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## Diverse Paths toward "the Right Institutions": Law, the State, and Economic Reform in East Asia

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# Diverse Paths toward “the Right Institutions:” Law, the State, and Economic Reform in East Asia

Meredith Woo-Cumings

April 2001

Prevailing thinking suggests that legal origins and traditions (Anglo-U.S. common law vs. continental civil law) fundamentally affect the nature of the state, its role in the economy and the success of economic development. If true, it would follow that adopting the rule of *common* law would be the surest way to promote development, transparency and accountability everywhere. This paper seriously questions this influential school of thought.

The author reviews the core literature on the rule of law and economic growth—including the La Porta thesis on the supposed superiority of Anglo-U.S. common law—and demonstrates the inadequacies and built-in biases of the current arguments, particularly in their application to East Asia. Instead, this current discourse may simply be misleading us into thinking that we have finally unlocked the conundrum of economic growth and reform.



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“the Right Institutions:”  
Law, the State, and Economic Reform  
in East Asia**

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**Meredith Woo-Cumings**

**ABOUT THE AUTHOR**

*Meredith Woo-Cumings is a Visiting Scholar at the Asian Development Bank Institute, on leave from Northwestern University where she has been teaching Political Science since 1989. Her teaching and research interests include East Asian politics, international political economy, and U.S.-East Asian relations. She has authored and edited five books, including Race to the Swift: State and Finance in Korean Industrialization (Columbia University Press, 1991), which was published under the name Jung-en Woo. Professor Woo-Cumings is currently finishing a manuscript, entitled Three Worlds of East Asian Capitalism, and expects to see her latest edited book, Neoliberalism and Reform in East Asia, in press in early spring 2001. She has received an M.A. in International Affairs (1982), and Latin American Studies (1984), and a Ph.D. in Political Science from Columbia University (1988). Before joining Northwestern University in 1989, she taught at Colgate University and Columbia University.*

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## PREFACE

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The ADB Institute aims to explore the most appropriate development paradigms for Asia composed of well-balanced combinations of the roles of markets, institutions, and governments in the post-crisis period.

Under this broad research project on development paradigms, the ADB Institute Working Paper Series will contribute to disseminating works-in-progress as a building block of the project and will invite comments and questions.

I trust that this series will provoke constructive discussions among policymakers as well as researchers about where Asian economies should go from the last crisis and current recovery.

Masaru Yoshitomi  
Dean  
ADB Institute

## ABSTRACT

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In the wake of the global financial crisis that began in 1997, an influential body of opinion arose which argued that a primary cause of the crisis in the affected countries was a lack of institutional transparency and accountability, and more generally, an absence of the rule of law. This argument reflected a growing international consensus in the 1980s and 1990s that different law traditions had differential effects on economic development. More specifically, the argument was that a common law tradition was more likely to promote economic development because it was the best source of and predictor for the rule of law, transparency and accountability. By the same token, the civil law tradition was more likely to privilege state intervention in economic processes, and to be less sensitive to concerns about the rule of law and transparency.

I argue that however compelling this argument may be—and I lay the argument out in some detail—legal traditions and institutions do not determine the nature of the state, or its likely role in the economy, nor do they critically determine the course of economic development. Therefore, the current tendency of pointing to the “rule of law” as an elixir which will fix various contemporary problems of development may simply be wrong. Instead of common law leading to a minimal state and the broadest extension of the market, or civil law leading to state intervention in the economy and corresponding shrinkage of market activity, there may be no relationship at all between forms of law and the role of the state. The current discourse about the rule of law, as well as the long intellectual pedigree behind the argument about law and economic development, may misguide us into thinking that we have unlocked the conundrum of economic growth and reform, when in fact we may be less well off today than when we tried to understand the reasoning behind state-directed development programs. This is because of the built-in bias in this literature against the state, which is viewed as *ipso facto* inimical to economic development. And it is the common law background that is assumed to be *ipso facto* conducive to development and to the virtues of transparency and accountability.

In this paper I review the core literature on the rule of law and economic growth; the influential arguments of some institutional economists on the relationship between law, finance and government; and the current consensus on the part of international development agencies, like the World Bank and the Asian Development Bank, on these issues. In particular I will examine the influential argument by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, on the superiority of the Anglo-American common law system (as versus the civil law tradition of continental Europe, Latin America, and East Asia) in fostering financial development. I demonstrate the inadequacy of these arguments on the rule of law and economic development, by flashing them against the backdrop of East Asia.

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# Diverse Paths toward “the Right Institutions:” Law, the State, and Economic Reform in East Asia

Meredith Woo-Cumings

## 1. Introduction

In the wake of the Asian financial crisis that began in 1997, an influential body of opinion arose which argued that a primary cause of the crisis in the affected countries was a lack of institutional transparency and accountability, and more generally, an absence of the rule of law. This argument reflected both the nature of the financial crisis itself and the likely policy remedies for it, and a growing international consensus in the 1980s and 1990s that different legal traditions had different effects on economic development. More specifically, the argument was that a common law tradition was more likely to promote economic development because it was the best source of and predictor for the rule of law, transparency and accountability. By the same token, a civil law tradition was more likely to privilege state intervention in economic processes, and to be less sensitive to concerns about the rule of law and transparency.

In this paper I will argue that however compelling this argument may be—and I will lay the argument out in some detail—legal traditions and institutions do not determine the nature of the state (although they may be reflected in it) or its likely role in the economy, nor do they critically determine the course of economic development (even though in some countries, notably Britain and the United States, they may seem to do so). Therefore the current tendency to identify the “rule of law” as an elixir which will fix various contemporary problems of development may simply be wrong: rather than common law leading to a minimal state and the broadest extension of the market, or civil law leading to state intervention in the economy and a corresponding shrinkage of market activity, there may be no relationship at all between forms of law and the role of the state. I argue that the current discourse about the rule of law, as well as the long intellectual pedigree behind the debate on law and economic development, may be misleading: it may lead us into thinking that we have unlocked the conundrum of economic growth and reform, when in fact we may be less well off today than in the past when we tried to understand the reasoning behind (and the successes of) state-directed development programs. This is because of the built-in bias in this literature against the state, which is viewed as *ipso facto* inimical to economic development, while the common law tradition is assumed to be *ipso facto* conducive to development and to the virtues of transparency and accountability.

I will begin by reviewing the core literature on the rule of law and economic growth; the influential arguments of some institutional economists on the relationship between law, finance and government; and the current consensus on the part of international development agencies, like the World Bank and the Asian Development Bank, on these issues. In particular I will examine the influential argument by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishney, hereafter LLSV, on the superiority of the Anglo-American common law system (as opposed to the civil law tradition of continental Europe, Latin America, and East Asia) in fostering financial development. I will seek to

demonstrate the inadequacy of these arguments on the rule of law and economic development, by flashing them against the backdrop of East Asia.

East Asia is not a uniform region, even though many analysts seem to think that it is. I will argue that there are *three* worlds, not one, in East Asia, consisting of Northeast Asia, Southeast Asia, and the People's Republic of China (PRC), the last being a complex amalgam of the contrasting elements of Northeast and Southeast Asia. In these three worlds of East Asia, the critical issue for economic change is the quality and strength of the state, and not the type of law background or tradition *per se*. Economic development has been rapid in these societies, because they have privileged *outcomes* over *procedure*, and yet it is proper procedure that is the *sine qua non* of good law in the common law tradition. Meanwhile, the *sine qua non* of development in East Asia was long thought to be the practice of administrative guidance, focusing on developmental outcomes. Thus when the East Asian economies ran into trouble, it was assumed that the era of state-directed economies had also come to an end.

On the contrary, I will first argue that these mechanisms of state intervention in the economy (*Gyôsei shidô* in Japanese and its direct transliteration, *Haengjong chido* in Korea) were highly *informal* mechanisms which had at best a tangential relationship to formal law or legal traditions, and thus this experience contradicts the argument that it is the structure of law that determines the nature of the relationship between the state, economy and society. Administrative guidance developed both in the “civil law” countries like Japan and Korea, but also in a “common law” country like Malaysia. In the latter case an elaborate and sophisticated common law system still posed no barrier to arbitrary decisions by the chief executive.

Secondly, I will also show that the process of reform itself has developed out of the same preexisting patterns of state intervention, in particular in the Republic of Korea, one of the success stories of reform since 1997. I will argue that the Korean government has used administrative guidance as an effective policy tool to restructure the corporate sector and to bring about neoliberal reforms—precisely in the direction of accountability and transparency. In other words administrative guidance remains a powerful tool of state intervention, whether to promote growth or to reform economic practice, in spite of the sense among advocates of the rule of law that such intervention ought to come to an end. It is not a case of the right goal being achieved by the wrong means, so much as the right goal (transparency, accountability) being achieved by means that run in predictable historical grooves, that is, by means that are hard to avoid in any case. More importantly perhaps, I will argue that administrative guidance bears little relationship to either a civil law or a common law tradition, and those who think it does are barking up the wrong tree.

The East Asian experience has on the whole been one of state action that was simultaneously heavy-handed and successful. It may therefore show that rapid economic reform in a developing society will bear fruit most quickly and effectively in countries already having a more centralized and powerful government, with the trick being to direct that state toward a commitment to reform. This experience may also point the policy community toward considering ways of fostering more effective state institutions, among which legal institutions are but one aspect, rather than uncritically assuming that the best path to reform lies in developing legal institutions and the rule of law, while reigning in the state.

## 2. Common Law and Civil Law

Nobel laureate Douglas North has been a prolific advocate of the idea that states throughout history have more often been inimical to economic growth than conducive of it, and that the key to economic development is to get states to behave as “impartial third parties,” or to adopt a role sometimes called that of a “night watchman state” (North 1981; North 1990). In his view, the state has the comparative advantage of its capacity for violence, typically directed toward a predatory goal of enhancing state revenue through the power of taxation. Set against this state, rather than alongside it, is North’s conception of property rights, and the capacity of property owners to resist the state and to exclude it from involvement in their separate sphere of activity—the (theoretically) free arena of impersonal economic exchange otherwise known as the market. The best state is one that can monitor property rights and enforce contracts, but knows how to step aside or into the background as an impartial enforcer. “Effective third-party enforcement,” he writes, “is best realized by creating a set of rules that then [or in turn] make a variety of informal constraints effective.” A good system of impersonal exchange, combined with third-party enforcement of the rules of the game, has been “the critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth” (North 1990: 35). By and large, the most effective of those modern economies have been ones that sprang from the common law tradition.

Another powerful argument for the virtues of a common law tradition comes from a number of economists at Harvard and the University of Chicago. Through an empirical study of the determinants of quality government in a large cross-section of countries, these economists seek to assess state performance using various measures of government intervention, public sector efficiency, public good provision, size of government, and political freedom (LLSV 1999). They argue that what defines “good government” is what is “good for economic development.” Following Montesquieu (1989 [1748]) and Adam Smith (2000 [1776]), they focus on the “security of property rights—lack of intervention by the government, benign regulation, [and] low taxation—as the crucial metric of good performance.”

The most standard view is that a good government protects property rights, and keeps regulations and taxes light; that is, a good government is relatively noninterventionist.... On average, greater interventionism should be associated with lower efficiency, since entrusting officials with greater regulatory and taxing powers invites corruption and bureaucratic delay (p. 225).

