underdeveloped state of the institutions involved.

On the other hand, the actual outcomes of the bankruptcy process still appear to differ substantially from what was envisioned in the law. The differences arise in large part from the underdevelopment of norms of fiduciary responsibility, the tremendous asymmetry of information access, and the weak incentives of some creditors to oversee the process and assure the maximum possible return on their outstanding credits. First, there is ample anecdotal evidence (not easily verifiable through surveys) that many managers take advantage of the

bankruptcy process as a means to privatize assets and socialize liabilities. In some cases they transfer valuable assets to separate private firms prior to filing, leaving the less valuable assets and the liabilities to enter the bankruptcy process. Creditors may also be involved in asset diversion, by colluding with the debtor firm to transfer assets and thus repay that particular creditor prior to bankruptcy at the expense of other creditors.<sup>14</sup> In advanced market economies, such transfers in anticipation of bankruptcy are void or voidable by the trustee. They are by law also voidable in Hungary, but liquidators report tremendous difficulty obtaining necessary evidence, due in large part to the underdevelopment of the "watchdog" institutions.<sup>15</sup> Furthermore, in advanced market economies well-developed laws and traditions of fiduciary responsibility inhibit such behavior, but these laws and traditions are not yet well-developed in transition environments such as Hungary's.

Second, liquidators and the managers of debtor firms may in many cases be following the letter but not necessarily the spirit of the law. It appears that liquidation is to a large extent perceived by all parties more as reorganization than as pure liquidation. This has become even more true since late-1993, when the number of reorganization cases began a steep decline<sup>16</sup> --

---

<sup>14</sup> The incentive for such creditor collusion is partly attributable to the weak legal protection given to collateral and the resulting difficulties that secured creditors face in collecting debts through formal and transparent legal means.

<sup>15</sup> To avoid detection, managers or creditors could either wait one year to file in order to avoid the period during which liquidators could retroactively void transfers, or they could destroy the records so that the transfers were not later traceable by creditors, trustees, or liquidators.

<sup>16</sup> Several factors have contributed to this decline, including (a) a natural decline after the initial glut of cases; (b) the elimination in September 1993 of the automatic trigger; (c) the elimination at the same time of the automatic 3-month moratorium on debt service (which motivated many filings); (d) the substitution of a separate process -- "debtor consolidation" -- for bankruptcy in many cases; and (e) the requirement, added in September 1993, that a trustee must be appointed in all bankruptcy cases.

i.e. when liquidation appears in effect to have replaced reorganization as the primary restructuring process. Interviews with liquidators and firms suggest that many if not most liquidators see themselves as active restructurers, representing first of all the interests of employees or the public rather than the interests of creditors. Virtually all "real" firms (as opposed to "shells" or firms with minimal assets, of which there are plenty) stay alive during the liquidation process as the liquidator looks for ways to privatize their viable parts.<sup>17</sup> This approach is encouraged by a design feature added to the law itself in 1993: the provision that liquidators earn 2 percent of gross proceeds of firms in liquidation as long as the firms are still in operation.<sup>18</sup> While this outcome may be good for restructuring and privatization, it is not necessarily good for creditors, who may lack either sufficient information and institutional enforcement power or sufficient motivation to challenge liquidators' actions. In the end, of course, this lack of a viable creditor-led "exit" and debt collection mechanism can be costly to firms, because it increases the cost and reduces the flow of credit in the economy.

In sum, Hungary's experience with bankruptcy reform indicates the difficulty of pushing economic and legal change "from above", given the lack of well-established norms of fiduciary responsibility, institutional weakness (leading to serious information bottlenecks), and continued soft budget constraints on the part of certain creditors. However, it also illustrates some progress can be made in a relatively short time period if a country undertakes strong forward-looking policy initiatives. Not only has the concept of bankruptcy gained some

---

<sup>17</sup> Gray, Schlorke, and Szanyi (1995).

<sup>18</sup> If the assets are sold, the liquidator earns 5 percent of sales proceeds, which in many cases is substantially less than 2 percent of ongoing revenues.



legitimacy it lacks in so many other transitional economies, but Hungary's initiative has contributed toward building the institutions needed for rule of law to take hold. The process has stimulated the development of a cadre of professional trustees and liquidators with in-depth knowledge of techniques of financial and organizational restructuring. Hungary has been willing to license both foreign and domestic firms as liquidators, and the foreign participation has brought outside knowledge and expertise into the picture. It has also led to an increase in the number and commercial expertise of judges and in the sophistication of the banks' understanding and approach to debt collection. Finally, for better or worse, it has probably been one of the main stimulants of privatization (both of assets and of parts of going concerns) in the Hungarian economy since 1992, and thus has furthered the separation of the economy from state control that is so essential to the healthy development of rule by law. In its reforms of bankruptcy law, Hungary appears to be moving generally in the right direction, albeit certainly not without some difficulty along the way.

#### Russia's Experience with Company Law

Russia presents a somewhat different case from Hungary. Its experience with state socialism was twice as long and infinitely more intense. Consequently, the behavioral patterns that grew out of socialist incentives and institutional structures were more deeply entrenched and arguably more resistant to change.

One of the key elements of Russian economic reform (as in Hungary and other transition

economies) was the legalization of private property and the subsequent privatization of the state industrial sector. Although the state retained an interest in most enterprises, the privatization process brought about a profound change in the ownership structure, as state enterprises were transformed into private entities. But privatization was only a means to an end. The goal was to increase the efficiency of Russian firms and, ultimately, to make them capable of competing in the global marketplace. Privatizing a firm is necessary, but not sufficient, to achieve that goal. More important is effecting a change in *how* the business is run. Such change comes about slowly. The state cannot unilaterally compel change in enterprise behavior. At best, the state can reshape the environment within which the enterprise operates, and thereby have some influence at the margins.

#### The Legal Framework: Russian Company Law

The technical problems of Russian law (including company law) are legion. Merely finding the law can be a struggle -- to say nothing of the difficulty of interpretation. Laws are often internally contradictory or make cross-references to laws that either do not yet exist or do not say what the first law claims. The desire to make the market reforms irreversible has led to impatience with the long debates within the legislature, and to a preference for executive decrees. Ruling by decree is easier in the short run, but does little to move society towards the rule of law. Decrees are inherently non-democratic; they are conceptualized and introduced in a top-down fashion that often ignores local legal culture. None of these shortcomings are unique to Russia, but they are particularly troubling in the Russian context because they tend to deepen

the general distrust of the legal system that lingers on from the Soviet period.

