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What local lawyers think: A retrospective on the EBRD's Legal Indicator Surveys

Over the past seven years the EBRD has conducted an annual Legal Indicator Survey of lawyers practising in central and eastern Europe and the CIS. The survey is designed to measure and assess lawyers' perceptions of the evolving commercial and financial legal systems in the region. This article describes the EBRD's survey methodology and, through an analysis of seven years of data, provides an overview of the trends in legal development and implementation that the Survey has revealed.



Office of the General Counsel

LEGAL INDICATOR SURVEY 2002 Measuring Legal Transition in the EBRD's Countries of Operations

Questionnaire to selected law practitioners and others in Central and Eastern Europe
and the Commonwealth of Independent States

Please complete this questionnaire in black ink and using black capital letters. Answers should be as brief as possible and letters ticked (marked) where appropriate. Please return the completed questionnaire to the EBRD by fax (+44 20 7330 6150) or email indicators@ebrd.com attention Ms. Olivia O'Mahony by 2 August 2002, or sooner, if possible.

The results of this survey will be published, in a non-attributable form, in future issues of *Law in Transition*, the EBRD's legal journal, as well as in the *Transition Report 2002*, a publication of the EBRD Chief Economist's Office.

If you have any queries regarding the questionnaire, please contact Ms. Olivia O'Mahony on +44 20 7330 6090, who may also be reached by fax on +44 20 7330 6150 or email indicators@ebrd.com.

Please also complete the section below:

Please check that the details below are correct and make any necessary changes. Please also include the name, telephone fax and e-mail addresses of the person whom you may contact to discuss any queries regarding the questionnaire.

Name	Authority	Position	Point of Contact Considered
①			
②			
③			
④			

Law firm:

Name of contact person:

Telephone:

Fax:

E-mail address:

Country:

EBRD questionnaire

Legal Indicator Survey - 2002

In 1995, the EBRD's Office of the General Counsel developed a Legal Indicator Survey (LIS) in an attempt to gauge the extent to which laws fostering investment in the Bank's countries of operations approximate international standards and their degree of effectiveness. To date, the LIS has been used to analyse the legal environment in 27 countries of central and eastern Europe and the Commonwealth of Independent States (CIS). The survey provides a useful benchmark to assess the success and pace of commercial legal reform as part of the region's move towards market-based economies. However, rather than identifying factual indicators, the survey seeks to capture perceptions of laws among those most familiar with how they operate.¹

An examination of written law is not, in itself, sufficient in determining the success or pace of legal reform within a country. What happens after a law has been enacted is equally important. Moreover, it is the discrepancy between the so-called "law on the books" and its application and enforcement that is one of the most pressing issues in legal reform today. Understanding the perceptions of lawyers and others who work with the law can contribute to our understanding of how law and legal culture is shaped in transition economies. Some scholars and policymakers believe that how well laws are enacted and implemented directly impacts the rate of foreign investment and external finance.² This article examines the development of the LIS as an important and innovative analytical tool when assessing commercial legal reform.

Why the Legal Indicator Survey? Taking a snapshot of legal reform

Understanding what the law "is" or how the law has changed is not an easy proposition. In many jurisdictions, keeping up with the pace of legal reform can be difficult. However, an understanding of the substantive law and how the law works in action are both important elements of a robust and effective legal system designed to attract investment. Furthermore, as the laws change it becomes important to understand their extent and how well they are being implemented at a given moment in time. This helps to trace historical progression and to evaluate the impact of various reforms or amendments within a jurisdiction.

In the early days of transition in the EBRD's countries of operations, legal reform was evolving extremely quickly, but there was a dearth of published legal materials or reliable legal advice. Not only does the clarity and accessibility of laws impact on how they work, the role of the courts, administrative structures and other institutions have an impact on their effectiveness. How the law worked in practice in the early days of transition is a largely unknown

factor, partly because laws and supporting legal institutions were still in a state of rapid development and had not been tested. The availability of information about the status of laws in the EBRD's countries of operations remains variable, because the law and the legislative process are not always sufficiently transparent and accessible. In some instances, laws are passed without the adequate involvement of affected constituencies; important court decisions are not always published, and independent legal advice may be difficult to find.

In 2002, the status of laws is better known and the Internet has revolutionised the dissemination of legal information. It is much easier, for example, to learn now which laws are applicable in a given jurisdiction. At the same time, data on how the law works in practice is not readily available. It is difficult, therefore, to assess how effective a given law or legal system is. Similarly, it may not be easy to assess the effectiveness of a specific legal reform project in a short time frame. Yet, such assessments may be necessary in order to identify what further legal reforms are warranted in the near future.³

Recognising this need, the EBRD developed the LIS in an effort to better understand the law and how it works in practice in the transition countries. LIS sought to catalogue the direct experiences of lawyers familiar with investment activities and to assess, from their standpoint, the nature of legal reform.⁴ It was hoped that by doing so, the EBRD would be able to understand how accurately and efficiently legal information was being disseminated and also how well laws were being enforced.

LIS methodology

The first LIS conducted in 1995 focused on laws fostering foreign investment,⁵ to coincide with the topic of that year's EBRD *Transition report*. The purpose of the survey was to give an impression of how conducive the laws in the region were to fostering investment. The survey was repeated in 1996 in an effort to gather additional data for comparison.⁶

In 1997 the Bank created the Legal Transition Programme (LTP). The 1997 survey mirrored the emphasis of LTP and focused on commercial law reform such as company law, secured transactions and bankruptcy. The survey continued to contain a segment on general legal effectiveness, with many questions carried over from the earlier version. This section focused on how well laws were disseminated and then enforced administratively and judicially. The commercial law survey has been repeated annually since 1997. Sample questions from this survey are discussed throughout this article.

¹ The survey sample covers private law firms, academics and other experts familiar with commercial laws in the transition economies. The majority of private sector lawyers are selected based on their experience in advising the EBRD on local laws in the context of the Bank's lending and investment activities.

² See generally, A. Ramasastry, S. Slavova and L. Vandenhoeck, "EBRD legal indicator survey: assessing insolvency laws after ten years of transition", *Law in transition*, p. 43 (Spring 2000).

³ In central and eastern Europe, countries have had to engage in significant amendments to their legislation due, in some measure, to the fact that laws may have been enacted too quickly or because of problems with impracticability, ineffectiveness or fiscal resource allocation to fund the project. See *Law Drafting and Regulatory Management in Central and Eastern Europe, Support for Improvement and Management in Central and Eastern European Countries*. Organisation for Economic Co-operation and Development (OECD) Centre for Co-operation with the Economies in Transition and EU Phare, p. 18. (1997).

⁴ The EBRD is not the only organisation attempting to assess how well laws are being implemented. The United States Agency for International Development has embarked on a Commercial Legal and Institutional Reform Assessment programme (CLIR) which attempts to assess how well legal reform has been progressed in the following areas: contract law, foreign investment, international trade, company law, bankruptcy law, pledge/collateral law. The World Bank and the International Monetary Fund are also in the process of assessing the implementation of international standards. See World Bank/IMF "Assessing the Implementation of Standard: A Review of Experience and Next Steps" (11 January 2001) located at www.imf.org/external/np/pdr/sac/2001/eng/review.pdf.

⁵ "The Contribution of Law to Fostering Investment", *EBRD Transition report 1995*, Ch.6, p. 101 (1995).

⁶ See Box 2.1 Legal Reform "Survey on Investment Laws", *EBRD Transition report 1996*, p. 14 (1996).

Table 1: LIS Commercial Law Indicators

	1997 Overall	1998 Overall	1999 Overall	2000 Extensiveness	2000 Effectiveness	2000 Overall	2001 Extensiveness	2001 Effectiveness	2001 Overall
Albania	2	2	2	3+	2-	2+	2+	2	2+
Armenia	3	3	3-	4-	2	3	3-	2	2+
Azerbaijan	1	2	3-	3	2	3-	3	2	2+
Belarus	2	2	2	1	2+	1+	3	3	3
Bosnia and Herzegovina	1	1	2-	3	1	2+	1+	2	2-
Bulgaria	3	4	4-	4	4-	4-	4	4-	4-
Croatia	4	3	3+	4	3+	4-	4-	4-	4-
Czech Republic	4	4	3	3	3+	3+	3	3	3
Estonia	4	3	4-	4-	3+	4-	3+	4	4-
FR Yugoslavia	-	-	-	-	-	-	3+	3	3+
FYR Macedonia	2	3	4-	3+	2+	3	3+	4-	4-
Georgia	2	3	2	3	2	2	3	3	3
Hungary	4	4	4-	4	4-	4-	4-	4-	4-
Kazakhstan	2	2	3+	4	4-	4-	4	4	4
Kyrgyz Republic	2	2	3	3+	3	3	-	-	-
Latvia	3	2+	3	4	4-	4-	4-	4	4-
Lithuania	3	3	3+	4	3+	4-	4-	4-	4-
Moldova	2	3	3	3	2	3	3+	4-	4-
Poland	4	4	3+	4-	4	4-	4-	3	3+
Romania	3	4	3+	4-	3	3+	4	4	4
Russia	3	3	3	4-	3	3+	3	4-	3+
Slovak Republic	3	2	3	3	3	3	3+	3+	3+
Slovenia	3	3	4	4	4-	4-	4-	4	4-
Tajikistan	-	2	-	2	2	2-	2	2	2
Turkmenistan	-	-	-	-	-	-	2	3	2+
Ukraine	2	2	2	3+	2	3	3	2+	3-
Uzbekistan	2	2	3-	3	2+	3-	3	3	3