These authors view legal systems as “indicators of the relative power of the State vis-à-vis property owners,” (p.224) or as “cruder proxies for the political orientation of governments” (p.232). More particularly, *common law* “developed in England to some extent as a defense of Parliament and property owners against the attempts by the sovereign to regulate and expropriate them,” whereas *civil law* has developed “more as an instrument used by the sovereign for State building and controlling economic life....” The latter tendency takes its ultimate expression in *socialist law*, yielding ultimate control of the economy by the state. As the authors say, “we consider a country’s legal system as a potential determinant of government performance.... We find that the use of a more interventionist legal system, such as socialist or French civil law, predicts inferior government performance...” (p.224)

Civil law is largely an instrument of the State in expanding its power, the authors write, so it is “no wonder that the greatest codes were introduced by Napoleon and Bismarck” (p.231). This type of law focuses on “discovering a just solution to a dispute (often from the point of view of the State) rather than on following a just procedure that protects individuals against the State,” and so the civil law tradition “can be taken as a proxy for an intent to build institutions to further the power of the State” (p.231-2). Common law, by contrast, was made by judges who “put their emphasis on the private rights of individuals and especially on their property rights” (p.232, quoting Sam Finer). Common law is therefore one’s best proxy “for the intent to limit rather than strengthen the state” (p.232).

LLSV’s “good government” and North’s “night watchman” state are analogs for the common notion of the rule of law. Advocates of the rule of law want an impartial body that is above the fray of day-to-day political and economic conflict, a body that may be composed of human beings, but that owes its allegiance to the law, or to interpreting the law, such that we have a government of laws and not of men, and a final arbiter of right and wrong when political men cannot reach a consensus. The closest analog for North’s “night watchman,” intervening primarily to keep the market functioning effectively, would be the United States Supreme Court’s role for decades before the New Deal in the 1930s, in which it interpreted the law from a *laissez-faire* and decidedly pro-business standpoint. This was an era of remarkable growth in the American economy, but it eventually foundered in the Great Depression and took the doctrine of *laissez-faire* down with the American economy. Fifty years would have to pass before another president would revive the Smithean or Hayekian notion of the “night watchman” state.

Arguments by North and LLSV have been important to the contemporary influence of *neoliberalism*, signified by a concern for applying “the rule of law” as it is known in Western countries, as a remedy for the defects of developing countries. Or as Frank Upham (forthcoming) has put it, “universal theories of the interdependence of legal form and economic activity lurk behind the rhetoric of the rule of law without a great deal of intellectual agonizing over exactly what this form of law entails.” This is something of an understatement: these clearly are universal theories, but they also may be so broad that they do not really differentiate between countries and regions. For example, Latin American cases can sensitize us to what a blunt instrument this distinction of civil or common law tradition may actually be; all the Latin American governments have civil law traditions, yet few would compare their record of economic growth to the East Asian civil law cases of Japan, Korea, and Taipei, China.

Thomas Heller has taken this critique of the law and economics doctrine to its logical conclusion, in linking concerns about the rule of law to the most basic assumptions of micro-economic theory. If economists start with the doctrine of “rational man” pursuing his interests in the marketplace, the standard narrative of American law is based on the notion of pre-social or naturally given individuals. Through the doctrine of the social contract, “these individuals voluntarily associate in civil society and contractually create the state to further their individual life projects” (Heller 1984: 174). These individuals or subjects appear as

a set of differentiations (legal rights) that define the space in which, and the instruments with which, the subject may freely act. The theory of property rights is essentially a structural code that defines the physical and intellectual area, as well as the material resources, available to a legal actor in pursuit of his or her normative ends. To trespass this differentiated ground is, in a serious sense, to invade the personality of another. For modern legal economics, property is more than a matter of material

rights—its categories construct a world by marking off the boundaries between self, others, and environment (p.175).

After linking these legal and political assumptions to basic doctrines of microeconomics, Heller then shows how the state can only be conceived of as that neutral arbiter which finds its proper role only when the market itself fails to decide an outcome on its own. Thus “the role of the state” can only be residual and derivative, because the state “acts only when private arrangements are insufficient to achieve this unchanging ideal of social order” (p.180).

Heller finds the actual practice of law is “complex, local, and filled with contradictions when examined relative to any comprehensive theory” (p.184). In other words, however elegant the minimal theory of the state may be in the work of Douglas North or LLSV, in daily life the practice of law will often depart from theoretical assumptions, and will often be messy and contradictory. The key is to keep departures from the legal or theoretical norm “from spilling over their boundaries and destabilizing established legal practices (p.186).” Of course, this quotidian, localized messiness will make it that much harder for non-common law countries to figure out what it is they are expected to do to approximate the ideal of acting according to “the rule of law.”

It is interesting that in contrast to Heller’s concern for the local, messy nature of law practice, LLSV have frequent recourse to what might be called “founding principles” of the law and economics doctrine, to the basics of an idealized common law tradition that may not exist anywhere. Even to the extent that such a tradition does exist in classic common-law countries like Britain or the United States, it is not clear how the authors would have us transfer these principles to countries that have no common law tradition, apart from shouting oneself hoarse reiterating basic theory. We can see this tendency when we examine the law and economics arguments in the specific context of corporate governance, or more particularly, the widespread demands in the wake of the 1997 crisis for the reform of corporate governance toward accountability, transparency and openness. Here the authors leave the plane of ideal rule of law theory and merely argue on behalf of defending the interests of outside investors.

In a recent paper, LLSV define corporate governance as “a set of mechanisms through which outside investors protect themselves against expropriation by the insiders” (LLSV 2000: 1). This expropriation may take the form of transfer pricing, asset stripping, investor dilution and outright stealing, with the authors finding several practices that may be legal (like investor dilution) having the same effect as stealing. Once again they argue that common law countries offer the strongest protections for outside investors, having judges who base themselves on precedents “inspired by principles such as fiduciary duty or fairness.” Effective investor protection, according to LLSV, enhances savings and also channels these savings “into real investment.” Meanwhile the development of strong financial protection “allows capital to flow toward the more productive uses, and thus improve the efficiency of resource allocation” (p.16). Civil law countries, on the other hand, offer much weaker protection to outside investors, with laws made by legislatures rather than by judges looking at precedent.

Raghuram Rajan and Luigi Zingales criticize the work of LLSV for giving too much emphasis to legal origin as a key determinant for financial development. Rajan and Zingales’ time series empirical data show that paths of financial market development have not been linear, but instead show many fluctuations and departures in countries like the United States, France, Germany and Britain. For instance they note that France’s stock market capitalization

as a fraction of GDP was almost twice that of the United States in 1913, but then decreased to almost one fourth of the US figure by 1980, subsequently rising again so that the two countries seem to have converged by 1999 (Rajan and Zingales 2000: 4). The authors also cite work by Richard Tilly (1992) to show that “both the volume of total market issues, and the proportion of issuance consisting of equity, were greater in Germany in the beginning of the 20<sup>th</sup> century than they were in the UK.” The authors deny that legal or cultural factors determined the level of financial system development; rather, they see political factors such as the support by government and interest groups for financial institution growth as having determined the course of development.

This article raises the critical question of why people do not simply adopt legal systems that are good for financial development. The answer is that they do, and those choices are not related to common or civil law traditions:

With the exception of England, the most developed countries in the world had a similar level of financial market development in 1913. The differences in the legal system existed then also, suggesting that if they did not create differences in financial development then, we should not attribute differences in financial development between countries today solely to differences in legal system” (Rajan and Zingales 2000: 4).

The authors point out that whereas it took over a century and a half for the British common law system to work out something like the limited liability form to its satisfaction, a mere ten years were required for the French civil code to emulate it: “This explains the almost instant success of continental European Governments in promoting financial development” (p.8). In the end, what is critical is the will of the government to develop the financial market; hence financial reform may bear fruit more quickly in the more centralized governments of the civil law tradition than in the weaker governments associated with the common law tradition.

It is also true that civil law countries can learn from common law traditions, and vice versa. Katharina Pistor and Philip A. Wellons (1999: 139-141) argue that classifying countries according to the origin of their legal systems may ignore the fact that “investor protection developed in most countries only after the period of transplanting major legal systems,” and that much of that transplantation involved civil law countries adopting Anglo-American law. They argue that this was particularly true for Japan, the Republic of Korea, and Taipei, China. In other words here is a sequence of events that “defies a simple categorization of countries according to the origin of their legal systems for laws governing investor protection ... different economies use different combinations of substantive and procedural protection in their laws. These combinations are the result of repeated legal change that can hardly be traced to the origins of an economy’s legal system” (p.140).

Another example along these lines would be the fairly remarkable experience in Latin America, a region made up almost entirely of civil law tradition countries, of governments moving quickly toward market-oriented policies. As Paul Mahoney (1999) puts it, in the light of this experience it is important to recognize that “legal systems are endowments but not straitjackets.” Indeed, Mahoney thinks that market-oriented policies do not require changes in the legal traditions of given countries, so much as the emergence of new political leadership committed to change; effective leaders can not only implement new market-oriented measures, but can also change public opinion and, over time, the nature of legal practice itself. Mahoney’s point here is an important corrective to the historical determinism that lurks in the

law and economics school: that is, if you have a civil law tradition, should you just give up? What chance do leaders in civil-law countries really have to chart a new direction, given the enormous historical advantages (according to LLSV) of a common-law tradition? But Mahoney shows that adopting the principles of this tradition is much easier and quicker than one might think.

Much of my previous work has been concerned with identifying the specificities of “late” industrial development, as a way of asking the question, what difference does it make when a country industrializes in the middle of the 20<sup>th</sup> century, as opposed to the early 19<sup>th</sup> century (England) or the late 19<sup>th</sup> and early 20<sup>th</sup> century (Japan)? How do the requirements of industrial strategy, finance, and the role of the state differ, depending on when a country begins to industrialize? (Woo 1991). Without putting too fine a point on it, from this perspective it seems clear that a common law tradition is consonant with early industrial development, in which the private sector is much more active than the state in promoting industrialization, the time frame for industrialization is much more lengthy, and leaders do not have to worry so much about competition from countries that have already arrived at an advanced industrial status. This sequencing would also suggest that judges have the luxury of time to develop precedents on a case-by-case basis. The civil law tradition, to the contrary, is much more identified with “late” industrializers like Germany and Japan, in which the state became a resource to be deployed to hasten the process of development and to make up or substitute for various disadvantages, like the modest scale of private sector business or the middle class.

One of the “advantages of backwardness,” in the words of Alexander Gerschenkron, was the ability of late industrializers to copy the earlier industrializers, and often the state was the key institution engaged in doing that. But copying a machine is much easier than copying the theory and practice of a legal tradition that evolved over centuries, through the establishment and subsequent citation of precedent. It was thus far easier to write a code authorizing the desired economic behavior. The same applies even more strongly to countries engaged in the intense competition for industrial development in recent decades. The need for speed naturally prompts countries to make haste in adapting legal institutions, and those who deplore this process or say that haste makes waste need to tell us how it might have happened otherwise, that is, how a common law tradition based on a long historical evolution could quickly be spliced into effective day-to-day practice in the hot-house conditions of late 20<sup>th</sup> century development.

### **3. Law Tradition and Bankruptcy**

The law-and-economics theory comes to an acute point of conflict when we examine what the theory would say about how to handle the many bankruptcies that attended the 1997 financial crisis. On the one hand are the interests of outside investors, who cite the rule of law on behalf of creditor rights in hopes of retrieving their loans; on the other hand are the interests of governments and societies in minimizing the cost to domestic owners and workers of firms going bankrupt. A simple bankruptcy might enable outside investors to get a significant percentage of their investment out of the country; but that same bankruptcy may harm the social safety net embodied in widespread and consensual practices of lifetime employment (Japan), or it may harm social stability by throwing workers out of jobs, thus enhancing the bargaining power of labor unions vis-à-vis the government (Korea).