The changes in company law over the past decade have generally tracked macro-level economic reforms, though they have often lagged a step or two behind. They began with the 1988 Law on State Enterprises,<sup>19</sup> which represented the first tentative move away from administrative controls towards greater enterprise autonomy. The years that followed brought new laws on property and business organizations that reflected an increased (and sometimes grudging) willingness to accept private property and passive investment interests. By 1990, both Soviet<sup>20</sup> and Russian<sup>21</sup> legislation recognized privately owned business organizations of various types. With the collapse of the Soviet Union, Soviet laws became null and void to the extent that they contradicted existing Russian law.<sup>22</sup>

While not yet contemplating full privatization, these early laws opened the door to experimentation with new forms of corporate organization. Some adventuresome managers, for example, took advantage of these opportunities to engage in "spontaneous privatization" on the

---

<sup>19</sup> Vedomosti SSSR, No. 26, Item 385, 1987. The law was passed in July 1987 and went into effect in January 1988.

<sup>20</sup> E.g., "On cooperatives in the USSR," Vedomosti SSSR, No. 22, Item 355, 1988; Fundamentals of Legislation of the USSR on the Lease, Vedomosti SND SSSR, No. 25, Item 481, 1989; "On property in the USSR," Vedomosti SND SSSR, No. 11, Item 164, 1990; Law on enterprises in the USSR, Vedomosti SND SSSR, No. 25, Item 460, 1990; Statute on joint-stock companies and limited liability companies, Sobranie Postanovlenii Pravitel'stva SSSR, No. 15, Item 82, 1990.

<sup>21</sup> E.g., "On enterprises and entrepreneurial activity in the RSFSR," Vedomosti RSFSR, No. 30, Item 418, 1990 (amended on June 24, 1992); "On property in the RSFSR," Vedomosti RSFSR, No. 30, Item 417, 1990; Decree on joint-stock companies, Order No. 601, 25 December 1990 (amended on April 15, 1992, Order No. 255, and on November 24, 1993, Order No. 2004).

<sup>22</sup> This sort of open-ended rule on the continuing validity of Soviet law was unfortunate, but unavoidable. The Russian government (whether the executive or legislative branch) could not possibly create an entire legal framework overnight.

enterprise and sub-enterprise level.<sup>23</sup> Yet these laws were superficial and provided little if any guidance on organizational structure, fiduciary duty or shareholders' rights. For example, the Soviet laws purported to create "collective enterprises," but the legislative language was unclear and incomplete.<sup>24</sup> Basic questions, such as whether equity interests were alienable, whether equity owners could be called on for capital contributions, or the extent to which they could participate in management, were left unanswered.

During the last few years of the Soviet Union, the Russian legislature (led by Yeltsin) had consistently been more committed to market reforms than its Soviet counterpart. Consequently, Russian company law represented a significant improvement over Soviet law.<sup>25</sup> In particular, the Decree on Joint-Stock Companies (1990) set forth guidelines on the rights and duties of shareholders and directors. But even this law fell short of creating a complete framework. In particular, it was silent on remedies and fiduciary duty. Shareholders had no legal mechanism for enforcing their rights, and had only minimal rights to information about the operation of the company.

---

<sup>23</sup> Johnson and Kroll (1991), Burawoy and Hendley (1992).

<sup>24</sup> This example is relevant to our case study. Article 2 of the USSR Enterprise Law recognized collective enterprises as a legitimate form of business organization. The subsequent articles failed to articulate the rights and obligations of holders of property interests in collective enterprises. Law on enterprises in the USSR, Vedomosti SND SSSR, No. 25, Item 460, 1990. See also Article 12, "On property in the USSR," Vedomosti SND SSSR, No. 11, Item 164, 1990.

<sup>25</sup> This first wave of market-oriented business legislation was largely home-grown. This is not to say that Russian reformers were not influenced by foreign models. Certainly they were. But the influx of foreign advisors did not begin in earnest until 1992, when the collapse of the Soviet Union and the liberalization of retail prices signaled the beginning of serious market reforms. See generally, Rutland (1994) and Boyko, Shleifer and Vishny (1993).

Incremental changes were made in company law during the next few years,<sup>26</sup> but attention was largely focused on privatization. The periodic omnibus privatization decrees addressed certain aspects of company law, but not in a comprehensive manner. For example, one decree included a "standard" charter that implicitly addressed certain aspects of fiduciary duty, and several other decrees designed to protect shareholders' rights were issued on the specific topic of registries.<sup>27</sup> More recently, in the 1993 version of the privatization program, the state imposed a requirement of cumulative voting and mandated that joint-stock companies with more than ten thousand shareholders should have no less than nine members on the board.<sup>28</sup> Embedding the rules on corporate governance in privatization decrees undermined the effort to create transparent and universalistic legal standards. Typically, these decrees were very lengthy, and it could be difficult to find the relevant provisions. Moreover, privatization decrees applied only to enterprises that privatized through traditional routes, not to the many enterprises who fashioned their own route.<sup>29</sup> In principle, how an enterprise privatizes should not affect the law that governs it subsequently as a privatized entity. A more comprehensive approach

---

<sup>26</sup> For example, the Russian decree on joint stock companies was amended on April 15, 1992 (Order No. 255), and on November 24, 1993 (Order No. 2004). The Russian enterprise law was amended on June 24, 1992.

<sup>27</sup> E.g., "On the Protection of Investors' Interest," No. 1233, 11 June 1994 (as amended on 4 November 1994), Sobranie zakonodatel'stva Rossiiskoi Federatsii, no. 8; Statute on Joint-Stock Company Shareholders' Register, No. 840-r, 18 April 1994, "Rynok tsennykh bumag," Financy, part 4, 1994; "On Measures to Ensure the Rights of Shareholders," No. 1769, 27 October 1993, Rossiiskie vesti, 2 November 1993; "On the Privatization of State and Municipal Enterprises in the Russian Federation," No. 701-r, 4 November 1992, Ekonomika i zhizn', no. 47, 1992.

<sup>28</sup> "On the state program for privatization of state and municipal enterprises in the Russian Federation," No. 2284, 24 December 1993, Sobranie aktov prezidenta i pravitel'stva Rossiiskoi Federatsii, no. 1, 1994.