Table 2: LIS Financial Regulations Indicators

	1998 Overall	1999 Overall	2000 Extensiveness	2000 Effectiveness	2000 Overall	2001 Extensiveness	2001 Effectiveness	2001 Overall
Albania	2-	2+	2	1	2-	2	2-	2
Armenia	2	3	2	3	2+	3+	3	3
Azerbaijan	2-	2-	2	2-	2	2+	2	2
Belarus	1	1+	2+	2	2+	3-	2+	3-
Bosnia and Herzegovina	1	1	1	1	1	1+	1	1+
Bulgaria	3	3-	3	2+	3-	3	3	3
Croatia	3	3-	3+	3-	3	3	3	3
Czech Republic	3	3	4	3-	3+	3+	3	3
Estonia	3	4-	4	3-	3+	4	3+	4-
FR Yugoslavia	-	-	-	-	-	3+	2	3
FYR Macedonia	2	2+	3	2-	2+	3+	2	3
Georgia	1	1	3+	2	3-	3	2+	3-
Hungary	4	4	4	4	4	4-	4-	4-
Kazakhstan	2	3-	3	3-	3	4	3	3+
Kyrgyz Republic	2	2+	3+	3-	3	-	-	-
Latvia	3	3-	3	3	3	3	3	3
Lithuania	3-	3-	4	4-	4-	3+	4-	3+
Moldova	2	3	3-	2-	2	4	3	3+
Poland	4-	4	4	4	4	4	3	3+
Romania	3-	3-	4	3	3+	4	3	3+
Russia	3-	3-	3	3-	3	3-	2+	3-
Slovak Republic	3-	3+	3	3-	3	3	3	3
Slovenia	3	3+	4	4-	4-	4	4	4
Tajikistan	1	-	2	1	2	2	2-	2
Turkmenistan	1	-	-	-	-	1	1	1
Ukraine	2	2	3	2+	3-	2+	2+	2+
Uzbekistan	2-	2-	2	2-	2	2+	3-	2+

Box A: Classification system for legal transition indicators***1. Extensiveness**

Legal rules concerning pledge, bankruptcy and company law are perceived as very limited in scope. Laws appear to impose substantial constraints on the creation, registration and enforcement of security over movable assets, and can impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws are perceived as unable to provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas have not been amended to approximate those of more developed countries or those laws that have been amended are perceived to contain ambiguities or inconsistencies.

Effectiveness

Commercial legal rules are usually unclear and sometimes contradictory. The administration and judicial support for the law is perceived as rudimentary. The cost of transactions, such as creating a pledge over a movable asset, is prohibitive so as to render the law ineffective. There appear to be no meaningful procedures in place in order to make commercial laws operational and enforceable. There also appear to be significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.

2. Extensiveness

Legal rules concerning pledge, bankruptcy and company law are limited in scope and are subject to conflicting interpretations. Legislation may have been amended but new laws do not appear to approximate those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty. Pledge laws may impose significant notarisation fees on pledges. Company laws may not ensure adequate corporate governance or protect shareholders' rights. Laws appear to contain inconsistencies or ambiguities concerning, among other things, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.

Effectiveness

Commercial legal rules are generally unclear and sometimes contradictory. There are few, if any, meaningful procedures in place in order to make commercial laws operational and enforceable.

3. Extensiveness

New or amended legislation has recently been enacted (i.e., within the past five years) in at least two of the three commercial legal sectors that were the focus of the survey. However, the legislation could benefit from further refinement and clarification. Legal rules appear to permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of security interests are still rudimentary and appear not to provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws appear to contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation but may place claims of other creditors above those of secured creditors in liquidation.

Effectiveness

While commercial legal rules are reasonably clear, administration or judicial support of the law appears to be often inadequate or inconsistent, creating a degree of uncertainty (for example, substantial discretion in the administration of laws and few up-to-date registries for pledges).

4. Extensiveness

Comprehensive legislation exists in at least two of the three commercial legal sectors that were the focus of the Survey. Pledge law appears to allow parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties appear to be clearly defined. Bankruptcy law appears to include detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

Effectiveness

Commercial laws are reasonably clear and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.

Overall score:

The overall score is the average of the scores given for the two indicators, rounded up where the average did not fall exactly into the existing categories. A "+" after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A "-" indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.

***Note:** The classification system described above relates to the Commercial Law indicators. The classification system for Financial Regulations is broadly similar, except that banking and securities regulations and stock exchange functions are used as a reference point. For a description of the Financial Regulations indicators, please refer to the EBRD *Transition Report 2001*.

⁷ Labadi, Gramshi & Ramasastry, "A Favourable Concessions Regime: A Lender's Perspective and Perceptions from Transition Countries", *Law in transition*, pp. 20-28 (Spring 2001). The concessions survey was added in core recognition that an increasing number of infrastructure and utilities projects in emerging markets are achieved using concessions. The LIS concessions questions are based, in part, upon the work of UNCITRAL, which has developed a legislative guide on privately financed infrastructure projects.

⁸ See www.bis.org/publ/bcbs30a.pdf.

⁹ See www.iosco.org/docs-public/1998-objectives.html.

¹⁰ See www.ebrd.com/pubs/sectrans/prin/main.htm.

¹¹ "The Contribution of Law to Fostering Investment", supra note 5, p. 101.

¹² For an article which notes that "no meaningful description of the secured transactions law of the West can be made" see Frederique Dahan, "Secured Transactions Law in Western Advanced Economies: Exposing Myths" *Law in transition*, pp. 37-43 (Autumn 2000); see also D. Bernstein, A. Ramasastry and L. Vandenhoek, "Insolvency Law and Practice in Transition Countries", *EBRD Transition report 1999*, Annex 8.1, p. 160 (1999).

¹³ A. Ramasastry and S. Slavova, "Market Perceptions of Financial Law in the Region – EBRD Survey Results", *Law in transition*, p. 24 (Spring 1999).

In 1998, the survey was expanded to include banking and capital markets. In addition to the general LIS that has been repeated every year since 1998, the EBRD has, from time to time, initiated special surveys on legal sectors of importance to the Bank and its countries of operations. The EBRD conducted a survey on perceptions of telecommunications law reform in 1997 and from 2000 a section was added to the general survey questionnaire on concessions.⁷ To develop each of the survey segments, the EBRD has consulted with its own lawyers, who have specific subject matter expertise, as well as with external lawyers and staff at other international financial institutions.

The LIS is a unique instrument in that it tries to identify or at least report the perceptions of how law reform is being implemented. Each year, the EBRD provides a numerical rating for each of the survey countries (based on a rating system of 1 to 4+ for both the extensiveness and effectiveness of its commercial and financial markets laws). In addition, each country also receives an overall score in both the commercial law and the financial markets categories. A description of the classification system, along with survey indicators for each country from 1997 to 2001, are set out in Tables 1 and 2. The indicators are based on raw scores that are, in turn, scaled.

As noted in the description of each of the indicators, the ratings are based on perceptions held by survey respondents rather than on an objective assessment of the laws. The EBRD reviews and compares these perceptions with its own experience as a legal "user" in the region (the EBRD being the largest investor in the private sector of the transition countries). At times, the EBRD has relied on in-house knowledge of the conditions in a given country to arbitrate among competing views of survey respondents.

The LIS, like other survey instruments, needs continuous improvement. At times, the sample size gleaned from a particular country has been very small (in some cases less than four respondents). Moreover, the perception of foreign practitioners (e.g., working in a transition economy but trained elsewhere) and of resident lawyers may vary. In the annual publication of country indicators the EBRD notes that care must be taken in reading and interpreting the results. The indicators, however, are useful for eliciting general trends about how the perceptions of practising lawyers may vary from an assessment of law on the books. In addition, the indicators can assist in the individual assessment of each country (in terms of perceptions of each category of commercial law) and in determining how perceptions within one jurisdiction have changed over time.

The survey questions are based on certain key factors that international experts consider to be

essential parts of an extensive law in a given area. For example, the ability of creditors to take a non-possessory pledge in movable property is viewed as a significant factor in the creation of a viable market in secured lending. Extensive company law, which includes protections for minority shareholders and capital markets legislation, is viewed as a precondition to robust equity investment in a country.

The EBRD has noted that it tries to capture the perceptions of lawyers with respect to whether laws approximate internationally accepted standards for commercial and financial laws. For example, for financial markets extensiveness is assessed on the basis of whether banking and capital market legal rules approach minimum international standards, such as the Basle Committee on Banking Supervision's Core Principles⁸ or the Objectives and Principles of Securities Regulation developed by the International Organisation of Securities Commissions (IOSCO).⁹ The questions on secured transactions originated from the EBRD's own Core Principles for a Modern Secured Transactions Law.¹⁰ It should be noted that universal principles are not always appropriate for specific countries. Commercial law reflects a diversity of options with respect to legal rules and approaches.

Mindful of these diverse legal approaches, the EBRD has noted that "legal rules that best foster investment do not proceed from first principles. It is possible, however, to evaluate investment laws in the countries of the region against the benchmark of legal rules that are generally accepted internationally as fostering investment. This evaluation reveals whether existing rules are likely to win the approval of the investing community, including foreign investment."¹¹ While EBRD commentary on the LIS examines whether countries meet certain legal standards, this is not meant to imply that there is a single optimal legal structure.¹²

Certain questions in the LIS that relate to features or provisions (including those of an aspirational nature) of a specific legal sector that are considered to be most important in creating a favourable investment climate are given greater weight in the final calculation of the ratings. One question in the company law section, for example, asks: "Does your company law provide for cumulative voting by shareholders for the election of directors?". Given the importance of cumulative voting for minority shareholder representation on boards of directors, this question is given greater than average weight. In financial markets, the EBRD also identified key questions that reflect those principles that are most important to a well-functioning financial system. For example, questions concerning the implementation of international accounting standards and insider dealing were identified as more significant than others.¹³

Identifying imprecision

Is the law on the books clear? Another goal of LIS is to assess how well lawyers feel that they understand recently enacted laws and also to learn whether the law as written is applied in practice.

Recognising that there may be a divergence between the law as written and the law as applied or simply an ambiguity in how courts and lawyers interpret a written provision, since 1997 the LIS has attempted to measure this uncertainty by allowing respondents to select from “Yes”, “No” or “Unclear” in response to extensiveness questions. The addition of the “Unclear” response was, in part, due to queries from survey participants who noted that written law and legal practice were often in conflict.