In a recent article by Claessens *et al.* (1999), we can find a good indication of the thinking of the Harvard group of law and economics theorists about bankruptcy. They

examine the use of bankruptcy procedures in Hong Kong, China; Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taipei, China, and Thailand, looking at their different institutional frameworks for resolving financial distress, which can then be partly attributed to “the different origins of their judicial systems.” One key difference among these countries turns out to be the strength of creditor rights: the authors write that bankruptcy is more likely to occur in countries with strong creditor rights and a good judicial system, perhaps because creditors are more likely to force a firm to file for bankruptcy. Ko-Young Tung (2000) also says that effective insolvency systems “are a fundamental building block of sustainable economic development.... Insolvency regimes operate within the framework of the wider legal system, including property rights, commercial and corporate laws, capital market laws, tax laws, and banking regulations.” In other words, bankruptcy law enters the same realm as other kinds of law and policy: it is good when it adheres to the rule of law, which is to say that the rights of outside investors will be protected. But bankruptcies have the wider consequence, especially in times of crisis, of dissolving an existing social contract and thereby threatening the stability of developing countries; those countries will therefore seek to balance their desire to retain foreign investment against their desire to maintain existing employment practices and norms.

In this light, a crisis like that of 1997 gives the state wide latitude to make or remake the economy depending on what kind of bankruptcy regime it has utilized, because particular kinds of bankruptcy law can shape entire national markets and restructure social practices. As Carruthers (forthcoming) argues, distributional consequences are at the heart of the political contention over bankruptcy law: the value to investors of having predictable and transparent bankruptcy laws and procedures clashes with the value of preserving the social compact between state and society. Sometimes protection of creditors may be critical, but sometimes it may not be the most important value: the state might have good reasons to protect other stakeholders, including the management, workers and customers of the enterprise in question.

Simple *liquidation* of an insolvent firm allows creditors to be repaid some portion of what they put in, but this means loss of jobs for the employees, the loss of a customer for suppliers, and may in the short run lead to higher unemployment and lower levels of economic activity, but a better payoff for highly ranked creditors. On the other hand various kinds of *reorganization* (sometimes called a “workout”) may require lenders, suppliers and workers to reduce the magnitude of their claims, but this route may be better for workers, managers, suppliers, shareholders, and the communities in which firms are based, even if the reorganization comes at the expense of secured creditors.

We can see how differing bankruptcy regimes affected the countries embroiled in the 1997 financial crisis. In Thailand, Carruthers argues, a combination of weak government and a senate filled with powerful debtors led to bankruptcy law being considerably weakened, and it remains difficult for creditors to enforce their claims over an insolvent firm. Here the problem seems to be the classic one of “crony capitalism,” resulting in many banks continuing to have (or to hide) non-performing loans. In Indonesia the government had appeared to emulate the so-called “London Rules,” but they were not actually put to much use. Prior to the crisis the bankruptcy law dated from 1906, deriving from Dutch law of an even more ancient vintage, offering various rather inadequate collection devices to creditors. Creditor rights thus turned out to be weakest in Indonesia; debtors simply could not be forced through the courts to pay their debts. In Korea, lending decisions were based on collateral and cross guarantees among subsidiaries within the big firms, but rarely were they based on good financial information. Unlike the United States, which offers different procedures under different chapters of one bankruptcy law, Korea had different laws for different procedures:



the **Bankruptcy Act** (for liquidations), the **Corporate Reorganization Act** (reorganization by court appointed receiver), and the **Composition Act** (reorganization while the management of the insolvent firm stays in control).

Quite apart from these different laws, Korea suffered (and continues to suffer) an acute conflict between the social and distributional consequences of firm dissolution, and the rights and demands of outside investors. In the recent well-publicized case of the dissolution of the Daewoo *chaebol*, the government had to balance the interests of outside investors (like Ford and General Motors), who wanted to take over Daewoo's automobile business but demanded the right to lay off workers, against the strength of Korea's auto unions, the fact that the President (Kim Dae Jung) counted them as part of his constituency, and the need to maintain both economic growth and social stability, both of which the strong unions could demolish if they chose to do so. The Korean case shows that a recourse to high-flown ideals of the rule of law, or briefs on behalf of the presumed rights of investors, may mask an elementary conflict over the best way to deal with insolvent firms amid demands both to reform the way things are done in Korea, and to continue Korea's strong economic growth over the past two years.

The Asian bankruptcy experience also raises questions about the very families of law that LLSV write about, because both Malaysia and India have a common law tradition, but the former has effective bankruptcy law and the latter does not. Meanwhile Japan, Korea and Taipei, China come from a civil law tradition, but both Korea and Taipei, China supplemented these laws with American bankruptcy practices that permit lenders to take broader security interests in personal property (Pistor and Wellons 1999: 159). The result is that we find profound differences within the same legal tradition, as well as considerable hybridity within some civil law regimes, yet neither seems necessarily to compromise effective performance. Japan, for instance, has long had a bankruptcy law based on French and German civil codes: this law, clearly expressed and interpreted by courts for upwards of a century, gives high priority to secured creditors, but a still higher priority to salaries owed to employees. Does this concern for the back wages of workers and the perceived social consequences of not maintaining a secure employment contract for workers grow out of Japan's civil law tradition, or out of its well-known practices and concerns about social stability?

We can develop this question in moral terms by asking what fundamental principle entitles creditors and their desire for stable and predictable economic transactions, to stronger protection under the law than the rights of workers, or the general right of a society to ensure stable and predictable occupations for its citizens? John Ohnesorge (1999) argues that the emphasis on corruption in the affected countries after the 1997 crisis was an attempt to substitute principles of law—or an objective foundation—for what in fact were very difficult questions of ethics that are by no means easily soluble. He examines this definition of corruption given by Vito Tanzi: corruption is “noncompliance with the principle of the arms length relationship, which states that personal or family relationship ought not to play a role in economic decisions by private economic agents or by government officials” (p.102). (The “arms-length relationship” is of course similar to North's theme of the “night watchman state.”) Ohnesorge argues that such a judgment cannot but be a political judgment, but the law and economics group tries to avoid that determination:

The Coaseian tradition, which teaches that in a world of transaction costs the allocation of property rights has economic implications, seems to evolve into a claim that because the allocation of rights has economic implications, it is non-political. The

tendency is to reduce every aspect of a legal/political system to an economic issue, ripe for technocratic intervention.. (p.104)

Ohnesorge goes on to argue that credit allocation in any society involves a great deal of informal interaction and consultation between government and business, or between law and the firm; it cannot be removed from the daily life of human give and take, and to call the practices of a different country “corrupt” is to add heavy normative overtones to the analytical problem of why ordinary practices of daily life exist and what might have brought them into being, and of course what might be done about them. Or as he puts it somewhat more bluntly:

What we call civil society is rife with non-arm’s length relationships and exchanges.... People living under oppressive governments survive by the “back door”... we should think about the consequences of insisting that these “back doors” be shut (p.107).

The above criticisms are not meant to gainsay the obvious virtues of arriving at a point where the rule of law and necessary standards of transparency and accountability hold sway; rather the critique points toward accepting diverse paths toward this ultimate goal—and recognizing that shortcuts may work and expedient instrumentalities (like state intervention) may function to achieve these important goals. There may also be a matter of simple realism: if the leopard can’t change his spots, why not use those “spots” to arrive at the point where the spots no longer have utility? It may even be that the end goal will not reflect a convergence around rule-of-law standards as accepted and practiced in the West, let alone just those of the common law countries; effective and transparent legal systems may emerge that amount to complex amalgams giving differential weight to the historical trajectories of different countries. Such systems, contrasting legal mosaics embodying past experience, may nonetheless function effectively to make markets work, to promote economic development, and to protect the rights of buyers and sellers of goods and services. This will become clearer as we examine the complexities of East Asian business.

#### **4. Three Worlds of East Asian Capitalism: Rethinking Trajectories for Reform**

East Asia is typically seen as the arena of *guanxi* (Chinese: personal relations) and other practices that short-circuit the rule of law. But most developing countries embody pervasive forms of what is sometimes called “informal legality.” The idea of informal legality is a familiar one in economic sociology, and in recent years a number of careful studies on “relational contracting” have juxtaposed their findings against the neoclassical theory stipulating that only legal contract enforcement can facilitate market exchange among strangers. Studies of informal legality show that various forms of personal trust (like the business reputation of a person or firm) can facilitate effective exchange relations. Modern diamond dealers (Bernstein 1992), Jewish merchants in medieval Europe (Greif 1989), and Chinese diaspora businesses of past and present (Winn 1994) have all relied on a variety of reputational bonds, customary business practices, and accepted arbitration proceedings to develop a set of rules and institutions that its participants find just as salutary for business as modern legal systems. Widespread use of personal trust and informal norms are cultural practices that reinforce and stabilize networks of human relationships, and while they may be seen as less desirable substitutes for formal legal systems, they may also be likened to an unwritten form of common law based on well-understood precedent. Informal legality may

also prevent or postpone system convergence toward plausible rule-of-law practices, but that does not necessarily mean that these systems cannot evolve toward effective norms of transparency and accountability.

For effective legal reforms to take root, they need to seek fertile ground in the differing cultures, formal and informal systems, institutional origins, and political, social and historical circumstances that the real world offers to us. In the case of East Asia there is not one “great tradition,” as a previous generation sought to argue, or a uniform set of norms and practices that can be summed up as “Asian values” (or pejoratively as “crony capitalism”), but three contrasting mosaics that result from differing state and legal traditions. Three types of modern rational-legal system exist in East Asia, offering different templates for reform and contrasting examples of pathways toward the transparent and predictable rule of law. We want to convey a sense of East Asia in *time* and *place*, and thus to understand the historical interplay of forces—historical, political, market, security—that have determined the structure of opportunity in East Asia, ensconcing particular amalgams of legal practice while launching different forms of development in a path-dependent manner. As we develop thumb-nail sketches of the different paradigms of development in East Asia, we will see that they also help us to think about the possibilities of legal and economic reform in the region, and enable us to recommend policies that are plausible and effective, but not driven by universal theories about separate and distinct legal traditions.

What does it mean to think about East Asia in time and place? First, it is to recognize that there is no such thing as an “Asian” model of development, not even an “East Asian” one—even though many analysts will lump free-market Hong Kong, China together with developmentalist Korea. East Asia is an enormously heterogeneous and diverse area, and cannot be reduced to a single model of trade or political economy. The World Bank’s ‘Miracle Report’ of 1993 recognized this divergence but preferred to place the differences on a continuum, such that Southeast Asia was perceived to be more liberal and open, and Northeast Asia less so—and the twain could meet when Northeast Asia and other developing countries moved closer to the Southeast Asian model. But what if—to paraphrase Macbeth—the Northeast Birnham Wood cannot move to the Southeast Dunsinane, because Korea and Japan have less in common with Thailand than with, say, Brazil?

### **(1) Northeast Asia**

The first paradigm is the one that is most familiar to us, and is found in three countries which formed the core of the prewar Japanese empire, and whose economic structures were tightly interwoven and articulated: Japan, Korea and Taipei,China. All three countries grow out of a long tradition of Chinese (or Confucian) statecraft and civil service, with bureaucrats of today having far more respect and prestige than their counterparts in the United Kingdom or the United States—something evident in the way the best universities send student cohorts into government or corporate bureaucracies, somewhat like the French educational system. Notwithstanding the great suffering that Japan inflicted on its former colonies, the postwar developmental trajectories of Korea and Taipei,China were heavily influenced by the models and policies that Japan imposed on them before World War II, or demonstrated to them in the 1950s and 1960s during Japan’s heyday of rapid export-led growth. Nothing succeeds like success, and thus Korea and Taipei,China absorbed lessons, advanced technologies, and capital from Japan, embarking on a similar trajectory of light-industrial exporting under multi-year plans, guided by strong state ministries (if less so in Taipei,China than in Korea). This gave all three economies a highly neo-mercantilist, nationalist tendency; it also meant

strong state intervention, combined in Japan and Korea with state promotion of big economic conglomerates—the prewar *zaibatsu* and postwar *keiretsu* in Japan and the *chaebol* in Korea (*chaebol* is the Korean pronunciation of *zaibatsu*). Legal practice in Northeast Asia is an historically inherited amalgam of Confucian statecraft modified by European civil law and, after 1945, American constitutional and common law. But because these three countries were important allies of the United States along the fault lines of the Cold War and the bipolar conflict with Moscow, the mutual security relationships that the United States had with them, combined with their status as “role models” of effective non-communist development, led the United States to overlook or indulge deviant economic behavior, and to be much less concerned than one might expect with inculcating American legal norms and practices—at least until 1997.