<sup>29</sup> As Pistor (1995) notes, a fair number of enterprises obtained exemptions from the normal privatization rules.

came only with the new Civil Code, the first part of which was adopted in October 1994.<sup>30</sup> Indeed, simultaneously with its passage came the nullification of many laws that had previously governed corporate affairs.<sup>31</sup>

In sum, in contrast to Hungary's one-shot introduction of a new, coherent, and universally applicable framework for bankruptcy, the potential impact of company law reform in Russia has been dissipated by its piecemeal nature, its incomplete coverage, and its failure to adequately address many fundamental issues.

### The Institutional Base: Russian Legal and Commercial Institutions

While they were weak in Hungary, the institutions needed to support a market economy were extremely feeble if not entirely nonexistent in Russia in the 1990-94 period. Consider first the courts. In Russia, economic disputes are generally resolved by the arbitrazh courts. During the Soviet period, these tribunals dealt with disputes between state enterprises. This was not high-profile work and did not attract the most talented or competent jurists. These and other judicial bodies emerged from the Soviet period with a besmirched reputation and a consequent lack of legitimacy. Recent years have witnessed major institutional reforms, including an expansion of the jurisdiction of the tribunals and their reconstitution as "courts," thereby raising

---

<sup>30</sup> Rossiiskaia gazeta, No. 238-239, 8 December 1994. But the Civil Code fails to resolve the disparity regarding the non-universal applicability of some company laws. Article 96-3 of the Civil Code provides that "the specifics of the legal status of joint-stock companies founded through privatization ... shall be determined by the laws and other legal enactments on privatization ..."

<sup>31</sup> For example, the Civil Code invalidated the 1990 Russian Property Law and the 1990 Law on Enterprises and Entrepreneurial Activity.

the status of the decision-makers. While these reforms represent a step in the right direction, they are only the beginning. Questions persist about the remedies available (legal vs. equitable), about the power of the arbitrazh judges to enforce their decisions, and about the standing of individuals to petition these courts.<sup>32</sup> A deep distrust of formal legal institutions persists, arguably much deeper than in Central Europe.

Other potentially supportive "watchdog" institutions in Russia are in their infancy. Since the late 1980s, the private business bar has experienced a remarkable regeneration, but its target clients are entrepreneurs, not disgruntled shareholders. Procedural rules stymie any possibility that lawyers would take on shareholder-generated claims against management. Such claims are costly and tedious as a result of the inability to aggregate them into class action lawsuits, and the unavailability of contingent fees gives private lawyers little incentive to pursue such claims.<sup>33</sup>

Institutional support is also needed to give meaning to financial disclosure requirements. Although Russian law requires that open joint-stock companies publish an annual report, a balance sheet and an income statement,<sup>34</sup> this requirement is difficult to enforce in practice. Many companies have responded by deeming such information "commercial secrets," and their flouting of the law has had few repercussions. State regulation of securities is in its infancy in

---

<sup>32</sup> See Hendley (1995) and Pistor (1995). On April 5, 1995, the State Duma adopted a new law "On Arbitrazh Courts in the Russian Federation" and a new Arbitrazh Procedure Code of the Russian Federation. Article 22 of the latter clarifies that citizens have the right to appeal to arbitrazh courts for relief under certain circumstances. Article 6 of the former law states that decisions of arbitrazh courts are binding, but does not directly address the question of enforcement.

<sup>33</sup> See Easterbrook and Fischel (1991), 100-102.

<sup>34</sup> Article 97-1, Civil Code.

Russia and thus is still largely ineffective. Even if the information is published, the lack of uniform accounting standards can render it virtually meaningless. An independent accounting profession that is capable of valuing assets and auditing ongoing operations is only beginning to form in Russia. As a result, financial statements are often prepared in-house, and put the best possible face on the situation.

Finally, an additional "watchdog" institution in the area of company law might be shareholder advocacy groups which, in recent years, have begun to form around the country. Yet their efforts tend to focus on legislative lobbying, rather than on the protection of shareholders' interests at individual enterprises. Moreover, the absence of any class action mechanism within the civil procedure code renders the collective action hurdle almost insurmountable and makes it unlikely that advocacy groups will take up violations of fiduciary duty.<sup>35</sup>

#### Demand for Law?: Incentives Within the Firm

How do the laws and institutions, inadequate as they may be, translate into behavior in the firm? And to what extent is there a demand for better laws and institutions? The answer to these questions depends in large part on the incentives of the parties -- in particular the managers and shareholders, whether insiders or outsiders to the firm.

---

<sup>35</sup> In some of the more notorious pyramid schemes (e.g., MMM), defrauded shareholders have attempted to persuade the legislature to reimburse them for their losses and to criminalize the activities of the fund's organizers. Whether such collective actions represent movement towards the rule of law or merely a reversion to old habits of relying on the state for a bail-out is questionable.



Russian managers, like managers in Hungary and elsewhere, obtain satisfaction from both the performance of their firms and their own personal economic remuneration. During the Soviet period, law was largely irrelevant for state enterprise managers in the pursuit of either objective. Personal relationships, rather than rules of general application, were the glue that held economic transactions together. Law was to be avoided; many managers regarded it as an oppressive instrument of the state.<sup>36</sup> The idea that law could be used affirmatively as a means to create an optimal form of business organization still strikes most Russian managers as absurd.

In theory, the combination of market-based economic reform and political fragmentation could generate a "demand" for law on the part of managers. No longer is any single group (e.g., the Communist Party) capable of dictating the rules of the game. Instead, a plethora of groups have emerged that need to find some way to co-exist. At the same time, private property has been legalized, giving rise to a nascent middle class eager to preserve its gains.<sup>37</sup> Under such conditions, law has the potential to emerge as a compromise solution for all concerned.

However, the peculiar nature of the Russian privatization, which left many firms in the hands of insiders, may have reduced managers' "demand" for law. Private connections remain critical in obtaining supplies and making sales, thereby to some extent obviating the need for universalistic rules. Similarly, as long as a firm can be internally financed, or can be financed through continued state subsidies (whether directly or through the banking system), neither the

---

<sup>36</sup> The attitude about formal legal institutions, such as courts and registration offices, was analogous, though their distrust was tinged with an assumption that the people staffing these institutions were incompetent and/or corrupt.

<sup>37</sup> See Weber (1978), vol. 1, ch. X; Unger (1976).

firm nor its managers need necessarily develop a reputation for following consistent standards and norms. That is not to say, however, that managers can run roughshod over shareholders. Managers of employee-owned firms may still need to develop a community of trust between labor and management to boost productivity and performance in the firm, and this may require some degree of (at least perceived) fairness and openness in the running of the company.

