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The Rule of Law, Legal Traditions, and Economic Growth in East Asia

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Abstract

This paper examines the literature on the rule of law and economic development, and in particular the influential argument by La Porta et al., on the superiority of the Anglo-American common law system in fostering financial development. In this paper I show that however compelling their argument might be, legal traditions and institutions do not determine the nature of the state, nor its likely role in the economy—nor do they critically determine the course of economic development. I build my case by examining the real and *informal* mechanisms of state intervention in the economy in East Asia.

Keywords: law, economic growth, East Asia

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This UNU-WIDER research project is an attempt to open up the academic debate on the role of institutions in economic development, to include the very real ways in which people, under different historical constraints, devise ways to organize their social and economic lives. It is an attempt to discover, then, the hidden rationalities in social behavior that may look irrational and even reprehensible from the perspective of the reigning economic orthodoxy regarding institutions of growth, but which may have their own methods to madness in propelling growth.

This paper is concerned with the rule of law, types of law, and economic development. While the rule of law is widely thought to go hand in hand with economic development, international financial institutions (barred through their charters from any political interference in member countries) have largely eschewed exploring the relationship between law and politics—until quite recently. But economic theorists who write on law have always had their eyes cocked on the state and its power. F.A. Hayek defined the rule of law as an understanding that government in all its actions is bound by the rules fixed and announced before hand, preventing it from stultifying the individual efforts by ad hoc action (1944, 1972: 72).

This Hayekian insight has not been lost to a group of economists who have taken the argument about the rule of law to an extreme: different legal traditions have different thumb prints of the state, and the legal tradition that bears the least imprint is the one mostly likely to promote economic growth. More specifically, the argument was that a common law tradition, which arose at arms-length to the state, was more likely to promote economic development. By the same token, the civil law tradition, which abets the power of the state, was more likely to privilege state intervention in economic processes, and hence less growth-promoting.

In this paper I will argue that however compelling this argument may be, legal traditions and institutions do not determine the nature of the state (although they may be reflected in it), nor its likely role in the economy—nor do they critically determine the course of economic development. 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.

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. In particular I will examine the influential argument by La Porta et al., 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 (often understood to be synonymous with economic 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.

I will first argue that these mechanisms of state intervention in the economy (*Gyosei shido* in Japanese and its direct transliteration, *Haengjŏng Chido* in Korea) were highly *informal* mechanisms which had at best a tangential relationship to formal law or law traditions, and thus this experience contradicts the argument that it is the structure of formal 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.

Second, I will also show that the process of *reform* itself has developed out of the same pre-existing 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. More importantly perhaps, I will argue that administrative guidance bears little relationship to either a civil law or a common law background. This experience of state action that was simultaneously heavy-handed and successful, may therefore illustrate that rapid economic reform in a developing society will bear fruit most quickly and effectively in countries already having a more centralised and powerful government, with the trick being to direct that state toward a commitment to economic growth.

Common law and civil law

Douglass 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 adapt a role sometimes called that of a 'night watchman state' (North 1981; 1990). 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.

A more detailed argument for the virtues of a common law tradition comes from Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishney (hereafter LLSV). Through an empirical study of the determinants of quality government in a large cross-section of countries, the authors assess state performance using various measures of government intervention, public sector efficiency, public good provision, size of government, and political freedom (LLSV 1999). 'Good government' is what is good for 'economic development', and 'economic development' is really about the security of property rights—lack of intervention by the government, benign regulation, and low taxation (p. 225). Because common law developed in England as a defence of Parliament and property owners against the attempts by the sovereign to regulate and expropriate them, and because it is made by judges who put their emphasis on the private rights of individuals and especially on their property rights, the LLSV authors see the it as the best legal system for economic development, as they define it.

Civil law, on the other hand, is seen as an instrument of the state in expanding its power—as illustrated by the fact that the greatest codes were introduced by Napoleon and Bismarck—and 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. Not surprising, the LLSV authors find that the use of a more interventionist legal system, such as the French civil law, predict inferior economic performance (p. 224).

Investor protection, which is interchangeably used as economic development, is also interchangeable with good corporate governance, which they define 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 which 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 the LLSV authors, enhances savings and also channels these savings 'into real investment;' the development of strong financial protection 'allows capital to flow toward the more productive uses, and thus improve the efficiency of resource allocation'. Civil law countries, on the other hand, offer much weaker protection to foreign investors, with laws made by legislatures rather than judges looking at precedent.