The Northeast Asian developmental paradigm served to industrialize all three countries, but by now the problems and diminishing returns of the paradigm are more obvious than the developmental successes of bygone days; indeed it may be hindering further development today, given the widespread anxiety and developmental quandary in Japan and Korea. Many analysts now see the once formidable bureaucratic structure of “administrative guidance” as an albatross, but one that Japanese and Korean leaders bear willingly, since they are used to it. The protectionism and hothouse incubation of Japanese industrial policy in the 1950s and 1960s gave way to free trade and deregulation in the 1980s. In this sense it is critical to understand that what we call “industrial policy” is contingent and relevant to particular stages of development, rather than set in stone to produce a political economy of just one type; furthermore what may look like a fossil left over from past practice can also spring to life as an instrument of contemporary reform.

What does this developmental paradigm have to do with law? From the 1880s onward Japan took its guidance less from Anglo-Saxon forms of economic development than from the continental experience, especially that of Bismarckian Germany; therefore Japanese leaders were also drawn to German legal institutions and civil law forms, rather than common law as practiced in Britain and the United States. If Adam Smith was the preeminent Anglo-American economic thinker, Friedrich List was the preeminent political economist for Germany and Japan. What became known as political science in the United States was less important to Japan than German “state science,” or science of the state (*staatswissenschaft*), a relatively unknown field in a country like the United States that did not even have a central (or federal) state worthy of the name until the 1930s (Cumings 1999). Even today it is not uncommon in Japan and Korea to find political theorists well versed in Hegel, while paying little attention to John Locke.

Chalmers Johnson (1982) argued that the “developmental states” of Northeast Asia were fundamentally different from the “regulatory states” of the post-New Deal United States or postwar Europe. Whereas the regulatory states were “procedurally oriented,” the developmental states were “outcome-oriented.” Where the former were guided by the rationality of market forces, the latter were “plan rational,” that is, effective planning and guidance often substituted for market signals, giving a long-term, futurist, and developmental perspective to the political economy and especially to industrial strategy. If the rule of law is fundamentally about the primacy of procedures, there may be a fundamental incompatibility between the Western notion of the rule of law, and the developmental states of Northeast Asia. This does not mean that Northeast Asia is lawless—merely that its highly rational and legal system of administration dances to a different drummer. Later on I will fill in this thumbnail sketch with a longer discussion of legal and administrative practice in Japan and Korea, and what it means for reform of their economies.

## **(2) Southeast Asia**

The second paradigm of the East Asian political economy may be found in Southeast Asia, which was (by and large) subject to Western colonialism. But it is a much less uniform region, with economic practices and legal regimes varying greatly by country. Singapore and Malaysia are the economic success stories of the region: they are very open to trade and investment, and have a common law tradition stemming from the era of British rule. However, this does not predict the emergence anytime soon of a “night watchman” state or the rule of law on the Western model. Singapore is a remarkable example of the rule of law operating in the economy within an authoritarian political system. Malaysia is the closest comparable political economy in the region to the Northeast Asian pattern, with sporadic use of a kind of administrative-guidance developmental paradigm, but it tried to remedy the 1997 crisis with a form of financial withdrawal, and historically has moved back and forth between democratic openness and one-man autocratic rule.

Viet Nam has a French colonial background, the influence of which lasted for three decades after 1945 in which warfare was the main national activity. In the past decade Viet Nam has mingled a socialist planned economy (Chalmers Johnson’s “plan irrational” system) with a growing market economy containing many small producers and businesses, while retaining high tariffs and a lack of transparency that comes close to opaque closure, especially in Hanoi where the Communist elite lives and where an impenetrable state bureaucracy gums up the works. Ho Chi Minh City, on the other hand, resembles a capitalist island in the socialist sea of Viet Nam, something reflected in the widespread tendency still to call it Saigon.

Indonesia used to experiment with industrial policy, preeminently in the national car program. However, these experiments did not enjoy broad domestic support, and after several years of rapid growth the economy nearly collapsed in the 1997 financial crisis amid a general collapse of the three-decade-old authoritarian political system built by the strongman Suharto. As yet neither the economic nor the political Humpty-Dumpty has been put back together. Today a shaky democracy functions alongside an economy that threatens to implode as often as it gives off signs of a return to the high growth of the later Suharto years, and the unity and integrity of this multi-ethnic nation has been under threat throughout the past decade.

Myanmar emerged from British colonialism with the most productive agrarian economy in the region. It was tipped to be a postwar developmental star but turned to a reasonably well functioning but blindly protectionist form of state socialism for many years after independence. Under the more recent rule of the military it has become the North Korea of the Southeast Asian region, reinventing the 1960s in terms of military dictatorship and protectionism, amid a failed economy.

Thailand is the only country in the region never to have been colonized, and before 1997 had grown so rapidly as to be called a new “tiger,” albeit without many of the developmentalist stripes worn by Korea and Taipei,China.

The countries of the region do not have the history of domestic manufacturing that developed indigenously in Japan and was successfully replicated in Korea and Taipei,China. This lack of manufacturing experience renders Southeast Asian countries more dependent on multi-national corporations for their industrial development, but has also created important niche positions for their producers in the world economy. Southeast Asian leaders believe that the best national production strategy is involvement in a cross-national division of labor, maximizing comparative advantages in existing or self-created niches. Accordingly they have

embraced a rich variety of policies to make their business environment attractive to multinationals, as part of a broader strategy to develop domestic capacity—meaning opening domestic markets and easing restrictions specified in trade and investment laws. The Southeast Asian environment is one of fierce competition for investment, and government restrictions on multinationals risk pushing these important investors to locate elsewhere. Far more characteristic of the Southeast Asian regional paradigm is the central role played by cross-national production networks, involving domestic and international firms and producers. Japanese, US, Taipei Chinese, Hong Kong, Korean, and European multinational corporations combine with the ubiquitous overseas Chinese firms to establish multiple, partially overlapping or competing cross-border networks.

A long history of western colonialism, the dearth of neo-mercantile or nationalist manufacturing experience, the absence (except in Viet Nam) of a long tradition of Chinese-style statecraft and civil service, and general openness to multinationals, might lead one to expect that these countries would adopt Western legal systems. One might also expect that Western concepts of the rule of law, left behind as colonial legacies or learned through common practice since 1945, would have the general influence on economic activity predicted by neoclassical economic theory (or the law-and-economics school). In fact, however, far from developing a legal system with the power to restrain the state, or a market economy guided by the (mostly) hidden hand of a night watchman or “impartial third party,” these countries have often done exactly the opposite.

The most extreme examples would be Myanmar, long under every kind of British influence, and the Philippines, the only American colony (from 1899 to 1946). Unlike its neighbor India, there is exceedingly little evidence that Myanmar’s colonial common-law tradition had any impact on the country’s post-independence politics and economics; and any lingering influence has certainly disappeared with the onslaught of military dictatorship in recent years. In the Philippines, the persistence of a small landholding elite (in a Latin American *latifundia* pattern) all through the colonial period and down to the present, combined with the absence of a strong state and civil service tradition, conspires to create what Paul Hutchcroft (1998) has dubbed “booty capitalism.” There is little separation between the enterprise and the household and large family holdings dominate the wealth of the country, creating patron-client politics and classic “back-door” opportunities for enrichment through favorable access to the state machinery. The most enduring division is that of the “ins” versus the “outs” in a zero-sum game of enrichment through political office, while a powerful but still quite small business class extracts privilege from a largely incoherent bureaucracy. It all goes on as if the American colonial experience (however similar it may or may not have been to Lockean liberalism and the rule of law) had never existed.

The general sociological tendency in the Southeast Asian region after independence was for upwardly-mobile “natives” to claim positions in the political realm (state bureaucracies, military organs, the police), while those with tested entrepreneurial skills were excluded, most often on ethnic grounds. These were usually people of Chinese ancestry who would put up with being relegated to the private commercial sector—but only so long as their position was protected by native political power. The overseas Chinese were thus the “real domestic motor” of the Southeast Asian “miracle,” but today their role and their presence varies across the region, and the politics of this racial division works differently in different countries. The truest generalization is that Chinese enterprises have found ways to thrive in highly adverse political and ethnic circumstances, have found opportunities in the unlikeliest places, and have turned adversity into advantage with no textbook formula to guide them.

Unlike industrial leaders in Korea or Japan who have stuck with one big idea (industrial policy), Chinese “pariah” capitalists have quickly adapted themselves to policy decisions made by alien ethnic elites, who have just one critical advantage over the Chinese: they hold state power, and thus can undo even the wealthiest Chinese business. Chinese businesses have thrived in all milieus: under protectionist *and* liberal political economies, under democratic *and* authoritarian regimes, under civil law *and* common law traditions. But here is not the place to look for finely-honed patterns of legal nicety; in truth the real conundrum is how Chinese business manages to do as well as it does without legal protections that would be thought minimally necessary in the West.

Close study will show that this form of business enterprise depends precisely on the mechanisms of “informal legality” that we discussed above: personal trust, familial bonds, company reputation, and the particular *lingua franca* known as Cantonese, all combining to produce a heritage of economic organization through clan lineage and linguistic-group networks. In this diasporic Chinese community law *does* play a significant role: often it is the common-law or civil-law legal structure of the countries they operate in, which Chinese businesses can master as well as anyone else (as their successes in Hong Kong, Canada, and the United States demonstrate). But more often it is the “common law” of long-established precedent practiced by a more fundamental source of social organization—complex, fluid, highly contextual networks of human relations. Pierre Bourdieu calls this “symbolic capital,” meaning productive capacity accumulated in the form of authority, knowledge, reputation, or personal relationships, which may be converted to the kind of “capital assets” recognized by economists. No matter what one calls it, however, this Southeast Asian form of diasporic Chinese firm has been the ubiquitous agent of economic growth in the region. It is a business form that remains most difficult to assimilate to the theories and assumptions of the law-and-economics school.

### **(3) People’s Republic of China**

When we turn from Chinese business to PRC itself, we find not an East Asian or Chinese paradigm of political economy, but instead the complex interaction of the paradigms that we have been discussing. PRC has a rapidly evolving system with multiple sources of influence in its current political economy.

It is possible to look at one part of the PRC mosaic in the past decade—the role of the state, the big firms, and the stupendous growth in exporting—and decide that the overwhelming influence on PRC is indeed our first paradigm, Japanese and Korean developmentalism, which clearly is much admired by the Communist Party leadership. PRC is quite frankly pursuing the latest version of the theory of the developmental state, a theory American economists have trouble understanding but that makes sense to Asians as diverse as former Japanese Prime Minister Kishi Nobusuke, Chiang Kai-shek, Park Chung Hee, Lee Kwan Yew and Deng Xiaoping. An apparent “moderate,” former Premier Zhao Ziyang personally sponsored a campaign in the late 1980s for something he called “the new authoritarianism,” as did economic reformer (and now Premier) Zhu Rongji; this campaign took Korea and Taipei, China as a model, arguing that both of them showed how an echelon of technocrats under strong state guidance could transform a backward economy through financial subsidies, cheap state credits, and successive multi-year economic plans. As Zhao put it, “the major point of the theory is that the modernization of backward countries inevitably passes through a phase ... centered on strong, authoritarian leaders who serve as the

motivating force for change.” Chinese analysts point to Samuel Huntington's theory that a period of political instability can be expected as per capita GNP moves from \$300 to \$4,000, but that beyond this level instability will end—and therefore so will Communist Party rule (or so some analysts hope).