With regard to more "private" goals of managers, at a minimum they almost certainly want to maintain their jobs and as much control over the firm as possible (considering the need for at least a perception of fairness as noted above). In addition, Russian managers, like those in Hungary, may face a substantial incentive to skim profits or transfer assets of companies to their personal use.

Who are the potential overseers that might temper the power of management and minimize profit-skimming and insider dealing in privatized firms? For firms that must raise money from equity markets or banks, these outside owners or creditors may be able to exert some controls if (as discussed earlier for Hungary) they are themselves motivated by profit-maximizing concerns.<sup>38</sup> For privatized firms with primarily insider ownership and the capacity for self-financing (even through decapitalization if necessary), the task falls to the shareholders and their representatives, the board of directors. But most Russian shareholders are also workers and so have conflicted loyalties. With no alternative management team waiting in the wings, shareholders are reluctant to throw out the existing managers. On a more personal level, an individual shareholder-worker has little incentive to rock the boat, fearing that the trouble-

---

<sup>38</sup> Banking reform is underway in Russia, but is far from complete. See Johnson (1994).

makers will be the first to be laid off. Board members themselves are likely to be employees also -- often other officers of the company. The incestuous nature of an employee-owned company makes it particularly difficult for insiders to hold board members accountable.

### The Role of Law in the Russian Enterprise: The Rule of Law?

While the picture in Hungary may be mixed, the picture in Russia appears more one-sided. To date there is little evidence of an underlying respect for law, of a perceived duty to abide by law, or of a clearly articulated demand for the development of rule by law. Illustrating and supporting such conclusion is difficult in the abstract. Therefore, we have chosen to describe in some detail the experience of one privatized firm during the 1991-94 period. Although no two firms are exactly alike, we believe the attitudes and actions of this firm are a typical response to the laws, institutions, and incentives now prevailing in the Russian environment.

The company is the Saratov Aviation Plant (*Saratovskii Aviatsionnyi Zavod* or "SAZ"), a large industrial enterprise that produces 125-seat passenger airliners (see Box for a more in-depth description). SAZ was privatized in January 1991, pursuant to a decree of the USSR Council of Ministers. In essence, SAZ purchased the assets of the enterprise on behalf of its workforce (then numbering in excess of 15,000), and thereby transformed itself from a state enterprise into a collective enterprise. In early 1993, the stakeholders in the collective enterprise reconstituted the entity as a closed joint stock company (*aktsionnernoie obshchestvo zakrytogo tipa*).

### Economic Challenges Facing SAZ

SAZ shares many characteristics of other Russian enterprises, particularly its locus within the transitional Russian economy and its consequent struggle for survival. Its key output is the Yak-42 civilian airliner. It also produces many unrelated items (e.g., bicycles, teapots, cutlery, baby carriages). During the Soviet period, SAZ was part of the military-industrial complex, but the conversion to civilian production has been less painful than for many other defense plants, since SAZ had the option of expanding already-existing lines of production, rather than having to completely reconfigure. Now SAZ receives almost no government subsidies. SAZ's primary challenge lies not in defense conversion, but in selling its planes. The market for planes in the former Soviet Union collapsed as Aeroflot split apart and the spin-offs and new airlines struggle for survival. SAZ's response has been to seek new markets, but its ability to compete effectively is limited by inexperience and by the fact that the Yak-42 is not certified in the West. Like many other large Russian enterprises, SAZ has had to face its own mortality. In order to avoid a stockpile of unsold planes, it now initiates production only upon receipt of a confirmed order. As a result, the plant went onto a three-day work week in the spring of 1994, with corresponding cuts in pay. When these measure failed to achieve the desired cost reductions, the plant ceased production for several months during the summer. This allowed SAZ to repay its debts, both to banks and to workers. During the summer, top management successfully negotiated the sale of several planes to China, which led to a partial resumption of production in the fall of 1994. An analysis of whether SAZ can overcome these short-term challenges is beyond the scope of this paper. A basic awareness of their existence is important for understanding the pressures brought to bear on SAZ management for internal organizational change.

SAZ is something of an anomaly, in that it privatized early. As a result, it did not go through the "corporatization" process later mandated and administered by the State Property Committee.<sup>39</sup> But our primary interest is not in privatization per se, but in how privatized enterprises actually function. SAZ is also somewhat peculiar in that it emerged from

---

<sup>39</sup> Taken together, the various laws and decrees on privatization required that a state enterprise transform itself into a joint-stock company *prior* to privatizing. See Frydman, Rapaczynski, Earle, et al (1993). Pistor (1995) contends that this corporatization process was merely a formalistic legal change, and that it did not lead to any change in organizational structure.

privatization as a one-hundred percent employee-owned company. The state retained no equity interest. This was not an option available to enterprises that privatized later.<sup>40</sup> Once again, this does not lessen our interest in SAZ as a subject for case study. As one of the few totally private enterprises in Russia, it provides an ideal setting in which to study the role of law.

There are two discrete stages in SAZ's post-privatization development. The first is the transition from collective enterprise to closed joint-stock company, which took place during 1992 and culminated in a shareholders' meeting in February 1993, at which the reorganization was formally approved. The second is the operation of SAZ as a joint-stock company during 1993 and 1994. In each stage law played a peripheral role in shaping enterprise behavior.

Transition to Joint-Stock Company. Ironically, the catalyst for the transition to joint-stock company did come from the law. The collective enterprise (*kollektivnoe predpriiatie* or "KP") was a form of business organization recognized under Soviet law but not under Russian law. With the collapse of the Soviet Union, SAZ's legal status became rather precarious.

But this technical legal problem was not the real reason for abandoning the KP form. The dissatisfaction went deeper. It stemmed from a failure to define the rights and obligations of the various participants at the outset. With the purchase of SAZ assets from the state in early 1991, all SAZ employees automatically became "co-owners" (*so-vladel'tsy*) and received "membership units" reflecting an equity interest in SAZ.<sup>41</sup> Neither the charter (*ustav*) nor the

---

<sup>40</sup> See generally, Rutland (1994).

<sup>41</sup> All SAZ employees received units worth 600 rubles. Additional units were distributed according to a formula based on seniority, salary and qualifications that was set forth in the bylaws. Notwithstanding the fact that property interests in SAZ resembled stock, we use the word "unit" to describe them because the SAZ organizational documents purposely avoid describing them as stock (*aktsia*), referring to them as lots (*dolya*).

bylaws (*polozheniia*) of the KP clarified the role of co-owners, and the law provided no guidance (as noted earlier). No certificates representing ownership of "units" were issued. This created considerable uncertainty among co-owners as to whether their ownership interests were real. Because the co-owners worked at SAZ, and the primary goal of privatization had been to spur productivity, top management felt compelled to take action.