History, however, does not support the contention of the LLSV authors. The path of financial market development have not been as linear, but instead show many fluctuations and departures in countries like the US, France, Germany and Britain. For instance in 1913, France's stock market capitalisation as a fraction of GDP was almost twice that of the US, but then decreased to almost one fourth of the US by 1980, and in 1999, the two countries seem to have converged (Rajan and Zingales 2000: 4). In the beginning of the twentieth century, Germany (a civil country) also outpaced England (a common country) in both the volume of total market issues, and the proportion of issuance consisting of equity. Thus it was not legal or cultural factors that determined the level of financial system development, but political factors such as the support by government and interest groups for financial institution growth that determined the course of development.

In fact, whereas it took over a century and a half for the English 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. The almost instant success of continental European Governments in promoting financial development seems to indicate that what is critical is the will of the government to develop the financial market, and furthermore, that financial reform may bear fruit more quickly in the more centralised governments of the civil law tradition, than in the weaker governments associated with the common law tradition.

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. Indeed, 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.

The concern with the origins of the legal system also has the effect of putting the cart before the horse. Investor protection tended to develop in most countries only after the period of transplanting major legal systems, and much of that transplantation involved civil law countries adopting Anglo-American law. This was particularly true for Japan, the Republic of Korea, and Taiwan. In other words the historical sequence of events

defies a simple categorisation of countries according to the origin of their legal systems for laws governing investor protection, in light of the fact that 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 (Pistor and Wellons 1999: 139-141).

Most tellingly, Kevin Davis and Michael Trebilcock (1999), in a study conducted for the World Bank, argued that there is little evidence of a causal relationship between law and economic development; empirical studies of the relationship between growth and law do not point to causality. They scrutinised the economic impact of property rights, including 'titling', 'privatisation', 'alienability', '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', and that exclusive or predominant occupation with the court system inappropriately discounts the important role played by government departments and agencies.

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 industrialises in the middle of the twentieth century, as opposed to the early nineteenth century (England) or the late nineteenth and early twentieth century (Japan)? How do the requirements of industrial strategy, finance, and the role of the state differ, depending on when a country begins to industrialise? (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 industrialisation, the time frame for industrialisation 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' industrialisers 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 nature 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 industrialisers to copy the earlier industrialisers, 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 law tradition that evolved over centuries, through the establishment and subsequent citation of precedent. It was thus far easier to write a code authorising desired economic behaviour, than splice a common law tradition based on long historical evolution into effective day-to-day practice in the hot-house conditions of the twentieth century development.

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 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 modelled 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. 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. Instead, economic policy was formed and implemented largely through informal mechanisms, 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 2000).

During the American occupation a new constitution replaced the Meiji Constitution with its continental notion of the *Reichstaatsprinzip*, and one of the major advances of the new constitution was to abolish the Administrative court and introduce the Anglo-American system of judicial review. Did that eventuate in 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 US, 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' (*hochishugi*) gave way after 1945 to the 'rule *of* law' (*ho no shihai*) (Takayanagi 1963: 13).

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 *hochishugi* (*pŏpch'ijuŭi* in Korean) is used without carrying 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, 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 1950-90 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.). This experience speaks quite soberly to the travelability of the arguments made by the LLSV scholars 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 authorised 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 rule 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 Ministry of Finance (MOF), got away with dusting off interwar laws dealing with financial regulation (especially 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). South Korea likewise often based postwar economic regulation on prewar (Japanese) law. Administrative guidance also effectively reflected the needs and demands of those being 'guided'. It was a regulatory form for government intervention in the economy that has helped to preserve a competitive market economy by maximising the freedom of individual firms over economic decisions although behind the veil of pervasive government direction (Haley 1986: 108).

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 2000, that probably happened because of the inutility 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, when procedures of judicial review were used 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; instead they 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 order 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 a priority to one side's view, as in an adversarial legal system, the courts have been reluctant to state their position and 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.

Have law, will travel: Korea learns from Japan

One clear case of dramatic international or cross-border learning is the Republic of Korea (ROK), 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 the 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 centralising 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 more uneven and less consensual, resembling a coercive demand more than an informal guidance.

For much of the period of authoritarian rule and world-beating economic growth Korea's judges were not so much as august interpreters of constitutional intent than dependent factotums; at best 'distinguished bureaucrats' and at worst 'expert clerks' (Song 1996a). They were essentially civil servants, and given that the administration of justice had little 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 or interest in interference, so the judges could have their 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) the law, the basic requirements for a judge were to be technically competent, inveterately apolitical, risk averse, and preternaturally quiet (Song 1996a: 300-2).