But the Japan-Korea model is just one important influence on PRC. A second influence is the historically recurrent geographic track of PRC's early industrialization, which relied on manufacturing and commerce in coastal areas and so-called “treaty ports,” fueled by investment by foreigners and overseas Chinese. In 1984 Deng Xiaoping proudly toured PRC's “Special Economic Zones,” which were described as “golden triangles” of development that would accompany the “golden necklace” of fifteen cities centered on Tianjin, the industrial city near Beijing. These places were, in his words, windows “to technology, management, knowledge, and foreign strategies.... the special zones will become the foundation for opening up to the outside world.” In the past two decades the influence of the old treaty ports has only deepened, and indeed the old Shanghai “bund,” once dominated by foreign firms and built to look like a European city, is again flourishing as the epicenter of Chinese and foreign investment. Such port cities, which Harvard sinologist John Fairbank analyzed in his first book, also have a golden appeal to huge numbers of Chinese from the global diaspora, who gladly take major risks to invest in these booming cities—given the windfall profits to be made. This part of the Chinese political economy resembles the Southeast Asian pattern that we have already discussed, the second political economy paradigm, with an even larger number of diasporic Chinese firms at work.

PRC has a continental geography, of course, being similar in size to the United States, and this also makes PRC very different from Japan and Korea, or the Southeast Asian countries. The reach of economic development in the past 20 years has not been great, and the burgeoning middle class lives mostly in the coastal fringe. Meanwhile a vast interior hinterland is much poorer, and includes both the vast majority population of subsistence peasants, and some far western regions barely integrated with the state. PRC can thus be called an industrialized country, if we look at the coastal zones and port cities; a developing country, if we look at the wealthier provinces of the interior; and a Third World country if we focus on the peasant majority and the poorest regions.

The third influence on PRC's political economy is an overwhelming one, but one that everyone in the West either forgets, or wants to hasten to its grave as fast as possible: the heavy-industry strategies of state socialism since 1949, the greatest “plan-irrational” political experiment in the world, in which very large and now obsolescent factories and enterprises (usually called SOEs or state-owned enterprises) became the ubiquitous employer of a blue-collar work force numbering in the hundreds of millions. While it may be that these workers pretended to work and the state pretended to pay them, in the old communist adage, the fact remains that the state sector is still huge and still plays an important welfare role: PRC's SOEs are like company towns, providing housing, health care, education, and retirement pensions in a cradle-to-grave social security system often called PRC's “iron rice bowl.” The state sector has been shrinking rapidly in recent years, as economic growth has created new jobs that can absorb discharged workers; it is often said that PRC's economy must grow by at least seven per cent per year if this absorption strategy is to be successful. But the state sector remains large, and the many hard-line communists who head up the SOEs work a kind of dead-hand-of-the-past influence or drag on PRC's leaders.

Just as the political economy of PRC is an interesting combination of the two other East Asian developmental paradigms added onto fifty years of state socialism, so too do PRC's legal influences reflect these combinations. PRC's legal tradition is the oldest of any



enduring political system in the world, rivaling that of Roman law in its historical importance and lasting influence. Imperial Chinese law combined a detailed set of administrative regulations with elaborate proscriptions and punishments. It was “a highly rational procedural system with heavy emphasis on confession, coerced if necessary. Although legislated rules did reflect the norms of various ethical or social philosophies, especially those influenced by China’s familial orientations and Confucianist beliefs, the idea of law remained purely secular without any claim to deistic origin” (Merryman *et al.* 1994: 406).

Traditional Chinese law differed radically from law in the West, however, in the absence of any conception of “the private ordering by law.” Indeed it might be the exact opposite of the night-watchman state, in that there was no provision for a “comprehensive corpus of legal principles, rules, and categories designed to govern private relationships and to be enforced within a remedial system of rights and duties through formal adjudicatory processes subject to the initiative and control of litigants” (p.406). Instead, to the extent that there were any rudimentary “rights” of property or contract, they appeared informally as creatures of custom and practice sprouting up in the interstices of administrative law. An example would be the informal role of so-called “pettifoggers” in PRC’s villages, intermediaries who would reconcile conflicts over property or commerce between contending family groups. Enforcement of such customary rights and privileges, however, “was left largely to extralegal remedies and sanctions applied by community, guild, or family...”(p.406). Finally, of course, anything remotely resembling an impersonal “rule of law” was subordinate to the long-established practice of rule by moral example, in which the scholar-official class and Confucian education played the greatest role. Social control of the common people was accomplished by very detailed administrative codes of right and wrong, and widespread exemplary justice in which punishments were designed to make a point, or to cow the public. Thus in PRC today it is still common to see the state carrying out public executions of miscreants convicted of various anti-social crimes.

PRC’s 20<sup>th</sup> century law has been subject to an amalgam of foreign influences. Some influence has come from those who have ruled over parts of PRC—for example British common law courts in Shanghai before 1945, or the civil law that Japan used to rule the Northeast (or Manchuria) from 1931 to 1945, in the context of rapid industrial development programs that left the Northeast as the regional motor of PRC’s industrial development in the 1950s and 1960s. These have combined with other practices of countries that have influenced PRC, like the huge impact of Soviet law since 1949, or the marked impact of American commercial law since Deng Xiaoping’s “opening” in 1978. Examples of the latter have included joint venture laws and regulations with regard to profit remission, labor provision, business contracts, patents, trademarks, and copyrights, etc., demanded by foreign multinationals for their own protection, along with new laws that developed as PRC property and business was privatized. The 1990s saw the creation of new laws, including ones designed to protect consumers and the environment, and to better secure commercial transactions amid burgeoning corruption scandals that ran into billions of dollars. But today it is still the case that PRC does not provide a legal environment similar to that in Europe or the United States, and state and party officials are still subject to few legal constraints.

So, what can we conclude from this quick tour through the various regional political economic paradigms in East Asia, with attendant observations about the forms of law one might expect to find in each case? The first point is to underscore the importance of looking beyond the formal legal structure, to informal and catch-as-catch-can legal improvisations that nonetheless make it possible for commercial life to flourish—a phenomenon that “Communist” PRC has become remarkably expert in since 1978. A second point is the need

to be sensitive to the complicated mosaics of legal history and practice that can be found across East Asia: this is a region that cannot be neatly classified according to any established legal tradition, and it seems particularly futile to search for any neat connection linking Western law inculcated under colonialism to present legal practice.

A regional perspective like this goes a long way toward providing us with *realistic* parameters for change. It allows us to shed the strait-jacket of thinking about change in terms of breaking with a Procrustean past or *status quo* (which may not really exist anywhere in the commercially bustling parts of East and Southeast Asia, where constant flux is the dominant tendency), and allows us to be creative in finding ways to graft onto East Asian legal practice the rule-of-law dictums embedded in the neo-liberal, Anglo-American model of law and economics. To think through how we might fruitfully do that, we can now turn to examining the most influential type of *informal legality* in East Asia, the main tool of industrial policy in Japan and Korea: administrative guidance.

### **5. Japan: Informality, Administrative Guidance, and “Rule-by-Law”**

It is a curiosity that Japan endured first an unconditional surrender and then a seven-year occupation (1945-52) by the standard-bearer of the rule of law, the United States, and yet law was more important in Japan before 1945 than it was in the long period of rapid growth that ensued after the Occupation ended. A civil law code modeled on German examples played a significant role in the eighty years of Imperial Japan after the Meiji Restoration in 1868, but with the advent of the postwar democracy came a “relative shrinkage of the legal sector” (Upham forthcoming). As Japan became a model of postwar industrial growth, formal legal institutions played at best a back-up role to informal mechanisms, especially the well-known state practice of administrative guidance. Or as Upham puts it, “economic policy was discussed, formed, and implemented largely through informal mechanisms that were consciously shielded from the interference of the formal legal system ....” The courts were relatively inactive, citizens rarely brought actions to them on behalf of individual rights or privileges, and consumer protection was minimal, at least through lawsuits brought to the courts. “Intervention by the courts in the implementation of economic policy on behalf of private parties,” was rare to the point of non-existence. Foreign firms were on the outside looking in on policy formation, of course, and had little recourse to the courts to protect their interests (Upham forthcoming).

Obviously the Japanese system worked to promote economic growth, so how did it do that without following, say, the World Bank criteria of transparency, openness, and arms-length adjudication of disputes, as described by the former General Counsel of the Bank, Ibrahim F. I. Shihata (1991)? First, the actors involved in policy implementation were stable institutions staffed by dedicated and competent private and public bureaucrats; second, there were pervasive and institutionalized means of communication between the public and private sectors; third, there was relatively little corruption in the public sector; and last, the legal system did impose distinct outer limits on the flexibility and arrogance of the insiders. As Upham lists these qualities, he also notes that Japan probably cannot be a model for the developing world because these practices are too unique to Japan (Upham forthcoming). At the same time, however, he also thinks that the World Bank criteria themselves draw primarily upon the experience of a unique political economy, namely, that of the United States.

As we have seen, a political science deriving from Lockean liberal assumptions never took root in Japan; instead early Japanese legal and constitutional scholars drew upon the

“state science” of Germany—and not just Germany, but the homeland of conservative reaction, Prussia. The Meiji Constitution of 1889 was modeled on the Prussian example, and constituted “a compromise between absolute monarchy and modern democracy” (Hashimoto 1963: 239). Hashimoto continues:

The Meiji Constitution adopted to some extent the Continental notion of the *Rechtsstaatsprinzip* (to be distinguished from the Anglo-American concept of the rule of law) ... [but] the formal or structural component of the *Rechtsstaatsprinzip* requires that administrative power be exercised in accordance with laws enacted by the legislature. This principle of legality ... is deemed essential to modern government.... [But in the Meiji Constitution] the principle was narrowly limited .... In the first place, the executive retained broad independent power to make substantive laws.... In the second place, delegation of broad legislative power to the executive was accepted and so widely practiced that the principle of legality could not serve to check administrative power.... Furthermore, remedies against illegal administrative action were extremely limited in prewar Japan... A basic principle of the Anglo-American idea of the rule of law is that one whose legal rights have been invaded by administrative action may challenge its legality in a court of justice. But the Meiji Constitution established instead an Administrative Court with a narrowly restricted jurisdiction to review the legality of administrative action... Administrative law in prewar Japan was thus based on the existence of a special law for cases involving the administration and of a special court to decide them. (Hashimoto 1963: 240).

Japan thus became a country of civil law, with one scholar attributing this largely to “the historical accident” that common law could not easily be emulated or copied: “Had Sheldon Amos’ civil code for England become a reality, Japan might have had a common-law-inspired civil code, and the subsequent course of her legal development might have been entirely different” (Takayanagi 1963: 37).

The new constitution adopted under the American occupation was not only modeled on Western precedents, but was even written mostly by Americans. One of its major advances was to abolish the administrative court and introduce the Anglo-American system of judicial review. Did that have the effect of grafting a system of common law onto the Japanese experience of civil law? Some scholars argue that the predictable did indeed happen: that Japanese law thereafter developed in the direction of American law, and that in spite of the vast differences in historical, political, economic, and social backgrounds of Japan and the United States, the postwar system has steadily been “proving its fitness,” with case law and precedent developing rapidly (Hashimoto 1963: 271). Or as another scholar puts it, the old practice of “rule by law” (*hōchishugi*) gave way after 1945 to the “rule of law” (*hō no shihai*) (Takayanagi 1963: 14).