SAZ management had consulted with Soviet experts when drafting the organizational documents for the KP. Their inexperience with market-based business organizations, combined with the shortcomings of the law, contributed to the creation of an entity that served no one's interests. The intermediary institutions, such as securities regulators, shareholder advocacy groups and private lawyers, that in principle could have provided assistance were almost non-existent in Russia in 1991-92. When seeking to remedy the situation, the general director looked outside the Soviet Union for assistance, and invited a group of specialists from Stanford University to come to Saratov for several weeks in January 1992. The task of this group (of which one of the authors was a member) was not to force Western models onto SAZ, but to introduce new methods by which SAZ management might achieve its goal of becoming a cohesive, efficient employee-owned joint-stock company.

The decision to reorganize as a joint-stock company brought SAZ within the ambit of the new set of Russian laws, which, as noted earlier, were somewhat better than the old Soviet legislation but still failed to define fiduciary duties or provide for adequate disclosure or remedies. The SAZ managers had a choice: whether to structure SAZ according to the statutory requirements or to go beyond those minimal requirements and create additional internal

standards. They chose the latter. In the short run, the choice is puzzling. After all, the gaps in the law would seem to work to their benefit, in that they enhanced management's capacity to maintain control of the company. Over the long run, however, any such manipulative behavior would undermine the goal of creating a community of trust between labor and management, which the SAZ managers believed essential for employee ownership to work.<sup>42</sup> In this way privatization did create some demand for objective limits on managerial discretion.

SAZ did not embrace all of the Americans' recommendations. It incorporated those that seemed to fit the local context. For example, the charter limits the amount of stock that any single person (or entity) can own.<sup>43</sup> Along similar lines, the bylaws governing the board of directors make an effort to forbid conflicts of interest.<sup>44</sup> These bylaws also hold directors accountable for losses to SAZ resulting from the "dishonest" or "unconscientious" (*nedobrosovestnoe*) fulfillment of their duties, and imply that such a cause of action can be pursued in the courts.<sup>45</sup>

The organizational documents evidence a strong commitment to the one share-one vote

---

<sup>42</sup> For an analysis of why SAZ managers acted in their long-term interests, see Hendley (1992).

<sup>43</sup> The chairman of the board of directors can not own more than 0.2 percent of the total outstanding shares. Other members of the board are limited to 0.15 percent, and ordinary shareholders are limited to 0.1 percent.

<sup>44</sup> The bylaws provide that: "Members of the board of directors do not have the right indirectly or directly to receive [outside] compensation for exerting influence on the decision-making process of the board of directors."

<sup>45</sup> The mechanism by which such a cause of action might be pursued was not specified in the bylaws, nor was it to be found in statutory law. In all likelihood, it was a symbolic right. No SAZ director was ever prosecuted under this provision. A recommendation to include a more straightforward right of shareholders to sue directors was rejected out of hand. Management contended that the courts' lack of familiarity with such cases would cause them to be dismissed. Proposals to get around this problem by making such shareholder claims subject to private arbitration were likewise rejected, suggesting that management was not eager to encourage shareholders to mobilize their rights.

principle. SAZ created its own system of proxy voting; it abandoned the old system of selecting delegates to the conference, which smacked of the Party system and facilitated managerial manipulation of the results.<sup>46</sup> Moreover, management took steps (not required by law) to ensure that worker-shareholders understood the reorganization process. Virtually every 1992 issue of the weekly factory newspaper contained articles about some aspect of the joint-stock company. Drafts of the organizational documents were published in this newspaper, giving workers an opportunity to comment. Top management held open meetings and answered questions. The stated purpose was to open up the process to all shareholders.

Neither law nor supporting institutions was critical in changing SAZ's behavior in this first stage of its development as a privatized company. The institutions were non-existent, and the written law was patently inadequate. Moreover, management was highly skeptical about the relevance of law to its situation. But the willingness to impose additional duties on directors reflected a desire -- albeit inchoate -- for rules of the game that would work over the long run. Thus, SAZ management's decision to reorganize as a joint-stock company and to impose minimal fiduciary duties on directors was to some extent the result of privatization and the beginnings of market-based incentives. The goal was a profitable company that was capable of competing with Western aviation firms. The SAZ managers believed that productivity would increase only if workers participated in the changes -- that this would generate a sense of trust and community. The beginnings of a demand for fair and objective norms -- if not yet overarching law -- are noticeable.

---

<sup>46</sup> Cf., Pistor (1995).



Operation as a Joint-Stock Company. Thus far, we have only a static vision of SAZ based on its organizational documents. More important in terms of assessing the prospects for the rule of law is what happened after the registration of the joint-stock company. Did management abide by its self-imposed rules? Did it pay any attention to subsequent changes in the statutory law?

At the beginning the reorganization created a sense of enthusiasm within the plant. The first election of the board of directors was taken quite seriously, and the candidates outnumbered the available seats.<sup>47</sup> They represented a wide variety of interests within the plant, and were not exclusively the hand-picked disciples of the general director. Similarly, the board that was finally elected, while made up of top managers, included individuals who had been known to disagree with the general director.

However, any hope that the board of directors would be a genuine decision-making body died a quick death. From the start, board meetings were elaborately choreographed; no real debate was permitted. The general director exercised dictatorial power. This is, of course, not unique to Russian companies, but it is particularly troubling in the Russian context because it creates an impression of "business as usual" -- of a continuation of hierarchical Soviet-style of "one-man management."<sup>48</sup> Given the absence of outside directors, the unwillingness of the board members to challenge the general director in a quasi-public forum made board approval of any decision virtually automatic. Not surprisingly, this deflated the post-reorganization

---

<sup>47</sup> A two-part election was necessary to winnow down the field.

<sup>48</sup> See generally, Berliner (1957) and Granick (1960).

enthusiasm and caused many to believe that the transition from state enterprise to KP to joint-stock company had been only a change in form, not in substance. By 1993, elections for the board had become routinized, with the number of candidates equalling the number of open spots. When questioned, those who ran unsuccessfully in 1992 said they had no interest in being on a board that merely rubber-stamped the decisions of the general director.