Over the past few years, survey respondents have often included written comments along with their responses to further explain contradiction or lack of clarity with legal rules. For example, the Czech Republic does not have an updated collateral law that would allow for non-possessory pledges in movable property. In practice, lawyers, however, have developed methods for circumventing the restrictions of the law. In Azerbaijan, the Civil Code 2000 required that non-possessory pledges are registered in a government registry but there is no government single registry where parties can register movable property. However, there are registries for only a few categories of movable property such as cars and ships. The law is, therefore, unclear.

Recognising that clarity and predictability are important goals, the EBRD took the decision to deduct a fraction of a point from a survey respondent’s score for “unclear” answers. Further points were deducted from a particular survey if there were multiple unclear responses. Multiple unclear responses are viewed as a potential sign that the law was imprecise and not easily applied by lawyers.

Measuring effectiveness

Since 1995 the EBRD has sought to capture the perceptions of the local lawyers of how commercial and financial laws are working in each transition country. Measures of the effectiveness of certain commercial and financial laws and the supporting legal institutions, as well as the legal system more generally, have become valuable to the EBRD, to investors and to many others because they provide an insight into how the laws are perceived to be working in central and eastern Europe and the CIS. The effectiveness measures are also comparable over time and across countries in the region.

The most challenging and therefore interesting task in terms of developing questions and measuring results has been gathering perceptions of how well various laws have

been implemented. Effectiveness indicators measure how clear and accessible laws are and the extent to which they are supported administratively and judicially in terms of implementation and enforcement. Perceptions of effectiveness also include some evaluation of legal institutions and government agencies.

Between 1995 and 1997 the LIS questionnaire gave a simple “Yes” or “No” option in answering many of the “effectiveness” questions. In 1997, this was changed to include an “Unclear” response for instances where a respondent was unclear as to whether a certain law or legal rule was being implemented or enforced. In 1999, the responses to the effectiveness questions were amended again and respondents were asked to rate how effectively laws were being implemented on a scale ranging from “never” to “almost always”.¹⁴ These responses correspond to numerical choices ranging from 1 to 5. By expanding the effectiveness responses to five categories, LIS can measure finer degrees of effectiveness. These categories, in turn, help the EBRD to understand whether respondents perceive implementation of a certain law as totally ineffective or whether the law is functioning well nearly all or part of the time.

Is there a role for perceptions-based surveys in the analysis of legal reform?

Perceptions-based surveys are not meant to be an objective report on the status of substantive laws. By way of example, a certain country’s bankruptcy law may or may not contain a provision for restructuring a debtor business. By reading the law, it may be possible to ascertain the answer (typically either a “Yes” or “No”). Sometimes, however, the law itself may be ambiguous or unclear and a plain reading of a statute, regulations or a decree will not provide a clear answer. In this case, an assessment of the law by itself is not a useful means for determining the extent or effectiveness of commercial law.

The LIS is based on two important factors. First, whether a law has been effectively implemented is important in assessing whether legal reform has been successful. Second, that assessing perceptions of legal reform both in terms of whether reforms are extensive and effective is an essential component to measuring the impact of laws in a transition economy.

The LIS measures perceptions in order to understand whether lawyers actually have a clear sense of substantive legal rules and whether such rules are being used and enforced. If no one knows or understands the content of the substantive law, lawyers or investors may not use it as frequently as envisaged. Perceptions of whether a law functions well are as important to their impact on economic transition as whether the written

¹⁴ As an example: “Are cases involving corrupting practices including bribery of public officials, routinely investigated and prosecuted?
1 Never 2 Rarely 3 Sometimes
4 Frequently 5 Almost Always”.

¹⁵ The quality of investor protection was assessed based on the legal rules granting such protections and the quality of their enforcement. See R. LaPorta, F. Lopez de Silanes, A. Shleifer & R. Vishny, "Law and Finance", National Bureau for Economic Research (NBER) Working Paper 5661 (July 1996), p. 4 (LLSV 1996), later published as R. LaPorta, F. Lopez de Silanes, A. Shleifer & R. Vishny, "Law and Finance", 106 (6) *Journal of Political Economy*, 1113 (1998).

¹⁶ R. LaPorta, F. Lopez de Silanes, A. Shleifer & R. Vishny, "Legal Determinants of External Finance", NBER Working Paper 5879 (January 1997), later published as R. LaPorta, F. Lopez de Silanes, A. Shleifer and R. Vishny, "Legal Determinants of External Finance", No.52(3) *Journal of Finance*, pp. 1131-1150 (July 1997) (LLSV 1997).

¹⁷ LLSV 1997, p. 5.

¹⁸ See LLSV 1997, p. 9. Five measures were used: the efficiency of the judicial system; rule of law; corruption; risks of expropriation by the government; and the likelihood of contract repudiation by the government. LLSV 1996, p. 28.

¹⁹ LLSV 1996, p. 28.

²⁰ See K. Hendley, B. W. Ickes, P. Murrell and R. Ryterman, "Observations on the Use of Law by Russian Enterprises" 13(1) *Post Soviet Affairs*, pp. 19-41 (1997), which notes that Russian managers' understanding of commercial law does affect their using legal institutions to solve economic problems.

²¹ See generally LLSV 1996 and LLSV 1997. For further analysis and discussions of perceptions of commercial law see also K. Hendley, B. W. Ickes, P. Murrell and R. Ryterman, "Observations on the Use of Law by Russian Enterprises" supra note 20.

²² K. Pistor, M. Raiser, S. Gelfer, "Law and finance in transition economies", EBRD Working Paper 48 (February 2000). See also, K. Pistor, "Shareholder and Creditor Rights in Transition Economies", *EBRD Transition report* 1999, Box 2.2, pp. 36-37 (1999).

²³ Supra note 21, p. 36.

²⁴ "Indeed, it seems that by 1998 the CIS countries were beginning to emulate the system of legal protection typical of common law countries, despite their civil law tradition." *Ibid.* p. 36 (1999).

²⁵ K. Pistor et al. supra note 22, p. 2. See also D. Berkowitz, K. Pistor and J.F. Richard, "Economic Development, Legality and the Transplant Effect", 1 CID Working Papers on Law and Development (2000); K. Pistor and P. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development. Hong Kong*, Oxford University Press (1999); D.M. Trubek and M. Galanter, "Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development", *Wisconsin Law Review*, pp. 1062-1101 (1974); *EBRD Transition reports* (1997-99).

law is substantively complete. Additionally, whether a law or legal system is effective to some extent is premised on whether the legal community perceives legal rules as effective.

While such surveys do not gauge directly the trust which people have in a legal system and its institutions, they do provide data about the individual understanding and views of laws and legal institutions. They may also provide a resource for understanding how law reform and legal frameworks affect external finance. As the LIS results reveal, countries with sophisticated investor protections may receive poor ratings when measured against countries with more rudimentary laws. This may be because the latter have had less occasion to put such laws to the test. In other words a country with fewer rules governing investor protection may be perceived as having a more effective legal environment than a country with more robust legal protections but where there may be clear evidence of enforcement problems. The LIS is an effort, in part, to understand how well commercial laws are understood, implemented and enforced as opposed to how well a legal system functions in the abstract.

The LIS is not the only attempt to gauge whether commercial laws are extensive or effective, although it is the only one focused on transition countries. In 1997, several economists, LaPorta, Lopez de Silanes, Shleifer and Vishny (LLSV) wrote a paper in which they concluded that differences in the nature and effectiveness of financial systems around the world could be traced, at least in part, to differences in investor protection against expropriation by insiders.¹⁵ The study of legal rules and their enforcement assessed the extent and effectiveness of investor protection regimes. In a subsequent paper, the same economists examined whether legal rules have an impact on a country's ability to raise external finance through debt or equity.¹⁶ The authors compared external finance across 49 countries as a function of the origin of their laws. They concluded that there was "...strong evidence that the legal environment has large effects on the size and breadth of capital markets across countries."¹⁷

The LLSV approach in measuring the extent of shareholder and creditor rights and the effectiveness of legal enforcement involves a scoring or assessment of the laws as they appear "on the books" (i.e., as written). The laws were read and scored based on the presence or absence of certain features in the relevant code or legislation. There was no assessment of whether lawyers and practitioners actually understood the law or perceived the law to be clear on a certain point in practice.

As for effectiveness, LLSV used a survey-based estimate of the quality of law enforcement in various jurisdictions and refer to this as the "rule

of law". LLSV used surveys, where investors from different countries were asked to assess the law and order in the region within which they operated.¹⁸ The authors examined "proxies" for the quality of law enforcement, namely estimates of "law and order" in different countries compiled by credit risk agencies.¹⁹ Based on their analysis the authors concluded that "good law enforcement has a large effect on the valuation and breadth of both debt and equity markets." While LLSV do factor in general perceptions of law enforcement and the rule of law, there is no measurement or assessment of how well creditor or shareholder rights in particular are enforced or protected.

The studies conducted by the economists examine the substantive laws in a country but do not measure the more subjective or normative factors such as the perceptions held by investors and their legal counsel or the ability of such individuals to understand the law as enacted. The dissemination of knowledge of legal rules may also have an impact on levels of external finance as investors need to understand the levels of investor protection in order to decide whether to invest in a given market. LLSV do acknowledge, however, that perceptions may have an effect on the way markets develop, noting that: "It is possible that some broad underlying factor related to trust, influences the development of all institutions in a country, including capital markets."²⁰

Do perceptions matter?

Recent analysis carried out by the EBRD suggests that the effectiveness of legal institutions may have a greater impact on the rate of external finance than the development of law on the books. The EBRD's Office of the Chief Economist commissioned a study that built on and expanded the research originally conducted by LLSV²¹ for each of the years subsequent to transition.²² The authors of the study, Martin Raiser and Katarina Pistor, also supplemented their analysis of the law "on the books" with an assessment of the effectiveness of legal institutions (which they refer to as "legality"). The results of this EBRD research underscore the importance of measuring whether laws are effectively enforced and implemented and using perceptions to gauge effectiveness.