Most others, however, do not think that postwar Japanese legal practice has ever come very close to resembling the Anglo-American system. Indeed, the translation of the above terms is quite revealing. In Japan and Korea *hōchishugi* (the phrase is pronounced *popch’ichuui* in Korean) does not carry the negative connotation that in the West would be attributed to the phrase “rule by law,” and this is not a matter of poor translation. Instead the phrase bespeaks the difficulty of translating or conveying liberal conceptions in a statist society; even the term “liberal” developed the connotation in Japan and Korea of conservatism (e.g., the ruling Liberal Democratic Party in Japan is not liberal, as this term is

understood in the United States), so the distinction may also be lost between the (liberal) “rule of law” and the (illiberal) “rule by law.” Or as a legal scholar puts this point,

[In] the introduction of rules and principles of common-law origin ... it is quite natural that those rules and principles were interpreted by Japanese jurists according to the civilian [i.e. civil law] methods in which they were experts. If one compares commentaries on the Philippine constitution with those on the new Japanese constitution, he will be surprised at the striking difference in the mode of exposition and interpretation, even in cases in which the constitutional text is exactly the same...” (Takayanagi 1963: 37)

Nor did the Japanese adoption of American-inspired law make people more litigious, as one might expect; instead they were far less litigious than citizens in any other advanced-industrial country, and even less litigious than they had been before 1945. The average civil litigation rate for 1892-1940 was 146,683 (or 26.8 per million people), whereas the average for 1950-1990 was 176,211 (or 16.6 per million people); in 1962, litigation per million people had not yet come back to the level achieved in 1916 (Pistor and Wellons 1999: 230). Thus the ubiquitous lawyer jokes that Americans love are inexplicable in Japan (“What do you call 10,000 lawyers found on the bottom of the ocean? A good start,” etc., etc.). This experience calls into question the cross-border applicability of the arguments made by LLSV and others of the law-and-economics school. That is: have law (but), won’t travel.

Instead postwar Japan preferred administrative action to litigious reaction, and even though the 1946 Constitution required that administration be based on legislation coming out of the Diet, in fact the Diet merely set general guidelines and then authorized the bureaucracy to flesh out the rules, which gave bureaucrats substantial discretion in practice. Constitutional legality receded as administrative guidance (AG) proceeded, a practice that we can usefully define as giving broad discretion to the bureaucracy to make, interpret, and enforce detailed rules of economic behavior. Or as the most famous analyst of this practice put it, administrative guidance

... refers to the authority of the government, contained in the laws establishing the various ministries, to issue directives (*shiji*), requests (*yodo*), warnings (*keikoku*), suggestions (*kankoku*), and encouragements (*kansho*) to the enterprises or clients within a particular ministry’s jurisdiction. Administrative guidance is constrained only by the requirement that the “guidees” must come under a given governmental organ’s jurisdiction, and although it is not based on any explicit law, it cannot violate the law (for example, it is not supposed to violate the Antimonopoly Law). (Johnson 1982: 265)

Not only was administrative discretion very broad, but powerful ministries, preeminently the former Ministry of Finance (MOF), got away with dusting off interwar laws dealing with financial regulation (especially the control of foreign exchange and cross-border financial flows), thus allowing the MOF to change policy by prewar ordinance if not by fiat. The MOF thus based its control over the financial sector on the Banking Act of 1928 and the Foreign Exchange Control Act of 1933 (Pistor and Wellons 1999: 92-93, 98). The Republic of Korea likewise often based postwar economic regulation on prewar (Japanese) law.

It is, of course, possible to overemphasize the degree to which AG held sway in postwar Japan. John Haley reminds us that many analysts have missed the degree to which

administrative guidance reflected the needs and demands of those being “guided;” often, business firms were in control. Or as he put it,

The predominance of administrative guidance as a regulatory form for government intervention in the economy—that is, the process itself as distinguished from the content of any particular policy—has helped to preserve a competitive market economy by maximizing the freedom of individual firms over economic decisions although behind the veil of pervasive government direction (Haley 1986: 108).

However critical Haley may be of what he sees as the overemphasis on AG by Chalmers Johnson and others, his understanding of the process still reinforces its essential informality:

Administrative guidance is descriptive of a process for implementing public policies as distinguished from the policy itself. With few, if any, exceptions it is defined quite simply as advice or direction by government officials carried out voluntarily by the respondents. By definition it involves neither formal legal action nor direct legal coercion. Compliance is thus voluntary in the narrow legal sense (p.109).

If the role of the MOF, MITI, and the reliance on prewar laws was mitigated by the atmosphere of reform and deregulation in the 1980s, and if administrative guidance seems at best vestigial in the year 2001, that probably happened because of the ineffectiveness of state direction in an era of information-age industries and technologies, not because someone in Tokyo finally saw the common-law light. Indeed, substantial legal scholarship by Michael Young has shown how, even in the atmosphere of change and deregulation in the 1980s, with judges using procedures of judicial review to try to confine AG to carefully-defined purposes, judges did not seek to eliminate AG in favor of an ideal vision of the rule of law, but instead sought a balance between the good that came from administrative flexibility, and the bad that came from excessive bureaucratic intrusion. Courts refused to determine the priority of competing claims of rights, as an American judge would do; in this they sought to protect individual rights without sacrificing the flexibility that AG provided. They were more concerned with bringing AG into line with an informal social consensus than with conforming to legal procedure or abstract legal principle, as might have happened in a common law system. Rather than giving priority to one side’s view, as in an adversarial legal system, the courts have been reluctant to state their position and have preferred to rely on societal consensus and informal agreement between the involved parties (Young 1984: 923-25, 965-67, 977). Of course AG was itself an informal system, and so the remedies for the abuses of administrative guidance also had to be informal.

## **6. Have Law, Will Travel: Korea**

One dramatic case of international or cross-border learning is the Republic of Korea, where administrative guidance remains the primary tool used by the state to intervene in the economy, something that Koreans learned under Japanese imperial tutelage before 1945, but also through emulation of Japan’s postwar industrial prowess. In Korea, however, there may have been a kind of *over*-learning, since the use of administrative guidance is far more pervasive than in Japan, and in two important ways goes to unheard of lengths: first, administrative guidance is not just the province of state ministries, but can be issued directly

by the president through the relevant ministries and agencies, in an executive-dominant political system where the president has far more power than in Japan's parliamentary democracy. Second, the informalities of AG in Japan, limited by formal mechanisms of judicial review and shaped by a prior consensus, give way in Korea to AG almost by fiat. Extensive consultations do not necessarily precede administrative guidance, and judicial review was non-existent during the decades of dictatorship and remains weak under the democratic governments of the past decade. Befitting Korea's long authoritarian legacy and its extraordinary history of centralizing everything in the capital (far more so than in Japan) and then concentrating that authority in the hands of the chief executive, administrative guidance is far more uneven and abrupt and less consensual, resembling a coercive demand more than informal guidance. This is so despite the fact that on paper Korea's administrative laws clearly call for AG to go through proper legal procedures, and not to involve coercion.

Perhaps because of Korea's authoritarian history and the reams of regulations and formal procedures that powerful executives have made into so much confetti, the literature on law in Korea is not only extremely slim, but is less rarefied and takes in a much larger social or political perspective than law literature usually does in other countries. While most bookstores have shelves groaning with books on law, these books explain and interpret very narrow forms of law (for example on export controls and the like), mostly for the consumption of students in legal studies. Let us have a look at just how weak the judiciary has been in Korea, and just how intrusive and arbitrary the state can be in its interventions in the market.

The well-known legal scholar Sang-Hyun Song (a respected law professor at Seoul National University), said that Korea's judges were less like august interpreters of constitutional intent than dependent factotums; at best they were "distinguished bureaucrats" and at worst "expert clerks." In other words they were essentially powerless civil servants, mostly incapable of exerting influence on the political system. Given that the administration of justice had virtually no bearing on governmental and political life, their real sphere of influence and action was in civil and commercial matters where their expertise was needed to adjudicate conflicts among private parties and to rule upon the application of criminal laws. Here the power brokers felt no need for or interest in interference (unless a friend needed a helping hand), so the judges could have their little realm of autonomy. Given the bureaucratic nature of the judicial system, which exercised its own effect on the basic lack of judicial creativity that all observers noted, and given the judges' lack of power even to interpret (let alone create) law, the basic requirements for a judge were to be technically competent, inveterately apolitical, risk averse, and preternaturally quiet (Song 1996a: 300-302).

Real change can come—and has come—to Korea's judiciary only from outside forces. Scholars like Joon-Hyung Hong (1999) argue that with democratization in the wider society has come the primary impetus for change, and in recent years there has been a lot of it—to the degree that the ideals behind Western conceptions of "rule of law" have become widely accepted. Since the national protest mobilization of June 1987, which ousted dictator Chun Doo Hwan, civil society has advanced rapidly and a proliferation of new laws has done much to democratize the judicial sphere: reform of government fiat under the Administrative Procedure Act (APA), opening of politics through the Freedom of Information Act and the Information Protection Act, devolution of power from the center under the Local Autonomy Law, and the development of case law through the (finally) vitalized law-finding activities of the courts. Like Lazarus the Supreme Court and the Constitutional Court sprang to life, trading rigor mortis for habeus corpus and discovering an utterly unaccustomed penchant for judicial review and a theretofore invisible activism in examining the constitutionality of laws.

Hong attributes this newfound judicial determination to the demands and pressures from an invigorated popular sphere, especially for good governance having both a better quality of performance and clear adherence to the principle of the rule of law. A major factor has been pressure from citizens, often in the form of suits filed against public authorities demanding that they do what the letter of the law has long instructed them to do – something unheard of under the dictators, even though all Korean constitutions going back to 1948 look liberal on paper. This pressure helped bring about the court reorganization of 1994, the establishment of the Administrative Court in 1998, and more recent reform measures that add up to a newly-invigorated judicial function in Korea. The significance of these gains cannot be underestimated, since for forty years Korean judges and government officials themselves often felt unconstrained by the very laws that they were called upon to implement, there having been so little force in the concept of “legal right” in Korean law practice. Even when there was evidence of good judicial intervention—or justice in the best sense—it rested upon “common sense,” “good will,” or the judge’s “benevolence”—but not the “rights” of the individual (Song 1996b: 1246).

Administrative guidance had been ubiquitous in Korea going back to the 1960s, of course, but its very breadth of activity made defining it quite difficult. Thus Song wrote that there is

... no clear definition of administrative guidance. It is generally understood that the Korean government will exert its authority under regulatory and criminal laws to provide protection or to prevent violations.... The Korean government has exercised and still exercises wide regulation over the Korean business community. Such control is possible as a result of the government’s authority to grant business licenses, and its direct or indirect influence on financing [with respect to] the specific industry. Furthermore, suggestions or requests from the government that a company act or refrain from acting in a particular way are generally honored by businesses. Therefore, administrative guidance may be effective.... (Song 1996b: 1249)

If the utility of AG to Korea’s rulers was so broad as to make defining its sphere rather difficult, the infamous mid-1980s case of the Kukje conglomerate can tell us what Korean-style AG actually felt like, through most of the years of its use by authoritarian governments.

By the mid-1980s Kukje was a typical Korean diversified conglomerate, making everything from jogging shoes to aluminum smelting plants, from automobile tires to farm tools. Its subsidiaries engaged in general construction, steel making, paper mills, shipbuilding, and the construction of tourist resorts. To keep these far-flung ventures going, Yang Chung Mo, Kukje’s founder and owner, had been contributing around \$700,000 annually to Chun Doo Hwan’s coffers, a yawning maw that subsequently turned out to hold billions of dollars in political funds. Although the owner’s son kept telling him that Kukje’s political contributions were deemed insufficient to keep Chun happy, the owner refused to increase the payoffs. To cut a long story short, in May 1985 the Chun government decided that it had had enough of Mr. Yang’s insolence and its Finance Minister instructed Kukje’s main bank to initiate and implement a dissolution plan, sharing out its factories among several other firms. For good measure it also dispossessed Mr. Yang of his personal fortune, sending him running for the cover of Los Angeles. As Mark Clifford put it, there was “no due process, no bidding for assets, only a multimillion-dollar takeover operation shrouded in secrecy” (Clifford 1994: 218-19).

