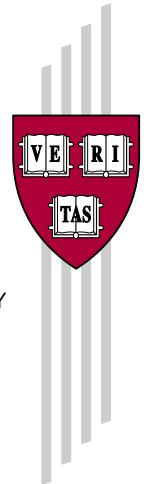


UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT



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G-24 Discussion Paper Series

The Standardization of Law and Its Effect on Developing Economies

Katharina Pistor

No. 4, June 2000

**UNITED NATIONS CONFERENCE ON
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G-24 Discussion Paper Series

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



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PREFACE

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

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

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

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

THE STANDARDIZATION OF LAW AND ITS EFFECT ON DEVELOPING ECONOMIES

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G-24 Discussion Paper No. 4

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Abstract

A widely used tool in law and development programmes is the supply of well-designed laws from the outside. This method of law development has now been embraced by international organizations as a way to improve the legal framework for global markets. The International Monetary Fund (IMF) has endorsed attempts by various organizations to develop legal standards with special emphasis on corporate and financial institution laws. The common idea behind these attempts is that the supplied laws once incorporated into domestic legal systems will improve the existing legal framework, and thus further economic development. This paper takes issue with this concept of law development. It argues that for developing effective legal systems, the contents of the supplied laws is of only secondary importance to the process of law development and the compatibility of the new laws with pre-existing conditions, including existing legislation and legal institutions. Three factors account for this: (i) only a few rules are freestanding, i.e. can be fully understood and enforced without reference to other legal terms and concepts; (ii) law is a cognitive institution, and the application and enforcement of rules is determined by the perception of new rules by users and enforcers in the receiving country; and (iii) effective law enforcement is a function of the extent of voluntary compliance and available resources in a given country. A closer analysis of the rules whose standardization is currently proposed for building an international financial architecture shows that the implementation of these standards and their effectuation will require more efforts by the law receiving countries than underwriting them, if the goals of standardizing the law are to be achieved. The paper discusses the implications for countries wishing to attract foreign investments by adopting the new standards, and makes some proposals for creating more effective legal systems in the area of financial law.

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THE STANDARDIZATION OF LAW AND ITS EFFECT ON DEVELOPING ECONOMIES*

Katharina Pistor

I. Introduction

The integration of markets has gone hand in hand with a proliferation of efforts to harmonize key aspects of the law relating to finance and trade. Following the recent financial crises in Asia, Russia, and parts of Latin America, the International Monetary Fund has embarked on improving the international financial architecture, with special emphasis on the legal framework for corporate finance and corporate governance.

The vehicle for building the legal architecture for global markets is the harmonization of law around the globe by way of developing legal standards.¹ These standards may be incorporated into international conventions, bilateral treaties, or retain the non-binding form of recommendations. The expectation is that standardization will accelerate the process of legal convergence, with the double ben-

duce transaction costs and to benefit from economies of scale, but to improve domestic legal institutions.³

The paper takes issue with this approach to reforming domestic legal systems. The proposed standards often do not hold what they promise, as will be further discussed in chapter VI. More importantly, the paper questions the assumption that legal harmonization will result in improvement of legal institutions. It argues that the quest for developing an optimal set of legal rules ignores a central feature of successful economic development, namely the constant change, innovation, and adaptation of institutions and organizations in a competitive environment. The standardization of “best practice” or “efficient” law replaces the Schumpeterian process of “creative destruction” with the ideal of the “perfect construction” of law. Instead of improving domestic legal systems, standardization or harmonization may in fact undermine the development of effective legal systems. The reason for this can be found in two essential features

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