One of the major conclusions drawn from the EBRD study was that changes in formal rules "may be largely ineffective unless matched by similar rules in enforcement".²³ Hence the objective measures or assessments of laws "on the books" may not be sufficient to determine how well a legal system is functioning or what impact certain legal rights will have on the levels of external finance. By way of illustration, CIS countries scored very high on the LLSV styled shareholder rights index and also had a "common law" model of company law.²⁴ However, Russia has had many cases where majority shareholders

have engaged in large-scale asset stripping and minority shareholders and creditors were cheated in various high-profile scandals.

As Pistor and Raiser note, past experience suggests that laws are frequently ignored for various reasons. Prevailing policies or practices may render law reform meaningless. Countries may also lack the resources or capacity to ensure that laws are enforced effectively.²⁵ According to them an assessment of the written laws is not sufficient, by itself, to explain patterns of external finance. They used three variables (referred to as proxies) to measure the effectiveness of legal institutions in transition economies: (i) a rule of law rating provided by a survey of regional experts in the *Central European Economic Review*; (ii) the LIS index for the overall effectiveness of commercial laws; and (iii) survey data on the ability of the legal system to protect property rights and enforce contracts. Analysing these three proxies, the authors noted striking differences among transition economies:

- a large proportion of firms do not trust the legal system to protect their rights – particularly in the CIS;
- most countries with lower effectiveness can be found in the CIS; and
- the EBRD's LIS effectiveness index and the rule of law ratings are relatively highly correlated.

Pistor and Raiser also note that in the CIS the high levels of legal protection achieved in 1998 for shareholder and creditor rights are not mirrored in similarly high ratings for law enforcement. In other words, the law on the books does not correspond to effective implementation of these laws. On the contrary, the pace of legal change may have had a negative impact on the enforcement of laws as legal practitioners, regulators and judges were confronted with new and changing rules. The authors concluded that improvement of the legal framework for the protection of shareholder and creditor rights is not sufficient in itself to attract financial investment. Rather, an assessment of "legality" or legal effectiveness is also crucial. In conclusion, the EBRD study noted that legality has a much higher impact for the level of equity and credit market development than the quality of law on the books.

Similarly, the EBRD concluded in its 1998 *Transition report* that the lack of effective banking regulations, as opposed to inadequate laws, was the cause of many problems in the financial sectors of various transition countries.²⁶ Thus, if enforcement of legal rules cannot be guaranteed, not only may the credibility of the law be undermined, but also sophisticated new legislation may be counter-productive in the short term.²⁷

Why are perceptions of the law important?²⁸

Subjective assessments of the quality of law and legal institutions may also help to explain certain economic outcomes.²⁹ The EBRD has noted "the best laws and lawyers are not useful if market participants do not trust the courts to uphold their rights fairly and impartially. In many transition economies, the lack of legal credibility has led to the emergence of private enforcement mechanisms, with the arbitrary nature and violence that this can entail."³⁰

Other studies,³¹ including the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) of entrepreneurs and managers, also used a perceptions-based approach for measuring transition.³² The BEEPS asked entrepreneurs and managers about the extent and nature of their dealings with the state and obstacles to their business. Questions in the BEEPS covered subjects such as corruption, organised crime, state intervention and the influence of firms on governments. The BEEPS further confirmed that perceptions of the legal system are equally important to understanding the role of law within transition economies with respect to business and enterprise performance. The results of the survey revealed that firms across the region did not have a high degree of confidence in the ability of their legal systems to defend their property and contractual rights. As the BEEPS study noted: "confidence in the security of property rights is closely linked with the firms' overall assessments of governance, suggesting that poor governance weakens property rights."³³

In 1999, the EBRD tested the significance of insolvency laws for the volume of bank credit to the private sector and for flows of foreign direct investment into transition economies. In general, the regressions revealed strong evidence that the country scores for legal effectiveness of bankruptcy rules are significant in determining the ratio of private sector credit to Gross Domestic Product (GDP) in the EBRD's countries of operations. A similarly strong positive correlation existed between the country scores for insolvency effectiveness and flows of foreign direct investment (FDI). The LIS results seem to confirm the view that legal effectiveness has a stronger impact on FDI inflows than does legal extensiveness. By contrast, the statistical regressions revealed no correlation between the extensiveness of insolvency laws and the ratio of private sector credit to GDP or the flow of FDI.³⁴

Both legal and economic research has thus shown that the effectiveness of legal implementation and enforcement are two determinants of economic development and investment. Perceptions-based surveys, such as the LIS, provide an important tool to measure and assess legal effectiveness.

²⁶ See "Progress and Patterns in Transition", *EBRD Transition report 1999*, Chapt.2 (1999); "Ten Years of Transition", *EBRD Transition report 1999*, p. 38 (1999). See also note 8 which states "This is indeed a general pattern. Preliminary results on the rating of the extensiveness of competition policy as well as financial sector regulations, based on the existing laws rather than on expert opinion, show that the CIS does not lag far behind the CEE in terms of laws 'on the books'".

²⁷ Ibid.

²⁸ Some commentators note that perceptions of legal and business climate can serve as a useful tool to governments of countries wishing to attract foreign direct investment. Perceptions may help a government to identify what are perceived shortcomings in the legal or regulatory environment. However, opinion-based surveys are not in themselves sufficient bases for legislative reform. See T. L. Ziack, "Surveys Help Improve the Business Climate in Estonia", *Transition Newsletter*, The World Bank Group (March-April 2000) at www.worldbank.org/html/prddr/trans/arapr00/pg17.htm. See also T. L. Ziack, "An Assessment of the Estonian Investment Climate: Results of a Survey of Foreign Investors and Policy Implications." BOFITS Discussion Paper No.3 (2000).

²⁹ Ibid. p. 2. See also D. Kaufmann, G. Meherz and S. Schmukler, "Predicting Currency Fluctuations and Crises: Do Resident Firms Have an Informational Advantage?", World Bank Policy Research Working Paper 2259 (1999) located at <http://www.worldbank.org/wbi/governance/pdf/predict.pdf>. The authors note that investor perceptions of future financial instability had significant explanatory power for future actual volatility in the context of the East Asian financial crises.

³⁰ "Progress and Patterns in Transition", supra note 26, p. 38.

³¹ While the LIS may be unique in its approach in trying to assess the effectiveness of commercial legal reform in the EBRD's countries of operations, there are other examples of perceptions-based assessments or indices – very often relating to the overall economic or credit rating of a country. See D. Kaufmann, B. Kraay, P. Zoido-Lobaton, "Governance Matters", World Bank Policy Research Working Paper 2196, p. 1 (1999). The authors of this paper refer to a "governance database" containing 200 governance measures relating to data assessing subjective perceptions of governance compiled for a variety of sources. Interestingly Kaufman described LIS as a "poll" although in fact it is a hybrid instrument that is a survey distributed to a select group of legal practitioners in the EBRD's countries of operations. Ibid. p. 21.

³² See, Chapter 6, "Governance in Transition", *EBRD Transition report 1999*, p. 6 (1999).

³³ Ibid. p. 16.

³⁴ A. Ramasastry, S. Slavova, & L. Vandenhoeck, "EBRD Legal Indicator Survey: Assessing Insolvency Laws after Ten Years of Transition", *Law in transition*, p. 34 (Spring 2000). See also S. Slavova, "Law and Finance in Transition Economies", Financial Markets Group Special Paper, No.89, London School of Economics (1999).

Analysis of LIS results and trends[†]

The following section examines some of the broader trends that emerge from an analysis of the LIS data from 1997-2001 in the commercial law and financial markets areas. This article does not provide an in-depth examination of the sector specific subject areas included in the LIS.³⁵

Extensiveness versus effectiveness

Regional comparisons

In 1995, the EBRD concluded that, “despite a great deal of activity, few countries in the region have investment rules that closely approximate international standards.” At the time it was also noted that central and eastern Europe had made greater progress than the CIS in adopting legal rules that foster investment. It is difficult to draw a fully reliable comparison between the 1995-96 surveys, which focus on investment laws generally, and the surveys used from 1997 onward, which focused on commercial law and financial markets. Some general observations, however, can be made.

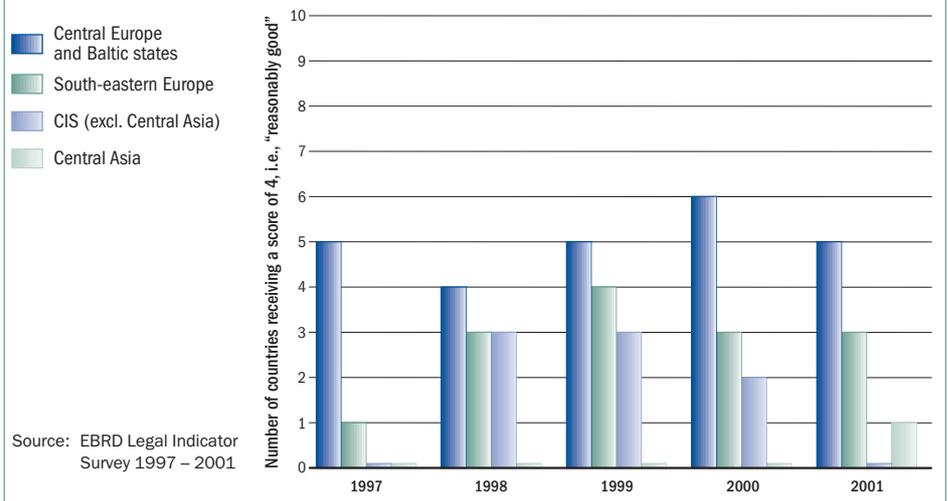
As early as 1995 the Czech Republic, Hungary and Poland were listed as the most advanced with Estonia being cited as having made considerable progress.³⁶ This trend remained consistent throughout the six years in which the LIS has been conducted. Countries within central Europe and the Baltic states are continually perceived as having more extensive and effective commercial and financial laws compared with other regions. In 1995 only three countries were cited as having made greater progress with enforcement of their laws than with legislation, namely Croatia, Estonia and Slovenia.

