The World Bank in a Changing World: The Role of Legal Construction

ROBERT C. EFFROS*

By virtue of his appointment as General Counsel of the World Bank during a signal epoch of its evolution, Dr. Ibrahim F.I. Shihata was uniquely positioned to reflect, advise, and act on the central issues of development and the law. A conference to consider his work affords a welcome opportunity to delve into these issues and to seek to understand his perceptions and contributions. This article will first explore development theory. It will then consider how Dr. Shihata helped position the World Bank to deal with the challenges of development as these were identified in modern development theory. Finally, this article evaluates Dr. Shihata's own views of law and development.

Through much of his career, Dr. Shihata had to deal with mysteries of development that still elude us even as the passage of the years progressively sheds more light on them. Why do some countries develop rapidly and others only slowly? What are the vital factors that enter into the process? In the field of development theory, we do not as yet have all of the answers. Nevertheless, we believe that we are on the right track. This track differs from that originally embarked upon by the leading development institution. The key to understanding the history of the World Bank's efforts in development is that the Bank's approach was not so much created at its inception, but that it evolved over time. A closer look at this evolution may suggest that the changes in the World Bank's approach were associated with changes in our understanding of how development takes place. It was in this evolution of the central concepts of development, their application to the real world, and the legal interpretations that were required for the World Bank to give them scope that Dr. Shihata played a central role.

I. Development Theory

A brief summary of some relevant development theory may be appropriate before we consider Dr. Shihata's work in order that we may appreciate his contributions. Elsewhere I have written:

This article is based on a speech delivered on October 5, 2001, at the Inaugural Event for the London Forum for International Economic and Development Law. Mr. Effros is Senior Counsel at the International Monetary Fund and is an Adjunct Professor of Law at American University.

> There has been perplexity at the different rates at which countries develop. . . . There are many factors that contribute to the phenomenon of development. Among those generally identified are the literacy, skills, and outlook of the citizens, the resources at their disposal, and the accumulation of capital upon which they can draw. Some believe that there remain certain other factors that have not adequately been recognized. One factor that some investigators have considered is the system of organization of a society and, in particular, the rules that govern relationships within that society. Although there have been a number of efforts to develop a theory that relates law and development, the most comprehensive of them is probably that put forward by the German sociologist Max Weber. Weber, who had been trained as a lawyer, sought an explanation why during the same historical period there arose in Europe the modern legal system, the bureaucratic state, and the industrial economy.[1]

Professor David M. Trubek has ably summed up Weber's work:

> His research led him to three basic conclusions. First, that the more 'rational' a legal system was, the more conducive it would be to the emergence of a capitalist, industrial system. Second, that European legal systems were more rational than those which had emerged in other civilizations. Finally, that this legal rationalism existed in large measure in Europe *before* the full development of the industrial economic system. From these observations Weber concluded that Europe's legal system was one of the factors responsible for the rise of capitalism.
>
> Weber's concept of legal rationality is composed of three sub-variables: autonomy, conscious design, and universality. In Weber's schema, a legal system is said to be rational to the extent that: (i) it is autonomous from other spheres of society; (ii) the norms it formulates and enforces are consciously wrought; and (iii) those norms are consistently applied to all similar cases.[2]

Weber's work, while innovative and influential at their time of writing, did not long occupy the field. He died in 1920, and little by little the influence of his writings waned and their significance was understood only by a specialized group of academics. Weber had been a sociologist and an historian and perhaps by constraining his audience to those similarly trained, the impact of his theories was limited. Fortunately, in a different field, economists began to ask questions similar to those that Weber had pondered and a new school of thought picked up the trail.