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. It 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 democratise 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, by intimidating use of punitive tax audits, and sometimes by cynical abuse of the criminal justice system (West 1998: 328).

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 one of Korea's leading legal authorities, Sang-Hyun 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)

Real change can come—and has come—to Korea's judiciary only from outside forces. Since the national protest mobilisation of June 1987, civil society has advanced rapidly and a proliferation of new laws has done much to democratise 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) vitalised 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.

This new-found judicial determination is attributable 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. Citizen pressures, often in the form of suits filed against public authorities demanding that they do what the letter of the law long authorised them to do (something unheard of under

the dictators, even though all Korean constitutions going back to 1948 look liberal on paper), brought about the court reorganisation of 1994, established the Administrative Court in 1998, along with 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 are 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: 1,246).

The revitalization of the judiciary, however, has not meant an end of the era of administrative guidance. Under a democratic government, administrative guidance can be invoked, 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, and proceeded to use this informal mechanism of state interventionism to bring about the rule of law, Korean-style. The 'rules of law' that Kim wanted to champion in the economic sphere were: creating transparency in corporate governance, reducing excessive reliance on the banking system for capital, improving the financial structure of the conglomerates, separating ownership from management, giving labour 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 industrial reorganisation of 1998 which proposed to find the comparative industrial advantage of each conglomerate and then demand that the firms stick to it. 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 gained its sustenance through capital provisioned 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 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 reorganisation, such that Adam Smith's hidden hand materialised 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 was the core architectonic force behind Korea's rapid industrialisation?

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, an energized

populace. 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 finding a way to prepare its own deathbed.

More like them: common law 'Looks East'

Malaysia is a fascinating case to compare to Korea and Japan, given that it long had a more liberal market and a state based in a common law background that was less interventionist than Japan's (let alone Korea's), yet under Mahathir it developed the aspiration to be more like Japan and Korea (during the so-called 'Look East' strategy), and even though it failed in that effort, it succeeded in destroying its own common-law based constitution. 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 executive and used it first to hamstring and then to demolish the judiciary. Law did not appear to be the 'proxy' for the state or the determinant of the state-market nexus as the LLSV scholars 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 English common law and equity and what the colonial judges thought was just, fair, reasonable and equitable. The 1957 Federal constitution was drafted by the British Parliamentary draftsmen, broadly based on the Westminster Parliamentary model.

The judiciary and the entire judicial process operated and is still operating under the profound influence of the English common law and equity, judicial precedents, principles, ideas and concepts. Even today venerations to the views, observations and comments of the British judges is very much prominent in the Courts 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 organised 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 as 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 many. 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 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. Concomitant with the 'Look East' policy in 1981, however, abuses of public office grew, and the legal system was used extensively to implement policy. More laws conferring discretionary power to the Executive were adopted than in any previous time since Malaysian independence. A common feature of these legislations was the confiding of exclusive discretionary power upon the Minister to make decisions, coupled with a right to enact subsidiary legislation to better administer the statute; it also carried the ubiquitous finality clause that made his decisions final and conclusive with no right of review (Das 1981).

The Malaysian state frankly adopted the Japanese and Korean model, claiming that there was a trade-off between economic growth and democracy. The policy was anti-Western, and more especially, anti-British. Prime Minister Mahathir pursued an interventionist strategy partially modelled on South Korea's Heavy and Chemical Industries industrial policy of the early 1970s, involving close collaboration between the government and big business. What was 'Malaysia Inc.' supposed to look like?

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 commodities such as petroleum and palm oil) and increasing external debt, alongside a slump in external demand in 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 investments, both public and private, dropped precipitously. In other words Malaysia tried to be Korea and it all ended in an embarrassing and massive failure, a fortunate outcome for rule-of-law believers attributable, among other things, to crashingly bad timing. Many of the firms the state has 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 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' (Khoo 1995: 288). In general, laws which at first blush seemed to undergird the power of the judiciary and various checks and balances, over time were used to entrench the executive's power. Rule-making in the executive expanded as its economic activism spread, despite the significant growth of lawyers in the economy (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 more likely 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, 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.

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 former 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 economic 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.

I have argued that this new emphasis on 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, generalising on the basis of a set of governmental institutions that are themselves anomalous survivors in the twenty-first century—this state form that Samuel Huntington once called the 'Tudor polity' (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 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 was not 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 industrialisation—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 realise 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 eighteenth century; often this will be a matter of creatively utilising those 'wrong institutions' that were the sources of past developmental success, like the heritage of administrative guidance that I focused on in this chapter. 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* firms, 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 citizen groups) to pressure the state, all in the name of reform.

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