In Charts 1 and 2, a regional comparison of countries is presented in the commercial law area for both extensiveness (Chart 1) and effectiveness (Chart 2). Perceptions of the extensiveness and effectiveness of commercial laws remained higher in central European and Baltic states from 1997 through 2001. South-eastern Europe is the region that has the second highest perceived level of extensiveness and effectiveness throughout the period, followed by the CIS countries and Central Asia.³⁷ It is noteworthy that in the mid 1990s, the south-eastern European region and the CIS both had closer scores with respect to extensiveness – this likely reflects the enactment in the CIS of new legislation in areas such as company law and bankruptcy.

Since 1997 Hungary and Slovenia have been two jurisdictions that have continued to receive consistently high marks for both extensiveness and effectiveness across all the survey categories. These two countries are noteworthy as jurisdictions where perceptions of commercial and financial markets legal reform remain high. For the majority of survey countries, however, there is less consistency in terms of perceptions of legislative reform and implementation. For further comparisons of individual countries, see Tables 1 and 2 on page 16, which show the commercial law and financial markets indicators received for each country annually.

Even central European countries lauded in 1995 have shown a decline in their indicators over time, reflecting perhaps increased understanding by lawyers of the nuances in their legal regimes. Some countries have experienced declines in their effectiveness indicators despite having a robust legal framework. Declining effectiveness may reflect increasingly negative perceptions held by practitioners in the region as to the ability of government agencies and the courts to grapple with complex commercial and financial markets legislation. Accession countries such as Poland

Chart 1: Perceptions of commercial law extensiveness over time

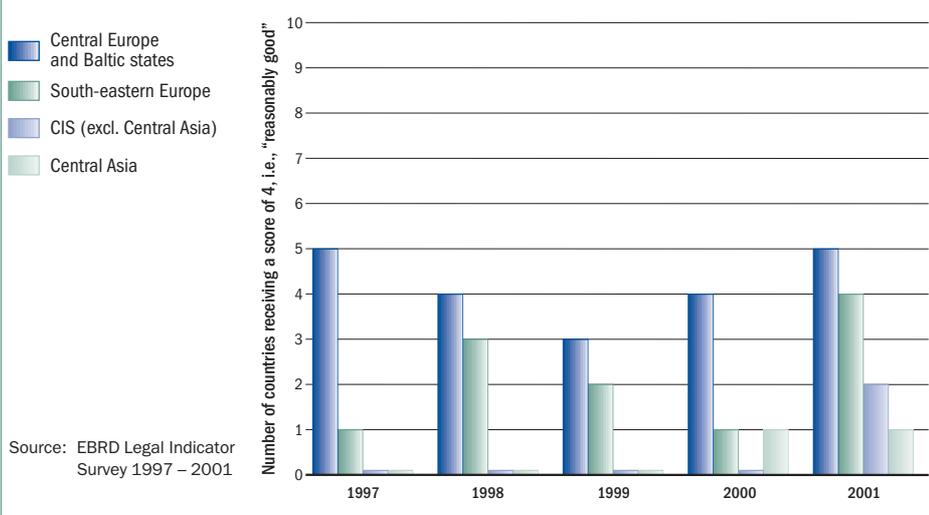


³⁵ For a closer look at the specific commercial and financial sectors covered by the LIS see the subject-specific articles included in previous issues of *Law in transition*.

³⁶ “The Contribution of Law to Fostering Investment” Chapter 6, *EBRD Transition Report 1995* at p. 106 (“With few exceptions the countries of eastern Europe have made greater progress than those of the CIS both in adopting legal rules fostering investment and in applying and enforcing them. The Czech Republic, Hungary and Poland are the most advanced, with the rest of eastern Europe and Estonia also having made considerable progress.”)

[†] Professor Anita Ramasastry, Assistant Professor of Law, University of Washington School of Law, and Olivia Oddi, Office of the General Counsel, EBRD.

Chart 2: Perceptions of commercial law effectiveness over time

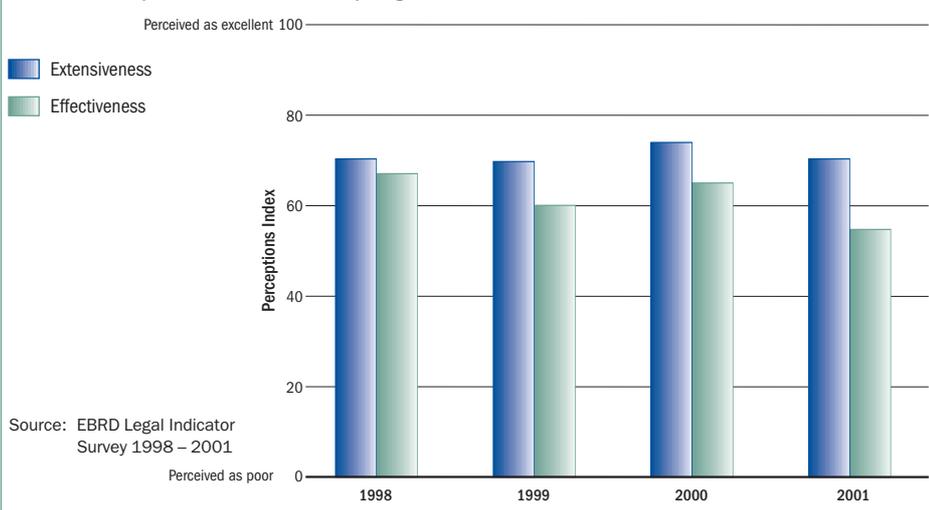


and the Czech Republic that have previously received strong scores in commercial law have experienced significant declines in perceived effectiveness of commercial laws, which lowered their overall indicators. In 1999 both countries experienced declines in their commercial effectiveness indicators which rose slightly in 2000 only to decline again in 2001. For Poland this decrease occurred despite revisions to the Commercial Companies Code and amendments to the securities laws to bring them in line with European Union (EU) standards. While these legislative changes were recognised (Poland's commercial extensiveness indicators were level or improving) the decrease in effectiveness indicators may, therefore, reflect a view that these changes were vague, contradictory or inconsistent. In addition, respondents may be revealing some scepticism as to whether all the legislative changes required by the EU can be effectively implemented. Poland's very low effectiveness scores for company law reflect this for 2001.³⁸

Another example of the decline experienced by Poland can be viewed as Chart 3, which shows that Poland's scores for effectiveness of its pledge laws has decreased over time – despite legislative amendments to create a system of non-possessory pledges in movable property and the creation of a pledge registry.

In contrast to countries with stronger positive perceptions, countries in south-eastern Europe and the CIS, such as Albania, Belarus, Bosnia and Herzegovina and Tajikistan, have received consistently low marks for extensiveness and effectiveness since 1997 (with one notable exception being Albania's extensiveness score in the pledge law category).³⁹ This may reflect, to a large degree, stagnation in terms of legislative reform and the lack of a robust legal infrastructure, which creates the perception of an ineffective legal system.

Chart 3: Perceptions of the status of pledge laws in Poland



³⁷ The following countries are present in each regional grouping: Central Europe and the Baltic states includes Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia; South-eastern Europe includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FR Yugoslavia, FYR Macedonia and Romania; CIS includes Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russian Federation and Ukraine; and Central Asia includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.

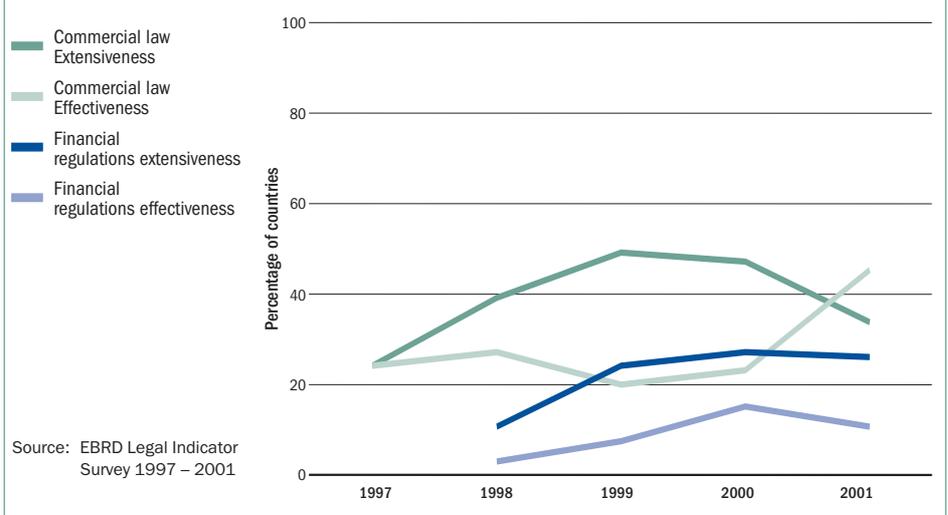
³⁸ Poland's effectiveness score for company law was 34.71 compared with 44.55 in 2000. This decline can be clearly seen in Poland's effectiveness indicators for its pledge laws which have decreased over time despite legislative amendments meant to create a system of nonpossessory pledges in movable property and the creation of a pledge registry.

³⁹ In 1995, Albania, Azerbaijan, Tajikistan and Turkmenistan were identified as countries where legal rules were furthest from international standards on investment. See "The Contribution of Law to Fostering Investment", *EBRD Transition report 1995*, p. 106.

⁴⁰ "The Contribution of Law to Fostering Investment", *EBRD Transition report 1995*, pp. 106-107.

⁴¹ 2001 marked the first instance where there was an increase in the effectiveness scores for the majority of the EBRD's countries of operations. Effectiveness scores increased for 17 countries in commercial law and 15 countries in financial markets regulations. In addition, effectiveness scores remained constant (i.e., within a 1 point difference) for 2 countries for commercial law and 4 countries for financial markets.