It is submitted that the most sophisticated and polished version of current development theory can be found in the writings of Professor Douglass North, the economist who won the Nobel Prize in 1993 for his theoretical expositions of the subject. North distinguishes between *institutions* and *organizations*. *Institutions* are the rules in a society that define and constrain the choices of the players.[3] These rules may be formal or informal.[4] There is a spectrum of formal rules from constitutions, to statutes and laws, to individual contracts.[5] Contracts govern particular agreements for the exchange of goods and services. Informal rules are important and often determine the ultimate outcome for the society, notwithstand-

1. 2 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS (Robert Effros ed., 1994) at ix-x, (Introduction by R. Effros) (from which some of these observations on Weber have been derived). *See generally* MAX WEBER, ECONOMY AND SOCIETY (Guenther Roth & Claus Wittich eds., 1978).

2. David M. Trubek, *Toward a Social Theory of Law: An Essay on the Study of Law and Development*, 82 YALE L.J. 1, 12 (1972). *See also* David M. Trubek, *Max Weber on Law and the Rise of Capitalism*, WIS. L. REV. 720 (1972).

3. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 36 (1990).

4. *See id.* at 4.

5. *See id.* at 36.

ing the existence of the formal rules.[6] *Organizations* can be political, economic, social, or educational.[7] They are groups of individuals created with purposive intent to take advantage of the opportunities presented by the existing institutional constraints.[8] In the course of their efforts to reach their objectives, they are an important agent of institutional change.[9] In summary, institutions (together with the basic economic characteristics of the society-capital, labor, resources) "determine the opportunities in a society."[10] Organizations are created to exploit "those opportunities, and, as the organizations evolve, they alter the institutions," that is, the general frameworks under which they function.[11]

Institutions affect the performance of the economy by their impact on the costs of exchange and production. The role of institutions is to reduce uncertainty through the establishment of a stable structure for interaction.[12] Depending on their substantive content, they may foster efficiency or inefficiency in a society. They do this by affecting the costs of economic activity in society.[13] The total costs of a society equal its transformation costs (costs of production) and transaction costs.[14] Transaction costs are associated with banking, insurance, finance, and trade, and include the cost of enforcing contracts that govern exchanges of goods and services. In many developed countries, one can identify examples of institutional frameworks that conduce towards efficiency by lowering costs for transactions.[15] By contrast, in many less developed countries the institutional frameworks promote inefficiency, which results in higher costs for transactions.[16] In Professor North's words, they do this when they "favor activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them."[17] Countries are poor because their institutional frameworks define a set of outcomes to political and economic activity that does not encourage productive activity.[18] These as I understand them, are the premises of Professor North in a nutshell.[19] He was undoubtedly familiar with Weber's pioneering work. But Weber's work was more of an historical analysis of European experience. North's theory could be universalized without the limiting particularities of European tradition. Moreover, it could be expressed in an economic model that offered the prospect of practical measuring and testing.

II. The Role of Dr. Shihata's Legal Opinions

Development theory had been in its infancy at the time when the World Bank's Articles were drafted. The outlines of development theory were becoming clearer decades after the World Bank had been established. Was the World Bank's charter adequate to sustain the

6. *See id.*
7. *See id.* at 5.
8. *See id.*
9. *See* NORTH, *supra* note 3, at 5.
10. *Id.* at 7.
11. *Id.*
12. *See id.* at 6.
13. *See id.* at 5.
14. *See* NORTH, *supra* note 3, at 5–6.
15. *See id.* at 9.
16. *See id.* at 67.
17. *Id.* at 9.
18. *Id.* at 110.
19. *See generally* NORTH, *supra* note 3, from which this summary has been derived.

burden of necessary change? The Bank's Articles of Agreement had been written at a time when little was known about the processes of development and when it seemed that financing of specific projects like dams or power plants or port facilities alone would jump start an automatic process. If the newer understanding were correct, development presupposed proper institutional and legal reform. With the World Bank charged with taking the lead in development efforts, how were the Bank's antique purposes and limitations to be squared with the measures that were now considered to be needed in order to further development? A number of serious hurdles would have to be surmounted by careful and adroit legal interpretation. These were the challenges that faced Dr. Shihata in his tenure as the World Bank's General Counsel. In a memorandum of April 18, 1988, the General Counsel took stock of the authorized purposes of World Bank loans. He wrote cautiously about the nature of the World Bank's Articles of Agreement:

