



# Democracy and the Rule of Law

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## Theme Report: Business, Economy and the Rule of Law



“Lack of transparency is not an accident; it is a deliberate act.”

**Joseph Stiglitz**, Nobel Prize Laureate in Economic Sciences and Professor, Columbia University

Three panels of distinguished economists and politicians debated the problems associated with the enforcement of the rule of law and the impact of the legal framework on economic growth and financial markets. The discussions focused primarily on the issues surrounding international regulation, economic performance, the ongoing financial crisis and transition economies.

### A Need for “Smart” Regulation

There was overall consensus among the panelists of the necessity of the rule of law for fostering economic growth and avoiding economic adversity. “The actions of the big banks have the potential to bring down the system,” said **Robert Hahn** (Director of Economics, Smith School of Enterprise and the Environment, Oxford University), who supported the rationale for regulation. **Hassan Cisse** (Deputy General Counsel, Knowledge and Research, The World Bank) spoke from the perspective of an international organization and maintained the need to restrict, to some extent, the liberties of individual countries through regulation.

Citing many examples of regulatory failure, the panelists were nevertheless cautious about the methods of enforcing the rule of law and stressed the importance of “clever regulation”. “What kind of rule of law?” asked each participant. “There are very serious problems of enforcing and monitoring,” stated Robert Hahn; enforcement may not always achieve its intended objective. For example, with regard to the reserve requirements for banks in order to increase the stability of financial markets, regulators must think very carefully how to maximize, rather than counteract, the intended effects of regulation. “The

bank sector may become safer (through extensive regulation) but it will be less attractive to investors and more costly for clients,” said **Zdeněk Tůma** (Former Governor, Czech National Bank, KPMG). Enforcement, stated Mr. Cisse, must enhance “participation, transparency and accountability,” these principles were also echoed by Professor **Joseph Stiglitz** (Nobel Prize Laureate in Economic Sciences, Professor, Columbia University). The rule of law should not inhibit but foster economic growth; the main task of the regulators is to understand risk.

### The Rule of Law and Economic Performance

In discussing the rule of law in the context of global economic performance, Professor Stiglitz focused on the role of institutions in the economy and on poverty reduction. He cautioned that “what works in one context (country) may not work in another”. Introduced effectively, property rights, which are a key pillar of the rule of law, may improve the well-being of the poor. However, he also stated, that well-defined property rights “are neither a necessary nor sufficient condition” to guarantee the accomplishment of economic growth and poverty reduction. China, for example, has had a record of strong economic growth while not having well-defined property rights. “Maybe they (China) would have done better if they had better property rights,” he asserted.

Professor Stiglitz also advocated caution when introducing microcredit schemes, one of the most powerful instruments for promoting growth and poverty reduction. In Bangladesh, the scheme has had enormous success in eliminating poverty. However, in countries where people are dependent on the harvest, where the weather is more variable and there is no adequate social protection, the unlimited collateralization of land can lead to impoverishment. Professor Stiglitz discussed the common tendency to formalize the rules of law, stating that formalization can harm the economy if formal laws are in conflict with traditions and informal norms.

### The Financial Crisis and the Rule of Law

**Hernando de Soto** (President of Peru’s Institute for Liberty and Democracy) attributed the current financial crisis to a lack of transparency and accurate recording in financial systems. Prof. Stiglitz agreed with Mr. de Soto emphasizing: “lack of transparency is not an accident, it is a deliberate act.” A non-transpar-



ent market allows financial institutions to provide asymmetric information thereby removing the element of competition. However, most debt contracts were created under terms of the rule of law and were transparent; the collapse of the financial system was the result of the complexity of the relationships between contracts. Both economists agreed that the current financial crisis had clearly demonstrated that the financial system protects bankers and shareholders but not the taxpayer. When information is not accessible and actual, the rule of law is violated and the economy is at risk, asserted Mr. de Soto. “We might be facing another economic meltdown and this will not be a financial problem, but a problem of the violation of property rights,” he remarked. Both economists proposed the creation of an international financial regulator and a reorganization of the legal framework as vital measures that must be implemented to avoid another financial collapse.