Chart 4: Percentage of countries receiving a score of 4, i.e., "reasonably good"



The implementation gap

As early as 1995, the EBRD had identified a persistent gap between the extensiveness and effectiveness of law reform: "In many countries, laws that closely approximate international standards on investment are severely compromised by being unclear, inaccessible or poorly supported administratively or judicially."⁴⁰

In 2001, the perception that laws are not effectively implemented or enforced remained high in many of the EBRD's countries of operations. Adequately assessing the gap between the enactment of comprehensive legislation and the implementation of new laws is an area where further study is needed.

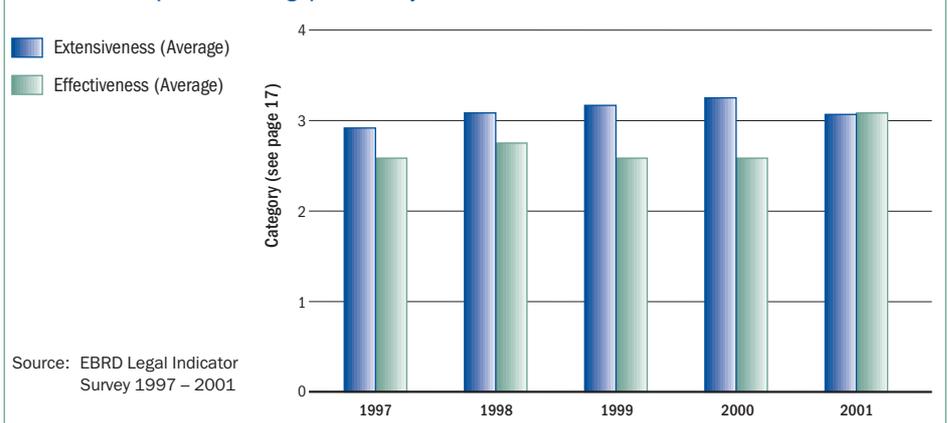
As depicted in Chart 4 the commercial law extensiveness indicators for most countries climbed from 1997 through 2000. Whereas in 1997 only six countries received a rating of 4 for their commercial extensiveness, by 2000, nearly a majority of countries in the region (12) have achieved a rating of 4. Interestingly, there was a slight dip in the extensiveness indicators in 2001, with only nine countries receiving a 4 or better. In 2001, respondents appeared to rate

substantive laws as being less extensive – through the use of more unclear responses and also through a decidedly more pessimistic view of various laws. This worsening perception may reflect an increased utilisation of commercial laws in some jurisdictions, creating a greater awareness of ambiguities, problems and gaps in substantive legal rules.

In 2000, 20 countries had a higher commercial extensiveness than effectiveness rating. This is representative of the persistent gap between extensiveness and effectiveness indicators that had appeared since 1997 (see Chart 5).

By 2001, however, commercial effectiveness appeared to have caught up with extensiveness ratings – only seven countries had higher extensiveness indicators than effectiveness scores; 11 countries had the same scores for extensiveness and effectiveness; while eight additional countries had higher effectiveness scores than extensiveness.⁴¹ For 19 countries, the implementation gap was perceived as closed and in some cases there was an inverse relationship between extensiveness and effectiveness. The commercial law

Chart 5: The implementation gap over the years



implementation gap closed, in part, because effectiveness scores increased and also because extensiveness scores decreased as discussed above.

How can jurisdictions have higher effectiveness than extensiveness scores? One of the possible explanations is that lawyers may believe that, despite legal rules being unclear or ambiguous, in practice, judges and attorneys have developed customs and practices that facilitate an effective functioning of the legal system. Hence, the law on the books may not be clear but legal practice may nonetheless be effective. An example of such a phenomena is Slovenia, which does not have a framework law on concessions but where there is significant concessions activity, especially at the municipal level. Slovenian lawyers and municipalities have developed a relatively effective practice in the absence of a formal framework law. Thus, written law may sometimes be perceived as not comprehensive or ambiguous but nonetheless can be seen to be effective.⁴²

In 2001, Russia was a jurisdiction where its extensiveness scores dropped while its effectiveness scores improved, most significantly in the commercial law area. While Russian respondents indicated that there were problems with the existing legislative framework, perceptions of how Russia has implemented or utilised existing laws appeared to have improved. The World Bank cited Russia's improvement in July 2001 stating that progress had been made in Russia's reform of the legal and judicial system, including more transparent procedures for the appointment of judges and a reform of Russia's civil and criminal codes. Russia's Arbitration Courts issued a Circular in January 2001 that contained a Survey on the Practice of Arbitration Courts in Dealing with Disputes relating to the Protection of Foreign Investors. This is an example of efforts to provide greater certainty to foreign investors with respect to the Russian court system.

Russia's perceived increase in effectiveness indicators offers a second explanation for the closed gap between extensiveness and effectiveness in 2001. Legislative changes that impact the overall effectiveness of courts and legislative systems are less frequent and their impact on perceptions of the effectiveness of legal reform are often more subtle. In 2001, many countries enacted legislation or promulgated government decrees aimed at reforming their judicial and administrative practices.⁴³ These systemic reforms may have impacted the perceptions of lawyers throughout the survey countries with respect to the effectiveness of specific legal reforms. Moreover, as noted in *Transition report 2000*,

several countries continued to revamp regulatory structures in the financial services sector with the creation of consolidated regulators. These reforms may also correlate with improved perceptions of the effectiveness of financial regulatory systems in these countries.⁴⁴

Although commercial effectiveness scores climbed, this does not mean that the EBRD countries of operations are perceived as having wholly satisfactory courts and administrative systems. The LIS includes questions about general legal effectiveness in a country. Questions in this segment related to the effectiveness of the legislative system (i.e., whether laws are made available to the public, and how transparent is the legislative process), and the courts as well as the overall perception of whether the rule of law prevails.

As of 2001, most countries score within a narrow range of between 40 to 60 points (on a scale of 100). While this indicates that general legal effectiveness is not as poor as the implementation of specific laws, a great deal of room for improvement remains. In particular, respondents routinely noted that the salaries of judges remain relatively low and that court proceedings are lengthy and time consuming. Additionally, the ability for parties to comment on draft legislation and regulations remains something that is not routinely made available.

With respect to the effectiveness of the courts and other implementing institutions, some of the areas in need of improvement were identified as early as 1995 and again in 1997, when the LIS shifted from investment laws to commercial laws. In 1995, for example, survey respondents indicated: "courts in most countries appear to lack the resources, training and experience, to handle complex investment disputes adequately."⁴⁵ Judicial salaries were specifically identified as a problem in 1995 and continue to remain an area of concern in 2001.

In subsequent years, the LIS revealed various types of deficiencies in the effectiveness of commercial law and legal system. In 1997, it was noted that large notarial fees appeared to impede secured lending in countries that had reformed their civil codes or pledge laws.⁴⁶ In some jurisdictions, respondents noted that there were significant disincentives to the commencement of reorganisation or bankruptcy proceedings, including high costs extensive involvement of the courts at each step of the proceedings, lack of qualified insolvency practitioners and lack of certainty of the outcome of proceedings. In 1998, respondents noted that procedures for the enforcement of civil judgments needed improvement as well as a shortening of the time involved for court proceedings.⁴⁷

⁴² "Frequency and awareness of concessions activity is one factor that may contribute to a belief that an adequate concessions climate exists." Labadi, Gramshi & Ramasastry, supra note 7 at p. 26.

⁴³ Annex 2.1 "Legal Transition Indicators", *EBRD Transition report 2001*, p. 33. Albania, Kazakhstan and Uzbekistan adopted plans designed to promote and improve the judicial system. Several countries reformed laws that deal with certain sectors or professions that serve as supporting institutions to the court system, including court executors, accountants, notaries and auditors. One notable example is the Czech Execution Decree that went into effect on 1 May 2001 and was designed to address well-known problems with the execution of Czech court judgments by increasing the qualifications of court executors and providing for a quicker and less formal execution procedure.

⁴⁴ Annex 2.2 "Legal Transition Indicators", *EBRD Transition report 2000* at p. 39.

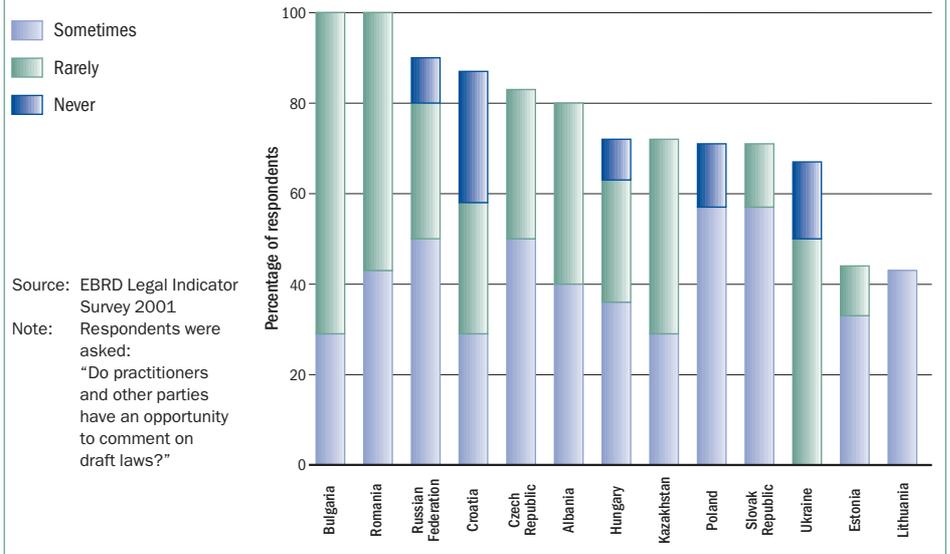
⁴⁵ Chapter 6, "The Contribution of Law to Fostering Investment", *EBRD Transition report 1995* at p. 106-07.