> *Written in the mid-1940s, the IBRD Articles of Agreement cannot be applied in the changing circumstances of today's world without a great measure of purposive interpretation.* Subjecting the few provisions of these Articles to a strict reading which reflects only the circumstances of the time of their adoption can hardly enable the Bank to serve its objective fully under present and future conditions (emphasis added).[20]

Among the serious obstacles to lending for legal and institutional reform were three in particular. First, there was language in the Bank's Articles that seemed to limit its efforts to *specific projects*. Second, it would be useful to find a broader *category* containing related matters into which legal and institutional reform could fit. Could such a category be found to make such reform understandable and acceptable to the Bank and to the outside world? Finally, there was language in the Bank's Articles that limited its financing to economic considerations and specifically prohibited taking account of *political considerations*. Would this language limit the efforts of the Bank to promote legal and institutional reform?

The first hurdle to surmount was the language in the Bank's Articles that seemed to limit the Bank's financial assistance to *specific projects*. If this language were read at face value, it would seem to preclude financial assistance to further necessary legal and institutional reform. The language in question appears in Article III, Section 4(vii), which provides: "Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development."[21] Dr. Shihata explained this language as follows:

> [T]he general rule is that loans made or guaranteed by the Bank should finance 'specific projects.' These words should be read in their ordinary or grammatical meaning, which generally constitutes the correct interpretation of treaty provisions. Such a meaning suggests that while the project to be financed has to be 'precise,' 'explicit' and 'exact in respect of fulfillment, conditions or terms,' it *need not be limited to the construction of physical facilities*. Indeed, the term 'project' is broad enough to cover any 'plan,' 'scheme,' or 'design' according to which something is made or any 'idea' or 'notion' according to which something is proposed for execution. A 'specific project' would thus cover what the Bank's staff used to call 'project lending' as well as a large part of the so-called 'program lending' in the Bank's previous practice . . . (emphasis added).[22]

20. IBRAHIM F.I. SHIHATA, THE WORLD BANK LEGAL PAPERS 157 (2000).
21. *Id.* at 159.
22. *Id.*

Dr. Shihata next considered the significance of the words "special circumstances," which he found could embrace departures from the general rule, provided that they were recognized by the Bank's Executive Directors as serving the Bank's main objective of facilitating investments for reconstruction or development. Such circumstances authorized structural adjustment loans and sectoral adjustment loans that help the recipient countries to introduce policy changes required for creating better investment conditions. He reverted to the general rule and concluded:

> Under normal circumstances, Bank loans and guarantees are to finance specific projects in the broad sense of this term, which, in my view, includes all well-defined productive purposes whether these are served directly (such as in industry and agriculture) or indirectly (such as in infrastructure, institution building, social services, etc.).[23]

Was Dr. Shihata's manner of engaging in broad interpretations too revolutionary to be accepted by the Bank? He showed that his interpretations were in a tradition of groundbreaking that the Bank had adopted earlier. Dr. Shihata's view of interpreting the language of the Bank's Articles broadly in the manner of a constitution had precedents. But Dr. Shihata would need to probe deeper to find the proper concepts on which to justify financing for legal and institutional reform. He sought a common category in which to include legal and institutional reform. As early as 1990, Dr. Shihata was examining the legal basis of World Bank lending to improve the governance of borrowing members. He wrote that, "[t]he World Bank has long been concerned with issues of institutional development and public sector management in its borrowing member countries. It has also recognized, from its early years of operations, that political stability and sound economic management are basic prerequisites for economic development."[24] In a pioneering legal opinion that considered the aspects of governance that are consistent with the Bank's mandate, Dr. Shihata began by seeking a definition to "governance." He found it to signify:

