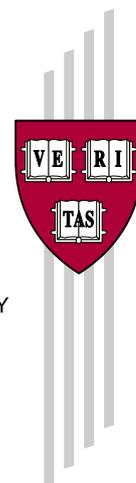


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G-24 Discussion Paper Series

The Politics of Legal Reform

Florencio López-de-Silanes

No. 17, April 2002

**UNITED NATIONS CONFERENCE ON
TRADE AND DEVELOPMENT**

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**Research papers for the Intergovernmental Group of Twenty-Four
on International Monetary Affairs**



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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s*. Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series*.

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

THE POLITICS OF LEGAL REFORM

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G-24 Discussion Paper No. 17

April 2002

Abstract

As a result of the emerging market crises of the last decade and a large body of academic research on the influence of investor protection in the development of capital markets and economic growth, there is a growing consensus that reforming the legal infrastructure supporting business should be an important component of reforms in many developing countries. But the consensus is unwieldy, as there are still many forces against reform and little agreement about what constitutes feasible legal reforms. This paper has two parts. In the first, we identify the forces for and against legal reform and review the role these forces play in episodes of reform. In the second, we seek to further our understanding of what constitutes good laws and regulatory mechanisms, and more importantly how to make them enforceable in different countries. If legal reform is to succeed, the commonly advocated principles of corporate governance in the international community must be brought down to the local political and judicial realities. Translating international corporate governance initiatives into clear and enforceable rights for creditors and shareholders that incorporate these constraints will be difficult but necessary. Bankruptcy law and corporate law reform need to be politically feasible and enforceable. Legal reforms should be complemented with carefully drafted judicial reforms, as well as market-based mechanisms that foster a culture of corporate governance.

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The Politics of Legal Reform

Florencio López-de-Silanes*

I. Introduction

As more countries make a transition to market economies, the focus of the public policy debate has broadened from macroeconomic stability to the design of institutions that sustain growth. Acknowledging that institutional reform is a vast topic, this paper focuses on the development of financial institutions such as banks and stock exchanges, the construction of the legal infrastructure supporting business, and the creation of regulatory mechanisms in line with best world practice. The ever increasing interconnections among financial markets and the waves of international turmoil in the last decade, such as the Tequila crisis, the Asian crisis and the Russian crisis, are creating a consensus among policy-makers that the reform of financial institutions is an essential component of reform. This belief has been backed up by continuing academic research showing that the institutions of corporate governance, in particular law and the quality of its enforcement, matter for the development of financial markets and economic growth.

Although some consensus has been reached and several international institutions and bodies have begun promoting legal reform, the consensus is unwieldy as there are still many forces against reform and little agreement about what constitutes feasible legal reforms. This paper first identifies the forces for and against legal reform and reviews their role in episodes of reform. Forces against reform include managers and families in control of firms, labour, and sometimes politicians themselves. On the other side, one of the main allies of reform is the opening up of economies and the increased interconnectedness of financial markets that allows investors from all over the world to “vote with their feet” when investor protection is not part of the agenda. The main lesson of this

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