While this provides some sense of the atmosphere that prevailed at SAZ, the more important question is whether the legal obligations imposed by the charter and bylaws have been enforced. The record is mixed. The restrictions on the amount of stock that can be owned by any shareholder have been enforced. Obviously, this is critical in an employee-owned firm, since a concentration of ownership (particularly within management) would undercut the rights of worker-shareholders. SAZ has continued to operate as a relatively open company. A detailed financial report is published in the factory newspaper before each annual shareholders' meeting, and a tremendous amount of supplemental information can be found in the newspaper throughout the year. A booklet containing the charter, bylaws and form documents for buying and selling SAZ stock and for voting by proxy has been printed and distributed to interested shareholders. Though shares may be voted by proxy, annual meetings continue to be open to all. There has been no reversion to the Soviet system of electing delegates, who then vote the shares of their work collectives.

On the other hand, the self-imposed rules on fiduciary duty lie dormant. Allegations of profit-skimming and insider dealing on the part of board members are rampant within the plant, but have resulted in no formal charges. Along similar lines, the general director is subject to

no meaningful oversight. He often makes significant contractual commitments on behalf of SAZ without prior board approval (or even knowledge). He has also brought SAZ into major joint ventures with Russian and foreign entities without seeking shareholder approval. This is not to say that these transactions are not in the interest of SAZ. Perhaps they are, but they still legally require vetting by the board and/or the shareholders. Certainly the general director speaks with great passion about his commitment to SAZ and to the workers. The point is that he feels no obligation to comply with legal niceties.

A second related question is whether SAZ has complied with company laws and decrees passed since its 1992 reorganization as a joint-stock company. In certain cases, such as the decrees regarding registries and cumulative voting and minimum board size, SAZ had to take no action, because the law paralleled the already-existing internal rules at SAZ. In contrast, it has flagrantly defied the state policy against large closed joint-stock companies. It has consistently refused to allow outsiders to take an active role in the management of the company,<sup>49</sup> relying to some extent on loopholes.<sup>50</sup> Eventually, these loop-holes will be closed. SAZ knows this well, but stubbornly refuses to change. The noose has begun to tighten

---

<sup>49</sup> SAZ has permitted several outsiders to purchase stock. All such sales were approved by the shareholders (as required under the charter), and each of purchasers has a sustained relationship with SAZ. None of these people has been put on the board of directors.

<sup>50</sup> This policy is reflected in the provision of the 1993 privatization program that limits the number of directors who may be employees of an open joint-stock company to one-third of the board. Technically, these rules are inapplicable to SAZ on two grounds. First, SAZ is a closed joint-stock company. Second, it was not a "state" or "municipal" enterprise at the time this decree (or any other decree or law on privatization) was issued, and so arguably does not fall within its jurisdiction.

with the adoption of the new Civil Code, though a bit of breathing room remains.<sup>51</sup>

Why can SAZ and its managers and directors disobey both company laws and decrees generally and the company's own charter and bylaws? They can because no one individual or institution attempts to force compliance. For example, although insider dealing is clearly prohibited by the organizational documents, no one has pursued the persistent allegations of insider dealing in SAZ. One reason is institutional weakness -- namely the dearth of qualified lawyers, the high cost of proving wrong due to weak "watchdog" institutions, and the deep-seated mistrust of formal enforcement institutions such as the courts. Yet even if weak institutions prohibit outside enforcement, why are potential violations of the duties owed by board members to SAZ not raised in internal forums, such as the periodic meetings between workers and managers or the annual shareholders' meeting? Even at the 1994 annual meeting, which followed on the heels of the introduction of the three-day work week and the announcement of impending layoffs, the questions posed to the board were not confrontational.

Perhaps the language of the bylaws, which does not clarify who has standing to bring such charges, has discouraged potential lawsuits. The more likely proximate cause is the absence of individuals or institutions with the means and incentive to instigate an investigation or sue. Arguably, SAZ itself (acting through the board) could bring a claim. The board of directors of SAZ has established committees to handle various issues, including an ethics committee. In principle, this committee should be monitoring potential conflicts of interest. In

---

<sup>51</sup> Article 97-2 of the new Civil Code contemplates a limitation on the number of shareholders in a closed joint-stock company, though leaves the specifics to the law on joint-stock companies. If a company exceeds this limit, then it must reconstitute itself as an open joint-stock company or face forced liquidation. At this point, the law on joint stock companies is silent on the maximum number of shareholders permitted for a closed company.

practice, however, the committee has done little. There was a great deal of energy surrounding the committee when it was first formed in the spring of 1993. Pamphlets setting forth ethical standards were gathered from a number of Western companies, but interest dropped off quickly. During 1994 and 1995, the committee rarely met, and took no formal actions. Of course, the membership of the committee also undermined its ability and/or willingness to act. The chairman of the ethics committee is the vice president for production; he is also a member of the board. Thus, it is difficult to see how the committee could assume a "watchdog" function. Shareholders are also unlikely to pursue an action against either managers or directors, for many of the reasons laid out above. Not only is there a conflict of interest arising from insiders' dual role as shareholder and employee, but precisely what remedies might be available to shareholders who attempt to hold directors accountable for breaches of fiduciary duty are not clear. Even if a shareholder prevails, it might well be a empty victory, in that enforcement is unlikely. In sum, in a world of interlocking self-dealing and shareholders beholden to managers for their jobs, who would initiate strong oversight actions?

In sum, the motivation for managerial behavior in SAZ is rarely influenced by the letter of the formal law, or even the requirements implied by SAZ's self-imposed standards. Indeed, there is little evidence of an underlying respect for law or standards of any kind. We do not believe that SAZ is unique among Russian enterprises. It is responding rationally to the existing legal framework (still incomplete and in flux), the institutions that support and enforce it (still in their infancy), and the underlying incentives currently existing within insider-dominated privatized firms.

## Summary and Conclusions

This paper has attempted to lay out three fundamental requirements for the rule of law to grow and flourish in transitional economies. These three requirements include a reasonably well-designed "supply" of written laws, a functioning set of institutions to generate the information and take the actions necessary to enforce such laws, and market-based incentives for the actors involved to generate the "demand" for rule by law and the use of laws and institutions once they exist. The absence of any one of the three requirements introduces major distortions and dooms the system to inadequacy if not utter failure. Laws or institutions without each other or without a supportive framework of incentives are likely to lie dormant, while incentives by themselves will be frustrated without a reasonable legal framework and institutions to support and enforce it. The problem in transition settings is that all three must to a large extent be created from scratch. Not only must new laws be drafted (a daunting task in and of itself, but still perhaps the easiest of the three), but they must be accompanied by the growth of supportive institutions (including not only formal judicial institutions but also the "watchdog" institutions that we almost take for granted in advanced market economies) and of economic reforms -- whether privatization (particularly with outside owners) or banking reforms -- that separate actors from the state and reinforce market-based incentives.