⁴⁶ Box 2.1, "Legal Transition Indicators", *EBRD Transition report 1997*, at p. 18.

⁴⁷ Annex 2.1, "Legal Transition Indicators", *EBRD Transition report 1998*, at p. 41.

⁴⁸ Chapter 6, "Legal Foundations for Sound Finance", *EBRD Transition report 1998*, p. 111.

Chart 6: Negative perceptions of the ability of practitioners to comment on draft laws in selected countries



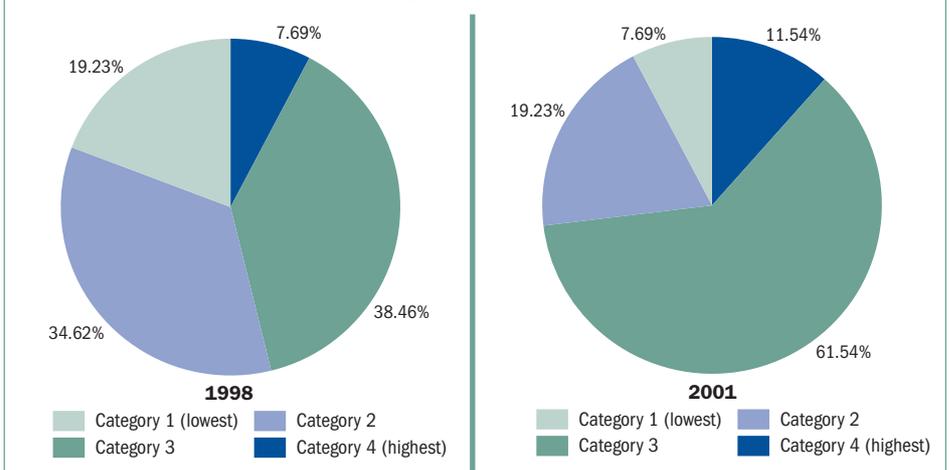
Effectiveness questions have often revealed interesting trends with respect to the perceptions of lawyers practicing in the EBRD's countries of operations. The company law segment of the LIS, for example, includes questions relating to corporate governance and the rights afforded minority shareholders. The LIS attempts to discern whether the protections included for minority shareholders in company law, are effective in practice.

One of the survey questions in the general legal effectiveness section asks, "Do practitioners and other parties have an opportunity to comment on draft laws?". Respondents were able to answer "almost always", "frequently", "sometimes", "rarely" or "never". For the majority of countries, the responses were mainly, "sometimes", "rarely" or "never". Chart 6 shows that in Albania, Bulgaria and Croatia respondents appeared to perceive the

legislative process as less open and transparent than in Lithuania, Poland and the Slovak Republic. Surprisingly, the accession countries fall in the middle of the chart. Some respondents in several jurisdictions, including Croatia, Hungary, Poland, Russia and Ukraine indicate that there is no opportunity to comment on draft legislation. These questions help to gauge the perceptions of the openness and transparency of the legal system which, in turn, fosters greater knowledge and understanding of laws that are eventually enacted and implemented.

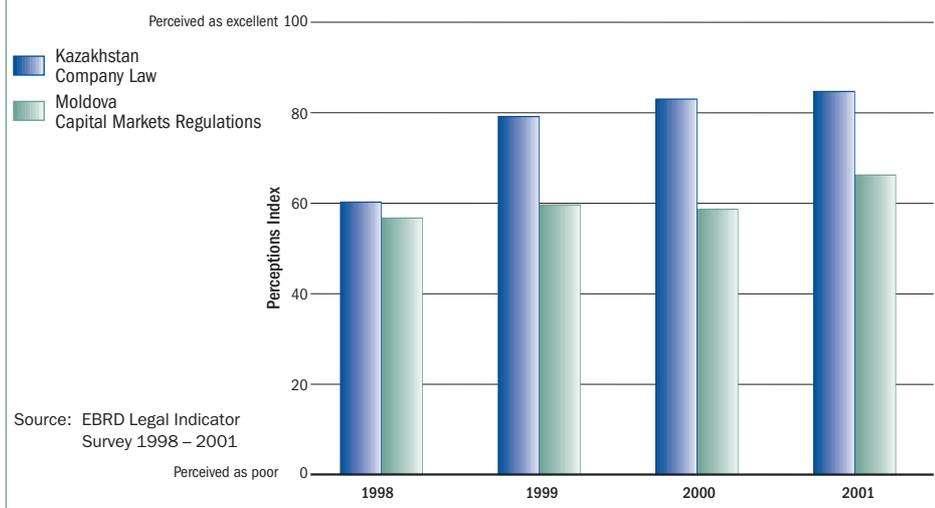
In contrast to commercial laws, the scaled extensiveness and effectiveness indicators for financial laws remains lower on average. As shown in Charts 7 and 8 the gap between extensiveness and effectiveness of financial markets laws has been persistent from 1998 through 2001. The number of countries that received a 4 for extensiveness increased only

Charts 7 and 8: Perceptions of financial regulations 1998 and 2001



Source: EBRD Legal Indicator Survey 1998 and 2001
 Note: For an explanation of categories, see page 17

Chart 9: Perceptions of extensiveness of selected laws in sample countries where they may not be fully utilised



slightly from 1998 to 2001. Charts 7 and 8 show that the number of countries that received a 4 rating had increased from only 7.69 per cent to 11.54 per cent. The slower increase in terms of extensiveness relates to the fact that financial markets reform was part of a second phase of legal reform that occurred after other commercial legal reforms had been implemented in many of the EBRD's countries of operations.

1998 was the first year in which the EBRD included banking and capital markets as part of the LIS. In 1998, the survey results indicated that in both the banking and securities sectors, countries faced serious problems with respect to enforcement and implementation of financial markets laws. Major impediments identified by respondents included a lack of trained regulatory personnel, a failure to conduct supervisory examinations of financial institutions and failure to take prompt and frequent corrective action with respect to troubled financial institutions.⁴⁸

The gap between extensiveness and effectiveness of financial market indicators was identified again in 1999 and has appeared subsequently in 2000 and 2001 data.⁴⁹ Many of the countries that had high indicators for financial market extensiveness and effectiveness were the same countries that had received higher scores for commercial law. These jurisdictions included Estonia, Hungary, Poland and Slovenia.⁵⁰ The effectiveness of capital markets enforcement has lagged behind that of banking. In some part, this is due to the fact that stock exchanges and securities regulators (commissions) were often created more recently. A lack of shareholder depositories and registration systems were another reason why capital markets enforcement was perceived as less robust than banking.⁵¹

Perceptions and the use of laws

The LIS sometimes provides counterintuitive glimpses of how lawyers perceive their legal system. In some instances for example, laws or legal systems in central European jurisdictions that would be expected to be perceived as strong and robust may receive lower scores than neighbouring countries in south-eastern Europe, the CIS and Central Asia. What could explain this?

Under-utilisation effect – optimism and pessimism

More frequent utilisation of laws and more robust legal practice may reveal ambiguities, gaps and problems in legislation that are less apparent in those jurisdictions where laws are not routinely used. Thus, in countries with a larger volume of foreign investment and a correspondingly more robust legal practice, lawyers may gain a deeper understanding of the shortcomings in commercial and financial laws through frequent use. Hence, jurisdictions with more frequent legal practice may have scores that decline (for example Poland). Whereas in countries with less economic activity and fewer opportunities to test new commercial and financial legislation, lawyers may view these laws as substantively adequate. These countries can end up with higher extensiveness indicators. This has been referred to as the under-utilisation and may explain higher extensiveness and effectiveness indicators than would be expected for certain countries.

Perceived optimism from respondents in the absence of true implementation is more pronounced in the area of financial markets. In 1999, for example, Albania, Armenia and Moldova received strong scores in both extensiveness and effectiveness of financial markets, despite the lack of a robust banking sector and almost non-existent capital markets. Chart 9 shows the consistently high extensiveness scores that Moldova has received for its capital markets

⁴⁹ Annex 2.2, "Legal Transition Indicators", *EBRD Transition report 1999*, p. 48.

⁵⁰ *Ibid* p. 49.

⁵¹ *Ibid* p. 48.

⁵² See, for example, "World Bank Report Urges Czechs to Limit Use of Capital Markets", Dow Jones International News (17 November 1998); John Reed, "No Comfort Zone: Bulgaria Makes an Appearance on Portfolio Managers' Radar Screens but Poor Liquidity and Shifting Rules Narrow the Investment Band", *Central Eastern European Economic Review* (February 1998).

⁵³ John Nellis, "Time to Rethink Privatisation in Transition Economies", 36(2) *Finance and Development International* (International Monetary Fund, June 1999); Eva Thiel, "The Development of Securities Markets on Transition Economies: Policy Issues and Country Experiences", *Financial Market Trends* (OECD, June 1998).

⁵⁴ Curtis B. Masters & Azamat A. Kuatbekov, "Kazakhstan's New Joint Stock Company Law". *BNA Eastern European Reports* 127-131 (March 1999). For a general discussion of perceptions of the Kazakh market and how legal reform efforts have influenced these perceptions, see "Eastern Europe's New Dawn Kazakhstan – From Little Acorns", *Euromoney* (10 April 1999).

⁵⁵ 1999 Investment Climate Statement on Moldova (2 July 1999) prepared by the U.S. and Foreign Commercial Service and U.S. Department of State (http://www.doc.gov/bisnis/country_wstnis.htm#Moldova).

legislation, despite the absence of an active securities market, and that Kazakhstan has received for its company law. In 2000, FYR Macedonia had high commercial law effectiveness indicators (in addition to high extensiveness scores). This can be contrasted with Chart 3, where Poland's scores have declined despite strong law reform in the pledge area. FYR Macedonia, for example, received high marks for the effectiveness of its bankruptcy laws despite the fact that very few proceedings had been commenced under the law enacted in 1998.