Mr. Yang sued in both the United States and Korea to get his firm and his property back, but nothing could be done until Chun and his successor (and close friend) Roh Tae Woo were finally removed from power. A court finally ruled on the Kukje case in 1993, and the late legal scholar James West summarized the points made by this court in a ruling that offered a revealing glimpse into the development of rule-of-law terminology in the early 1990s and into previous practices of administrative guidance, which bordered on the pure executive fiat of the state. The Constitutional Court ruled the dissolution of Kukje illegal on the following grounds:

- Paternalistic intervention by the state, which may paralyze the autonomous problem-solving capacities of enterprises and impede their adaptation to the market economy, does not comport with Article 119 of the Constitution... However good the cause [for intervention], there must be legal grounds for limiting the rights of citizens and imposing duties upon them, and the same is true in the case of intervention into the management of an enterprise ...
- The legally groundless exercise of state power in this case not only infringed the requirement of a process based upon law, but also [the fact] that the person exercising power was lacking in authority contravened the prohibition on arbitrariness, which derives from the guarantee of equal protection of the laws in Article 11 of the Constitution.
- Democracy as a product of human wisdom has its primary concern in respecting the means and process, not merely in achieving certain ends. A measure ignoring the due process of law, an arbitrary act, which is nothing but an abuse of state power, cannot be upheld as constitutional. Everyone is equal before the law. The president, the Minister of Finance and other public functionaries are all subject to the rule of law. This, as well, is the way to a society where legal security and predictability are guaranteed. (West 1998: 321-351).

What is the legal basis for administrative guidance in Korea? When the president or other executive organs of the state intervene into the private sphere of civil society and commerce, the legal basis of such intervention must be knowable in advance by the subjects of such regulation. In a constitutional order, such state action is subject to public scrutiny and if necessary, to legal challenge. The legitimate use of AG is stated in Article 119(2) of the ROK Constitution:

The state may regulate and coordinate economic affairs in order to maintain the balanced growth and stability of the national economy, to ensure proper distribution of income, to prevent the domination of the market and the abuse of economic power, and to democratize the economy through harmony among the economic agents.

In truth, however, administrative guidance was complex, opaque and often legally irregular. Discipline was imposed through explicit regulations, tacit threats of unfavorable treatment in the future, intimidating use of punitive tax audits, and sometimes by cynical abuse of the criminal justice system (p.328).

What happens when these provisions are used for the good of the country and to accord with the new 1990s concepts of the rule of law, instead of being a mere means to punish and dispossess a political enemy of the president, as in the Kukje case?

In contrast to its diminished status in Japan, administrative guidance is alive and well in Korea—even if under a democratic government, and even if its uses today are often to



correct the abuses of yesterday. Kim Dae Jung came to power in February 1998 as a result of the first truly important political and democratic transition in Korean history (the ruling party in its various transmogrifications having held power since 1961), he proceeded to use this informal mechanism of state interventionism to bring about the rule of law, Korean-style. The “rules of law” that Kim wants to champion in the economic sphere are: creating transparency in corporate governance; reducing excessive reliance on the banking system for capital; improving the financial structure of the conglomerates (cozy and shady financial arrangements having been both the daily-life norm and the corrupt nexus between the state and big business); separating ownership from management; giving labor a voice at the bargaining table; and improving minority shareholder rights.

The best symbol of how administrative guidance went from stoking the Korean industrial economy to reforming it, in the process saving flagship firms from their own worst selves as the entire economy teetered on the brink of bankruptcy, is the “Big Deal” industrial reorganization of 1998 which proposed to find the comparative industrial advantage of each conglomerate and then demand that the firms stick to it. Thus Samsung would do electronics but give up making cars, Daewoo would make cars but forget about shipbuilding, Hyundai would make ships and cars, Lucky-Goldstar would get its nose out of semi-conductors, and so on. The end goal was to reduce over-investment by shrinking the number of firms in a given industry, thus forcing firms to focus on their “core competence” after years of excess, redundant diversification. Kim’s reforms sought both to preserve the perceived comparative advantage of Korea’s *chaebol* in world markets, and to break the nexus of state and corporate power, which had been sustained by capital provided by the government to the big firms in the form of huge, state-mediated, preferentially-priced loans, something that had long been the distinguishing characteristic of the Korean model of development.

In January 1998, even before Kim Dae Jung was inaugurated but under the prodding of the International Monetary Fund (IMF) for serious reform of Korean economic practice, the president-elect met with conglomerate leaders and concluded a major agreement on five key principles of the corporate reform that became known as the “Big Deal.” These were: increased corporate transparency, elimination of cross debt-guarantees by firm subsidiaries, improvement of the capital structure of the firms (a euphemism for the big firms no longer depending on the government for loans), the above-mentioned concentration on core competence areas, and strengthened cooperation with small and medium-sized enterprises. The Big Deal was agreed upon quickly, but implementing it took the rest of 1998, and a particular sticking point was the state’s demand that Lucky-Goldstar (now known simply as LG) give up semi-conductor production. LG, quite predictably, could not see much difference between what Kim Dae Jung wanted to do to it, and what Chun had done to Kukje. If the legality of the Big Deal becomes an issue, as some expect it to be after Kim Dae Jung’s term expires, the contention will likely evolve around the interpretation of administrative guidance, especially its limits under the rule of law. It had not been okay for Chun Doo Hwan to disabuse Mr. Yang of his investment and property in Kukje because this went beyond the realm of friendly advice and voluntary compliance. Was it okay for Kim Dae Jung’s government to use AG to decide which corporations should produce what products?

In attempting to reform corporate governance in Korea in the current milieu, where civil society is active and quite strong, the state has had to find a balance between democratic activists (often holding the same values that elsewhere might be called neoliberal, such as adherence to the rule of law) and the undemocratic status quo, which is deeply shaped by informal practices (like AG) that gave great power to the state and carry correspondingly little expectation that ordinary people can make any difference in the way the state and the

big firms operate. For instance, activist groups like The People's Solidarity for Participatory Democracy have been demanding instant reforms to introduce mandatory cumulative voting in corporate appointments (a tool used by minority corporate shareholders to elect their preferred directors) and the introduction of class-action lawsuits into corporate law. In response, the government announced that it could not introduce the practice of cumulative voting immediately, and pledged that class action lawsuits would be introduced gradually. It is still unclear, though, whether corporations will actually implement new voting procedures giving small stockholders a voice, and the government fears that if it were immediately to approve class-action lawsuits, the courts would be flooded with petitioners.

In short, in the worst of times Korean administrative guidance has been destructive of the rule of law, involving outright expropriation of property in the name of industrial reorganization (or just punishing someone who was stingy with political funds, as we saw in the Kukje case), such that Adam Smith's hidden hand materialized as an all too conspicuous mailed fist; in ordinary times it has been the mundane, informal instrument of an intrusive executive power. But does that necessarily negate the value of administrative guidance, which in the best of times has been the core architectonic force behind Korea's rapid industrialization?

In the empyrean of the Hayekian rule of law, administrative guidance should be (at best) no more than the handmaiden of an arm's-length, disinterested third-party justice, and even then it would be better if it simply did the right thing and abolished itself. But perhaps the Japanese precedents we surveyed earlier provide a more realistic roadmap toward how real-world AG can morph into a useful practice constrained by an evolving and ever-stronger form of judicial review or, as in the Korean case, by an energized populace. In any case this is more realistic than to hope that this manifest, blatant, unambiguously domineering "hand" will sign its death warrant and disappear gently into that good night. The alternative of a delayed and dilated euthanasia for Korean administrative guidance looks even better when we grasp that in the aftermath of the 1997 crisis it did in fact become an effective mechanism of reform, the intrusive arm of government that propelled financial restructuring, cleaned up corporate governance, and got economic growth back on track. Perhaps now we can look forward to administrative guidance in Korea finding a way to prepare its own deathbed.

## **7. Malaysia: Common Law "Looks East"**

Malaysia is a fascinating case to compare to Korea and Japan, however briefly, given that it long had a more liberal market and a state based on British common law tradition that was less interventionist than Japan's (let alone Korea's), yet under its leader Mahathir Mohamed it developed the aspiration to be more like Japan and Korea (during the so-called "Look East" strategy), failing in that effort and damaging its own common-law based constitution in the process. How did it do so, and what happened to its British common law tradition? The simple answer is that Mahathir expanded the power of the state and used it first to hamstring and then to compromise the judiciary. Law did not appear to be the "proxy" for the state or the determinant of the state-market nexus as LLSV would claim, but quickly fell away before the advance of a powerful state.

The legal basis of pre-colonial Malaya was customary and Islamic law, but it had a far longer period of exposure to British or common law than did many colonies, as British control lasted from 1874 to 1957. The post-independence legal system consisted basically of British law and some elements of Islamic law, which reflected the ethnic balance between Chinese businessmen and other non-Islamic groups, and the majority Malays who believe in

Islam. Existing laws and statutory and judicial precedents bear the indelible marks of British common law and equity and what the colonial judges thought was just, fair, reasonable and equitable. The 1957 federal constitution was drawn up by British parliamentary draftsmen, broadly based on the Westminster parliamentary model. The judiciary and the entire judicial process operated and are still operating under the profound influence of British common law and equity, judicial precedents, principles, ideas and concepts. Even today veneration of the views, observations and comments of British judges is a prominent feature of Malaysian court decisions. The polity had a number of major democratic features, such as regular elections contested by independent parties, a parliament to which the government is responsive, and a constitutionally independent judiciary (Biddle and Milor 1999: 11). If the organized bar was small, countervailing legal efforts to control the government's growing power were rule-based. Administrative law, as interpreted by the courts, provided rudimentary controls over the government; judicial independence was high; and judges were career appointees and not at that time part of the political majority.

Despite the trappings of democracy, though, the actual limitations on democratic process were numerous. When a twelve-year state of emergency, originally announced to fight a communist insurgency, ended in 1960, the government implemented an Internal Security Act (ISA) allowing detention without trial. Following racial riots in 1969, and a temporary suspension of parliament, authoritarian controls were expanded. The ISA and other government measures, such as the Sedition Act and the Official Secrets Act, continued to hamper the exercise of democratic political rights, especially free expression. But these limitations on Malaysia's democracy were not fatal, and until the 1980s most observers applauded the functioning of its democratic system. The same was true of the economic system, formed in a common-law incubator.

As the Malaysian economy began to take off in the 1960s laws and legal procedures were "market-allocative" and rule-based. In this period the procedures reflected a rights-based approach to internal government controls, and laws provided for the regulation of various professions (accounting, architecture, engineering, and so on). There was also a mix of state and market-allocative laws to support the government's economic strategy. After the "Look East" policy began in 1981, however, abuses of public office grew, and the legal system was used extensively to implement policy. More laws conferring discretionary powers on the executive were adopted than in any previous time since Malaysian independence; "a common feature of this legislation was the confiding of exclusive discretionary power upon the Minister to make decisions ... it was coupled with a right to enact subsidiary legislation to better administer the statute and also carried the ubiquitous finality clause that made his decisions final and conclusive with no right of review" (Das 1981: 2).