Two case studies -- Hungarian bankruptcy law and Russian company law -- have been used in the paper to illustrate the interaction of these three requirements in practice. These particular cases illustrate our general view that Central Europe is somewhat further along on all

of these dimensions than Russia. Quite well-designed laws are in place in many commercial areas, as evidenced by the Hungarian bankruptcy example discussed in this paper, and the presence of these laws is stimulating the development of the legal and commercial institutions needed to implement them (among which, in this example, are courts, trustees, and banks). Russia is not as advanced in the development of either laws or institutions, among other reasons because it lacked Hungary's pre-war legacy and it started its economic reforms much later. With regard to incentives, in both cases relevant actors exert weaker demand for proper implementation of the laws on the books than one would expect in more mature market economies. In the Hungarian case, creditors' (particularly banks') potential demand for a well-functioning bankruptcy system has been arguably weakened by their ability to turn to the state for recapitalization support rather than having to depend for survival on debt collection mechanisms. In the Russian case the demand for a corporate law with strong corporate governance potential and shareholder protections has been compromised by the preponderance of employee ownership and the resulting conflicts of interest that make employee shareholders reticent to assert ownership rights. Yet here, also, Central Europe is further along than Russia. While Hungary may have lagged behind Poland and the Czech Republic in imposing tight macroeconomic policy and hard budget constraints on banks and enterprises, all three Central European countries are still relatively well-advanced in implementing these reforms, which also helps explain the arguably greater "demand" for rule of law in Central Europe than in Russia. If Russia can continue to tighten its macroeconomic policies and impose harder budget

constraints on firms, this may hasten the "degeneration"<sup>52</sup> of employee-owned into outsider-owned firms and thereby increase the demand for further development and enforcement of company law.

Yet it is not true that the "rule of law" is fully developed even in Hungary. In particular there is still a long way to go in the development of laws, institutions, incentives and societal norms needed to impose fiduciary responsibility on enterprise managers and thus to limit insider dealing and asset stripping, whether in bankrupt or in healthier firms. These fiduciary norms are even more problematic in Russia, as evidenced by the SAZ case study discussed earlier. Unlike in Hungary, many Russians also seems to have a fundamental lack of respect for law and an almost total lack of confidence in either law or legal institutions.

Finally our framework and our cases belie any simplistic notion that the rule of law can be mechanically dictated from above. Indeed, there is constant tension between the desire of policy makers to push social and legal change from above and the need to generate legal norms from actual practice and acceptance below. But there is more the government can do than simply pass legislation; its policies can profoundly affect incentives and institutions as well. In the case of bankruptcy law in Hungary, top-down legislative reform appears to have been at least marginally successful in changing expectations and behavior, in part because it stimulated the growth of new supporting institutions. It might have been even more successful if other areas of government policy had created more complementary incentives, particularly in banks. In the case of company law in Russia, attempts at top-down legislative reform appear to have been less

---

<sup>52</sup> Earle and Estrin (1995).



effective to date, in large part because of the almost complete absence of either supporting institutions or incentives for shareholder monitoring. The hope is that the law on paper will eventually become the law in practice as continued economic reforms move enterprises away from dependence on the state toward dependence on the market.

## References

- Abel, Istvan (1994), "A gradual approach to banking reform: the Hungarian bad loans problem," paper presented at International Conference on Bad Enterprise Debts in Central and Eastern Europe, Budapest, Hungary, 6-8 June 1994.
- Baer, Herbert L. and Cheryl W. Gray (1996), "Debt as a Control Device in Transitional Economies: The Experiences of Hungary and Poland," in Frydman, Gray, and Rapaczynski, eds., Corporate Governance in Central Europe and Russia, Central European University Press, forthcoming.
- Berliner, Joseph C. (1957), Factory and Manager in the USSR. Cambridge: Harvard University Press.
- Blasi, Joseph, and Andrei Shleifer (1996), "Corporate Governance in Russia: An Initial Look," in Frydman, Gray, and Rapaczynski, eds., Corporate Governance in Central Europe and Russia, Central European University Press, forthcoming.
- Bonin, John and Mark Schaffer (1994), "Banks, Firms, Bad Debts, and Bankruptcy in Hungary 1991-94." Paper presented at Workshop on Enterprise Adjustment in Eastern Europe, 22-23 September 1994, the World Bank, Washington, D.C.
- Boyko, Maxim, Andrei Shleifer and Robert W. Vishny (1993), "Privatizing Russia," Brookings Papers on Economic Activity, 2, 139-92.
- Burawoy, Michael, and Kathryn Hendley (1992), "Between Perestroika and Privatization: Divided Strategies and Political Crisis in a Soviet Enterprise," Soviet Studies, 44:3, 371-402.
- Earle, John S. and Saul Estrin (1996), "Worker Ownership in Transition", in Frydman, Gray, and Rapaczynski, eds., Corporate Governance in Central Europe and Russia, Central European University Press, forthcoming.
- Easterbrook, Frank H., and Daniel R. Fischel (1991), The Economic Structure of Corporate Law, Cambridge: Harvard University Press.
- Frydman, Roman, Andrzej Rapaczynski, John S. Earle, et al (1993), The Privatization Process in Russia, Ukraine and the Baltic States, London: Central European University Press.
- Granick, David (1960), The Red Executive, Garden City, N.Y.: Doubleday & Company, Inc.