One of the most interesting trends identified is that respondents seem to rank countries with comprehensive laws more negatively when these laws have been in place for some time and problems have possibly arisen with respect to enforcement and implementation. In the company law context, for example, scores of countries that have moderate corporate governance protections such as Bulgaria, Poland and Romania have declined recently. This may reflect, to some extent, frustrations experienced by foreign visitors who have attempted to enforce their legal rights.⁵²

More broadly, the Czech Republic, Hungary and Poland experienced downturns in their commercial law scores in 1999, which resulted in lower overall scores for each country. Despite small increases in 2000, aggregate commercial law scores dipped again for the Czech Republic and Poland again in 2001. Although these countries have stronger scores as compared with other regions, it appears that over time, practitioners may have increased expectations of what constitutes extensive and effective legal reform and may have become more pessimistic that these expectations are being met.

Similarly, in 1999 the Czech Republic received lower scores for its extensiveness and effectiveness in both the financial markets and commercial law segments despite having comprehensive company and securities legislation – possibly because of conflicts of interest arising from high levels of indirect bank ownership of many companies leading banks to act simultaneously as investors and creditors.⁵³ Romania also experienced a decline in extensiveness scores in 1999.

Perceived optimism arising from laws that are recently enacted

Newly enacted laws may be perceived as comprehensive and extensive when they are initially enacted. This may be due to the fact that lawyers need to have ample time to become aware of any possible defects or gaps in the legislation – such understanding comes with the passage of time. Thus, laws may be perceived more favourably when enacted and then scores may decline – even though the law has not changed.

Generally, countries with recently enacted laws tend to score higher in the year following these legislative changes. Kazakhstan, for example, enacted a new company law in 1998 that replicates many of the provisions of the Delaware Corporations Law.⁵⁴ The enactment of the legislation led to Kazakhstan receiving a higher score in 1999 compared with significantly lower scores in 1997 and 1998. This pattern can also be seen in other countries.

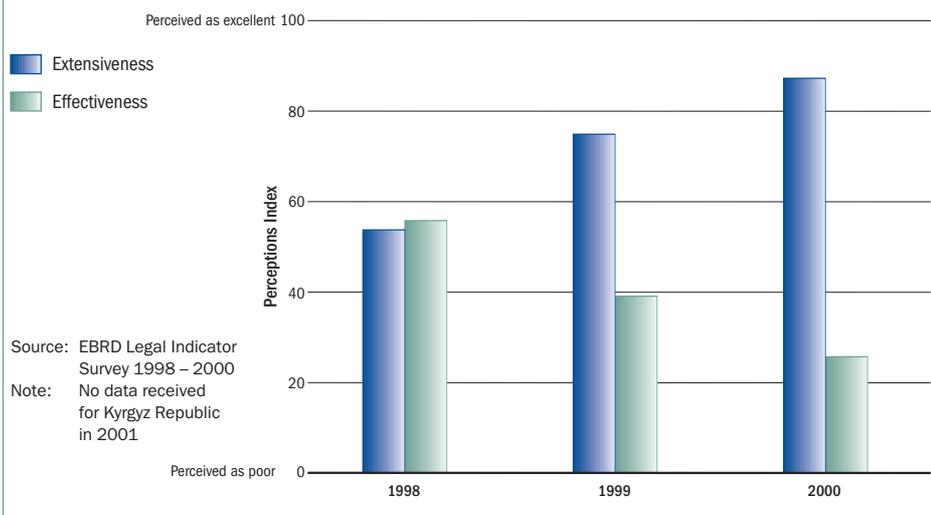
The Kazakh example reveals another interesting trend that often repeats in the LIS: perceptions of new legislation may not be as high in the year of enactment as in the subsequent year. This may occur because lawyers may not be aware of legislative changes immediately after a law is enacted. New laws may not be widely disseminated or the dissemination may take some time to register in public perceptions. This lack of recognition of new legislation manifests itself in a higher number of unclear responses from lawyers or in answers that are incorrect or contradictory. Moldova's high score for company law in 1998, for example, may reflect its enactment of new legislation in 1997. In 1999, however, Moldova's ratings dropped significantly, possibly because problems had been identified with the execution of the law.⁵⁵

Russia and Uzbekistan also received higher company law scores in 1998, possibly due to new legislation being enacted in 1996. However, their scores dropped significantly in subsequent years. This trend seems to reflect the evolving perceptions of the law once it is implemented. The drop in effectiveness once a law has been enacted and has had time to be tested and utilised is also reflected in the charts relating to Azerbaijan and the Kyrgyz Republic. Legislation that appears comprehensive and robust when it is enacted may be perceived as less effective and also less extensive once implemented.

Strong extensiveness is only one element of legal reform

Extensiveness scores must be read in conjunction with effectiveness scores to come to a more complete understanding of how legal reform is perceived in any jurisdiction. For example, the Kyrgyz Republic is one country that has consistently received strong scores for the extensiveness of its commercial laws. Since 1997, it has undertaken wholesale reform of its pledge, company and bankruptcy law. Nonetheless, it has developed a significant gap between its extensiveness and effectiveness scores – which shows that its relatively comprehensive laws are not perceived as being properly implemented. To review only the Kyrgyz Republic's extensiveness score, therefore, would be to see only one part of the story with respect to how respondents view the sufficiency of the commercial legal reform.

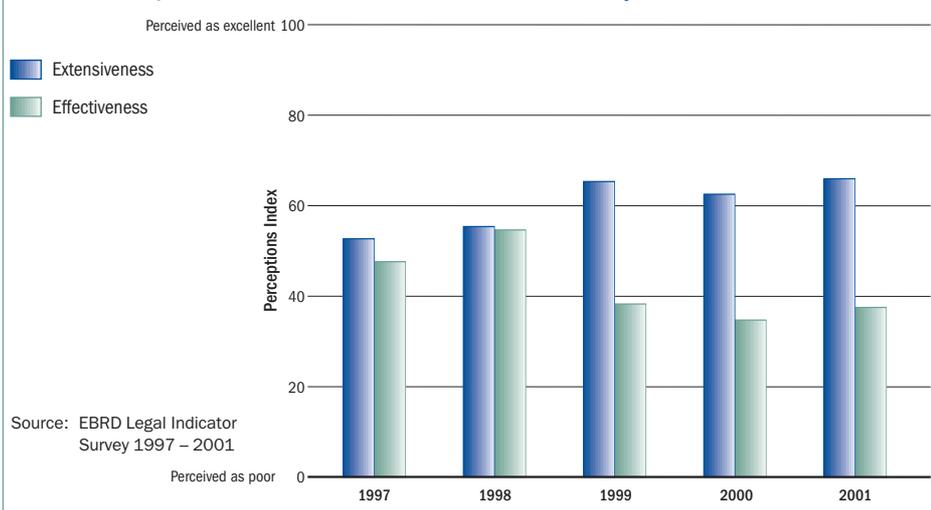
Chart 10: Perceptions of the status of bankruptcy laws in the Kyrgyz Republic



An example of these phenomena is the perception of the status of bankruptcy laws in the Kyrgyz Republic depicted in Chart 10. The bankruptcy scores steadily improve from 1998 through 2000 – this follows comprehensive reform on the areas of pledge, company law and bankruptcy in 1997. The increase in extensiveness scores may reflect the increased knowledge and understanding that lawyers gained about the substance of the new law the year after it was enacted. As noted above, this result provides some interesting insight into how legal knowledge is disseminated and suggests that it takes time for practitioners to gain a mastery of the topic. While the Kyrgyz Republic's extensiveness indicators increased, its effectiveness indicators decreased. In 1998, respondents rated effectiveness as somewhat higher than the extensiveness of the law. However, within three years, the effectiveness score had dropped by 50 per cent.

As of 2000, other countries with large gaps in at least one of the two survey segments (commercial law or financial markets) include Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, FYR Macedonia, Georgia and Ukraine.⁵⁶ Chart 11 shows the commercial law scores for Azerbaijan between 1997 and 2001. Azerbaijan experienced a series of commercial law reforms in 1997, 1998 and 2000 in the area of pledge and bankruptcy law. The extensiveness scores for Azerbaijan have increased between 1997 and 1999, stabilised in 2000, and experienced a slight increase in 2001. The effectiveness scores also mirrored the extensiveness scores for the first two years. In 1998 the effectiveness scores plummeted and there has been a significant gap of more than 20 points between extensiveness and effectiveness.⁵⁷

Chart 11: Perceptions of the status of commercial laws in Azerbaijan



⁵⁶ Annex 2.2, "Legal Transition Indicators", *EBRD Transition report 2000*, p. 33.

⁵⁷ Where there was more than a 20-point gap between extensiveness and effectiveness (on a scale of 100), extensiveness indicators have been discounted for the country. Hence for a country with a 4 for extensiveness and a 1 for effectiveness, which would correspond to a large gap in raw scores between the extensiveness and effectiveness scores, the extensiveness indicator would be decreased. This discounting is based on the assumption that if the gap between legislation and its implementation is too severe, then the law on the books cannot be functioning properly.

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Conclusion

The LIS tries to understand how lawyers perceive the development of new legal rules and whether such rules are being implemented effectively. At times, some of the LIS indicators appear contrary to received wisdom concerning the quality of certain laws or assessments of how well a legal system functions when enforcing those laws. This is why the LIS and other perceptions-based research can be illuminating. They provide another dimension to help to assess the pace and success of commercial and financial legal reform in transition economies.

For example, the demand for law reform in many countries may be tied in some respect to how frequently law is used in practice and the perceptions that have developed in relation to various laws. Thus, in countries with relatively few company registrations, bankruptcy proceedings or pledge registrations, there may be fewer calls for change coming from within a country for the reform of a particular law. This might also help international financial institutions and other organisations engaged in finance and investment recognise that a simple reading of the laws in a given country is no substitute for understanding how legal perceptions shape (i) the way in which lawyers advise investors and other clients about the legal climate in a given country, and (ii) the way in which perceptions may shape the demand (or lack thereof) for commercial legal reform and for greater enforcement of substantive legal rules. 