The Malaysian state frankly adopted the Japanese and Korean model, choosing the same trade-off between economic growth and democracy characteristic of Park Chung Hee's Korea. The policy was anti-Western, and more especially, anti-British. Prime Minister Mahathir pursued an interventionist strategy partially modeled on Korea's Heavy and Chemical Industries industrial policy of the early 1970s (often called "the Big Push"), involving close collaboration between the government and big business. At the same time, however, the Malaysia Inc. policy was if anything even more encompassing, with collaborative relations envisioned between public and private sectors in all sectors of the economy, between the differently-placed racial groups, and at the state as well as federal levels. What was "Malaysia Inc" supposed to look like? Let us get it straight from the horse's mouth. In 1984 Mahathir said, "the Malaysia Incorporated concept means close and mutually supportive cooperation between the public and private sectors.... The private sector must

understand national policies, objectives and procedures in order to facilitate their dealings with the Government. They must appreciate that regulations and procedures are not meant to frustrate them but are in fact a means of ensuring orderliness in commerce and industry.... The service sections of the Government, the policy and lawmakers, have a duty to ensure that no undue hindrance is put in the way of the private sector,” etc (Biddle and Milor 1999: 15).

The Malaysian government established HICOM (Heavy Industries Corporation of Malaysia) to diversify manufacturing activity, increase local linkages, and generate local technological capacity. HICOM, however, suffered significant financial losses, and these, combined with a deterioration in the terms of trade (fueled by drops in world prices for major Malaysian export commodities such as petroleum and palm oil) and increasing external debt, alongside a slump in external demand for primary commodities and electronics and curtailed demand for steel, cement and cars, occasioned a recession lasting from late 1984 until 1987. As a consequence, Malaysia experienced negative growth rates, and investment, both public and private, dropped precipitously. In other words Malaysia tried to be Korea and it all ended in an embarrassing and massive failure, the “correct” or predicted outcome for rule-of-law believers attributable, among other things, to crashingly bad timing. Many of the firms the state sponsored proved to be inefficient, usually due to cronyism, but also because there were simply too many competing firms in the region (Pillay 2000: 209).

But the economic failure did not stop Mahathir from decisively defeating judicial activism, at the hands of the executive; basically the independence of the judiciary was destroyed in a few years in the late 1980s. Let us trace this back a little bit. Previously Article 4(1) of the Constitution had proclaimed the Constitution to be supreme, and borrowing from the US model, allocated certain powers, including judicial review, to the Malaysian courts. Judicial review was also one of the five pillars of the national ideology, called the *Rukunegara*: “The rule of law is ensured by the existence of an independent judiciary with powers to pronounce on the constitutionality and legality or otherwise of executive acts” (Milne and Mauzy 1999: 46).

The year preceding the crippling of the judiciary saw a great deal of judicial activism, with a number of important decisions going against the government. For example, in 1986 the judiciary upheld a challenge against a government expulsion order against a foreign journalist; in 1987 it granted *habeas corpus* to an ISA detainee; but the upshot of this judicial activism (or resistance) was that Mahathir, who had encountered no resistance in the cabinet or the Parliament, felt that he faced resistance only from the judiciary—and so judicial independence had to go. Mahathir got much assistance from the Parliament, which passed the Federal Constitution (Amendment) Act of 1988, removing the powers of the judiciary from the Constitution, deeming instead that they would be conferred by parliament through statutory decree. By this Act, the Courts were summarily stripped of the power of judicial review previously granted in the Constitution (Milne and Mauzy 1999: 47).

Observers were understandably shocked that the whole judicial system could so easily be transformed, but Mahathir claimed that he was merely guarding the prerogatives of the legislature to ‘develop the law’...” Or as Mahathir told *Time* magazine: “If we find out that a Court always throws us out on its interpretation, if it interprets contrary to why we made the law, then we will have to find a way of producing a law that will have to be interpreted according to our wish” (quoted in Khoo 1995: 288). In general, laws that at first blush seemed to undergird the power of the judiciary and to enshrine various checks and balances, over time were used to entrench the executive’s power. The legislature, which should have been a main source of resistance to Mahathir’s rule, turned out to be the handmaiden of his will in demolishing the power of the courts and removing even as lip service the

constitution's protection for judicial review. Rule making by the executive expanded as its economic activism spread, despite the significant growth in the number of lawyers in the economy—there were almost 6,000 advocates and solicitors in the country by the end of 1995 (Pistor and Wellons 1999: 91).

In short, there is precious little in the Malaysian case to suggest that the heritage of common law, a carefully-crafted democratic constitution, or several decades of human experience with the workings of the rule of law, offered much of an obstacle to an authoritarian reworking of the system. It seems that Korea, moving out of its authoritarian path even as it uses the mechanisms of state intervention to do so, comes much closer to democracy and to an effective form of the rule of law than does Malaysia, which is going in the opposite direction. In any event neither the Korean nor the Malaysian case offers much support for the idea that learning how to act according to the ideal of disinterested third-party rule enforcement will ever be a simple or easy process of hearkening to the scholars and then acting accordingly.

## **8. Conclusion: The Right Institutions**

The concern with law and economic governance is part and parcel of the “second generation reform,” which in the words of the President of the World Bank, James Wolfensohn (1999), refers to “the structure of the right institutions, of the improvement of the administrative, legal, and regulatory functions of the state, addressing the incentives and actions that are required to have private sector development and to develop the institutional capacity for reforms...” First generation reform had focused on macroeconomic policies designed to make markets work more efficiently—“pricing, exchange rate and interest rate reforms, tax and expenditure reforms and the establishment of rudimentary market institutions” (Camdessus 1999)—but with the second wave the very structure of law and government, that is, *politics* came to the fore.

The 1997 financial crisis was the real-world disaster that opened up many developing countries to the ministrations of neo-liberal reformers, and it is clear that the World Bank, in particular, has high hopes for the contribution of second-generation reforms to economic growth—even to the point of mathematical estimates of how much of projected real GDP growth in East Asia for 2000-2010 might be attributable to better institutions. Thus the World Bank estimates that for 2002-2010, Korea will grow by 4.5% to 6.5%, out of which a good 2% would be the result of a 20% improvement in institutions and policies; Malaysia will grow by 6 to 8%, out of which again 2% will have been attributable to institutional reform (*Asiaweek* 2000: 53). It doesn't require genius to see that this would of course be the way that economists would think about the problem: a quantifier for “the rule of law” becomes the multiplier for economic growth.

One does wonder where such calculations come from, however; given that Korea grew much faster than anyone had predicted in 1999 and 2000, would I be right to say that 3% of the 10% growth in 1999 came from enhanced transparency, or from the Kim Dae Jung government wielding administrative guidance to reform banks and the corporate sector? It is far from clear how such quantitative judgments can rightfully be made, but I do wish to say that the mathematical and micro-economic training that economists get in our universities may not be the best route to thinking through complex issues of how governmental institutions can be changed to contribute more to the generation of wealth. As a political scientist, this is where I wanted to make my contribution in this paper.

I have argued that this new emphasis on rule of law, conceived as an elixir for developing and transitional countries, cannot solve the vexing problems of politics and development. However admirable in its intentions, the new World Bank perspective draws on a peculiarly Anglo-American discourse and experience, generalizing on the basis of a set of governmental institutions that are themselves anomalous survivors in the 21<sup>st</sup> century—this state form that Samuel Huntington once called the “Tudor polity” (Huntington 1968). As the *Federalist Papers* long ago noted, the point of this state form was to disperse and confine political power, to divide it into three branches of government that would check and balance each other, to have the legislators keep an eye on the executive, the local states corral and confine the central government, and the judges watch them all. It was a form of politics suitable to an agrarian economy of yeoman farmers, and as that economy slowly became urban and industrial, no less a personage than Thomas Jefferson condemned this transformation in the name of the pastoral ideals that underlay his conception of American governance. That was more than 200 years ago, of course, and for the past 150 years the central problem has not been how to *restrain* power, but how to *create* it in the first place. Ever since, the problem of good governance has been how to comprehend and deal with the large bureaucratic central states that emerged in the context of industrialization—either to further the growth of industry, as in Germany and Japan, or to reign in the excesses of industrial capitalism, as in the American New Deal.

I think the real problem—the actually-existing practical conundrum of good *policy*—is how to find effective tools to realize the substance of arm’s-length, third-party governance in the existing context of strong states that may not be “the right institutions,” but happen to be the ones we have to work with in the real world. We have to find ways to achieve the admirable goals of transparency, accountability and disinterested justice without expecting to mimic a set of institutions developed in the tranquil, bucolic ambience of the 18<sup>th</sup> century. Often this will be a matter of creatively utilizing those “wrong institutions” that were the sources of past developmental success, like the heritage of administrative guidance that I have focused on in this paper. As the contemporary Korean case makes clear, tools of strong state intervention can be an effective expedient to achieve the goals of second-generation reform. Kim Dae Jung has wielded these tools against the big banks and the big *chaebol*, but has also used the state to reform the state (as with the increasing effectiveness of judicial review and prosecutorial activism), and has used the people (in the form of new citizens’ groups) to pressure the state, all in the name of reform.

My arguments were qualitative and not quantitative, but other scholars have used quantitative methods to arrive at similar conclusions: Kevin Davis and Michael Trebilcock (1999), in a study conducted for the World Bank, argue that there is little evidence of a causal relationship between law and economic development; that empirical studies of the relationship between growth and law do not point to causality. Davis and Trebilcock scrutinized the economic impact of property rights, including “titling,” “privatization,” “alienability” and “land redistribution,” concluding that it is difficult to say that clear property rights lead to positive economic benefits. They obtained the same inconclusive results in examining the economic impact of contract laws, taxation law, criminal law, social welfare legislation, human rights, family law, and the like. The more daunting challenge, they think, is to enhance “the quality of institutions charged with the responsibility of enacting laws and regulations” (p.9), and that exclusive or predominant emphasis on the court system inappropriately discounts the important role played by government departments and agencies. Both of these points support my arguments about working within the existing governmental systems to increase the influence of the rule of law.

My paper has pointed to the need to rethink the role of the state in economic reform. It supports the central points of work by Jean-Philippe Platteau (1994), who has argued that strong states are often required to *create* the rule of law, or that in the absence of appropriate private-sector moral or legal norms, a strong state is needed to support economic exchange. State intervention can alter social norms and correct “trust failure,” in his view. My study of the East Asian countries—Korea in particular—shows how better economic governance can be mandated, if not coerced, by the state (in countries with strong state traditions), albeit through means that are informal and discretionary. A second point follows from the first, namely, that legal and institutional reform has to be moored in local experience and know-how—preferably with the help of an energized citizenry. Again Korea shows how the mobilization of state tools to reform the political economy can be helped by pressure coming from outside, through new participatory political institutions that also help to aggregate local knowledge and thereby help build better institutions.

This forum might not be the ideal venue for the presentation of my ideas, since the Asian Development Bank has produced an account (Pistor and Wellons 1999) which might be a legal brief for the relationship between law and economic development, arguing for an increasing *convergence* of law and legal institutions in Asia, moving away from the state-centric and discretionary system, toward a market- and rule-based system. The editors of this ADB volume argue that the factors bringing this happy result about were economic development, political convergence, and globalization. I think that this argument about convergence tends to conform with the a priori assumptions that people hold, thus becoming a kind of self-fulfilling prophecy. In fact I think that much of the time people talk about convergence, it is not really about the convergence of actual law or legal systems, but about a converging consensus in ideology. In other words what has changed in the past decade may be in the realm of politics and ideology, not law and economic development. To put it bluntly, the developing countries today are being asked to do what the communist countries were expected to do a decade ago, which is to give up their bad old ways and manufacture not simply a liberal political system, but the liberal values that underpin those systems. Surely, therefore, they cannot be blamed for taking shortcuts on the path toward “the right institutions.” An American baseball sage named Yogi Berra once opined that when you come to a fork in the road, you should just take it. The developing countries of East Asia hit that fork in the road in 1997, and then took it—according to their own past and their own institutions.

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