- Gray, Cheryl W. and Associates (1993), *Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe*, World Bank Discussion Paper 209, July 1993.
- Gray, Cheryl W., Sabine Schlorke, and Miklos Szanyi (1995), "The Bankruptcy Experiment in Hungary, 1992-1993: Findings from an In-Depth Survey", World Bank Policy Research Working Paper, forthcoming.
- Hendley, Kathryn (1992), "Legal Development and Privatization: A Case Study," Soviet Economy, 8:2, 130-57.
- Hendley, Kathryn (1995), "The Spillover Effects of Privatization on Russian Legal Culture," Transnational Law and Contemporary Problems, forthcoming.
- Jowitt, Kenneth (1992), New World Disorder: The Leninist Extinction, Berkeley: University of California Press.
- Johnson, Juliet (1994), "The Russian Banking System: Institutional Responses to the Market Transition," Europe-Asia Studies, 46:6, 971-89.
- Johnson, Simon, and Heidi Kroll (1991), "Managerial Strategies for Spontaneous Privatization," Soviet Economy, 7:4, 281-316.
- Kornai, Janos and Agnes Matits (1984), "Softness of the Budget Constraint--An Analysis Relying on Data of Firms," Acta Oeconomica 32/3-4.
- Mizsei, Kalman (1993), "Bankruptcy and the Post-Communist Economies of East Central Europe," Institute for EastWest Studies, 1993.
- Pistor, Katharina (1995), "Company Law and Corporate Governance in Russia," paper presented in the John M. Olin lecture series, February.
- Rutland, Peter (1994), "Privatization in Russia: Two Steps Forward, One Step Back?" Europe-Asia Studies, 46:7, 1109-31.
- Schaffer, Mark E. (1989), "Redistribution of Profit, financial Flows, and Economic Reform in Polish Industry: Evidence from the Lista 500," unpublished manuscript, February.
- Stark, David (1992), "Path Dependence and Privatization Strategies in East Central Europe," East European Politics and Societies, 6:1, 17-54.

Unger, Roberto Mangabeira (1976), Law in Modern Society: Towards a Criticism of Social Theory, New York: The Free Press, 1976.

Vodopivec, Milan (1994), "Appropriability of Returns in the Yugoslav Firm," Eastern Economic Journal 20:3, Summer 1994.

Weber, Max (1978), Economy and Society, eds. Guenther Roth and Claus Wittich, vol. 1, Berkeley: University of California Press.





**Policy Research Working Paper Series**

	<b>Title</b>	<b>Author</b>	<b>Date</b>	<b>Contact for paper</b>
WPS1517	Inflation Crises and Long-Run Growth	Michael Bruno William Easterly	September 1995	R. Martin 39120
WPS1518	Sustainability of Private Capital Flows to Developing Countries: Is a Generalized Reversal Likely?	Leonardo Hernández Heinz Rudolph	October 1995	R. Vo 31047
WPS1519	Payment Systems in Latin America: A Tale of Two Countries — Colombia and El Salvador	Robert Listfield Fernando Montes-Negret	October 1995	S. Coca 37664
WPS1520	Regulating Telecommunications in Developing Countries: Outcomes, Incentives, and Commitment	Ahmed Galal Bharat Nauriyal	October 1995	P. Sintim-Aboagye 38526
WPS1521	Political Regimes, Trade, and Labor Policies	Arup Banerji Hafez Ghanem	October 1995	H. Ghanem 85557
WPS1522	Divergence, Big Time	Lant Pritchett	October 1995	S. Fallon 38009
WPS1523	Does More for the Poor Mean Less for the Poor? The Politics of Tagging	Jonah B. Gelbach Lant H. Pritchett	October 1995	S. Fallon 38009
WPS1524	Employment and Wage Effects of Trade Liberalization: The Case of Mexican Manufacturing	Ana Revenga	October 1995	A. Revenga 85556
WPS1525	Is Ethiopia's Debt Sustainable?	Ejaz Ghani Hyoungsoo Zang	October 1995	A. Nokhostin 34150
WPS1526	Do We Face a Global "Capital Shortage"?	Zia Qureshi	October 1995	V. Barreto 87216
WPS1527	Foreign Direct Investment, Other Capital Flows, and Current Account Deficits: What Causes What?	Maxwell J. Fry Stijn Claessens Peter Burridge Marie-Christine Blanchet	October 1995	R. Vo 33722
WPS1528	Developing Commercial Law in Transition Economies: Examples from Hungary and Russia	Cheryl W. Gray Kathryn Hendley	November 1995	G. Evans 85783
WPS1529	Interest Rates, Credit, and Economic Adjustment in Nicaragua	Ulrich Lächler	November 1995	G. Carter 30603
WPS1530	Poverty, Inequality, and Social Policy in Transition Economies	Branko Milanovic	November 1995	G. Evans 85783

**Policy Research Working Paper Series**

	<b>Title</b>	<b>Author</b>	<b>Date</b>	<b>Contact for paper</b>
WPS1503	Africa's Growth Tragedy: A Retrospective, 1960–89	William Easterly Ross Levine	August 1995	R. Martin 39120
WPS1504	Savings and Education: A Life-Cycle Model Applied to a Panel of 74 Countries	Jacques Morisset César Revoredo	August 1995	N. Cuellar 37892
WPS1505	The Cross-Section of Stock Returns: Evidence from Emerging Markets	Stijn Claessens Susmita Dasgupta Jack Glen	September 1995	M. Davis 39620
WPS1506	Restructuring Regulation of the Rail Industry for the Public Interest	Ioannis N. Kessides Robert D. Willig	September 1995	J. Dytang 37161
WPS1507	Coping with Too Much of a Good Thing: Policy Responses for Large Capital Inflows in Developing Countries	Morris Goldstein	September 1995	R. Vo 31047
WPS1508	Small and Medium-Size Enterprises in Economic Development: Possibilities for Research and Policy	Sidney G. Winter	September 1995	D. Evans 38526
WPS1509	Saving in Transition Economies: The Summary Report	Patrick Conway	September 1995	C. Bondarev 33974
WPS1510	Hungary's Bankruptcy Experience, 1992–93	Cheryl Gray Sabine Schlorke Miklos Szanyi	September 1995	G. Evans 37013
WPS1511	Default Risk and the Effective Duration of Bonds	David F. Babbel Craig Merrill William Panning	September 1995	S. Coca 37474
WPS1512	The World Bank Primer on Reinsurance	Donald A. Mclsaac David F. Babbel	September 1995	P. Infante 37642
WPS1513	The World Trade Organization, the European Union, and the Arab World: Trade Policy Priorities and Pitfalls	Bernard Hoekman	September 1995	F. Hatab 35835
WPS1514	The Impact of Minimum Wages in Mexico and Colombia	Linda A. Bell	September 1995	S. Fallon 38009
WPS1515	Indonesia: Labor Market Policies and International Competitiveness	Nisha Agrawai	September 1995	WDR 31393
WPS1516	Contractual Savings for Housing: How Suitable Are They for Transitional Economies?	Michael J. Lea Bertrand Renaud	September 1995	R. Garner 37670