The issue of transparency was never far from the agenda during the discussions. Hassane Cisse stressed that transparency was a key ingredient for enhancing the accountability of international organizations when dealing with global problems. There has been no accounting for the USD 700 trillion which has disappeared from balance sheets, and Mr. de Soto criticized the West for allowing such a vast sum to be left untraceable. Developed nations have found ways around the rule of law by ignoring transparency, manipulating their available resources and using other legitimate actions to avoid accountability, he explained. Developing nations will no longer be able to base their decisions and transactions on “informal contracts”.

Zdeněk Tůma indicated that the future will see a shift of power towards authorities, as regulators will need to enforce law and order to ensure transparency. Joseph Stiglitz again asked the question: “It is not an objection to the rule of law, but to what kind of rule of law?”

### Impact of the Rule of Law on Transition Economies

In the context of transition economies, **Kenneth W. Dam** (Professor of Law Emeritus and Senior Lecturer, University of Chicago) emphasized the need to focus on comparative law and on particular fields of law, rather than on the rule of law in general. Criticizing the econometric approach to relations between these countries’ legal systems and economic performance, he demonstrated the complexity of the problem. He cited the example of China and was echoed by **Gérard Roland** (Professor of Economics, University of



California, Berkeley) who asserted that China is a “unique” exception where the rule of law is not a major element of its economic boom. Referring to Professor Stiglitz’s belief that the bankruptcy laws that supported the Russian economic system during the crisis could have saved the economy in the USA, Mr. Dam queried the extent to which such particular laws had made any difference.

Commenting on Russian politics and business, **Boris Nemtsov** (Russian Politician and Opposition Leader) offered various examples to demonstrate that “the main problem with Russia is the absence of the rule of law.” He referred to “the dictatorship of the law” in his country. Explaining why the system is cultivated by Western business, he stated: “If you want to be successful in big business, you need to know influential people in the Kremlin”.

Gérard Roland outlined the relationship between the rule of law and the successful transition of Central and Eastern European (CEE) countries. He attributed the success of Central Europe’s transition in comparison with Eastern European countries to the stronger institutions which were the result of EU accession requirements and the more active development of civil society. He noted that CEE countries were “lucky” to be the closest neighbors of the major European powers and that this had contributed to their early accession. The period preceding EU accession had fostered institutional reform in these countries and stronger enforcement of the rule of law. It was initially carried out with great enthusiasm. Nevertheless, Mr. Roland concluded that subsequently, EU membership had resulted in the radical deceleration of developments in the new member states: “When you enter the EU you have a carrot, but you don’t have a stick”.



## Business, Economy and the Rule of Law Theme Speakers

**Jiří Bárta**, Executive Director, Via Foundation, Czech Republic; **Hassane Cisse**, Deputy General Counsel, Knowledge and Research, The World Bank, Senegal; **Kenneth W. Dam**, Professor of Law Emeritus and Senior Lecturer, University of Chicago, USA; **Hernando de Soto**, President, Institute for Liberty and Democracy, Peru; **Vladimír Dlouhý**, Economist, International Advisor, Goldman Sachs, Czech Republic; **Robert Hahn**, Director of Economics, Smith School of Enterprise and the Environment, Oxford University, United Kingdom; **Jerry Hirsch**, Philanthropist, Chairman and Founder, The Lodestar Foundation, USA; **Karel Janeček**, Mathematician, CEO, RSJ Algorithmic Trading, Czech Republic; **Hana Lešnarová**, Member, Corporate Council, Forum 2000 Foundation, Associate Director, Control Risks Deutschland, Germany/Czech Republic; **Boris Nemtsov**, Politician and Opposition Leader, Russia; **Gérard Roland**, Professor of Economics, University of California, Berkeley, USA; **Stephanie Shirley**, British Government's Founding Ambassador for Philanthropy, United Kingdom; **Joseph Stiglitz**, Nobel Prize Laureate in Economic Sciences, Professor, Columbia University, USA; **Zdeněk Tůma**, Former Governor, Czech National Bank, KPMG, Czech Republic

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### Published by:

Forum 2000 Foundation  
Pohorelec 6, 118 00 Prague 1, Czech Republic  
secretariat@forum2000.cz  
www.forum2000.cz

### Prepared by:

Oldřich Černý, Jakub Klepal, Lasha Lanchava, Eleanor Hammond, Boris Kaliský, Tereza Šritrová

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