> . . .'good order', not in the sense of maintaining the status quo by the force of the state (law and order) but in the sense of having *a system, based on abstract rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules.* This system of rules and institutions is reflected in the concept of the '*rule of law*,' generally known in different legal systems and often expressed in the familiar phrase of a 'government of laws and not of men.'. . .The existence of *such a system is a basic requirement for a stable business environment; indeed for a modern state.* In its absence, the elements of stability and predictability, so basic to the success of investment, will be lacking and the fate of enterprise, like that of individuals, will be left to the whims of the ruling individual or clique. Such absence will also reflect a general lack of social discipline which could render meaningless any process of economic reform.
>
> A system which has the basic elements . . . addresses the processes of the application of rules, rather than their substance. Such processes are meant to serve several objectives, among which the economic objective figures prominently. The substance of rules will of course reflect the policies of each government and should be based on its choices and convictions. The Bank may and should assist, if requested, in the design of such policies to the extent they are related to its fields of competence and its mandate (emphasis added).[25]

23. *Id.* at 172.
24. IBRAHIM F.I. SHIHATA, THE WORLD BANK IN A CHANGING WORLD 53 (1991).
25. *Id.* at 85–86.

In reaching these conclusions, Dr. Shihata was aware of the danger of running up against those provisions of the World Bank Articles that prohibit political activities in the Bank's work. In particular, Article IV, Section 10 of the IBRD Articles of Agreement provides:

> The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighted impartially in order to achieve the purposes stated in Article I.[26]

He noted that the prohibition is drafted in absolute language that does not authorize exceptions. He also noted that:

> In its broad sense, 'governance' includes both the exercise of political powers and the overall management of human, natural, and economic resources. It covers all the functions of government, which is a 'more modern word for governance.' Clearly, the Bank does not have a legal right to oversee the governance of its borrowing members, or to participate in such governance.[27]

Nevertheless, he identified certain principles with respect to issues of governance that could provide possible guidance to the work of the Bank staff in this area. He cautioned that, "[t]he Bank should not advocate through its operations any particular political system or form of government; nor should it take sides with any particular political faction."[28]

In his opinion, it was the *consent of the member* that should control. He took the position that, "[u]pon the request of a borrowing member, the Bank may finance projects for purposes of ensuring predictability and stability of the business environment and efficiency of public administration, such as civil service reform, legal and regulatory reform, and judicial reform."[29]

The breakthrough had been achieved. Dr. Shihata had noted that nowhere in the World Bank's Articles had explicit mention been made of a scope of authority to support legal and institutional reform. Nevertheless, he had been able to assist the World Bank in navigating the obstacle-ridden waters of the prohibition against loans made on political considerations, and the tradition of making project loans, to reach the ultimate objective. He did this by making legal and institutional reform facets of "*governance*," a field in which the World Bank could reasonably choose to exercise its expertise. Dr. Shihata did not, of course, invent or discover the concept of governance. The concept had been gaining ground in and beyond the Bank, in academia, and in other international institutions as well. But he recognized its importance to the Bank and to the principles of law and development that he espoused. In his lectures to the American Bar Association and to the First Global Rule of Law Conference in 1994, he said:

> Recognizing that *good governance is central to fostering strong and equitable development* and is an essential complement to sound economic policy, the World Bank has in recent years considered the legal framework as one of the areas of 'governance' it can address consistently with its mandate . . .
>
> Activities such as civil service reform, legal reform and judicial reform have been found to be relevant to the maintenance of 'good order' in the management of a country's resources

26. SHIHATA, *supra* note 20, at 198.
27. *Id.* at 230.
28. *Id.* at 231.
29. *Id.* at 232.

through the introduction and implementation of appropriate rules and institutions, and were therefore found to fall within the Bank's mandate if a borrowing country requests the Bank to assist in these areas. This was confirmed in a legal opinion which I submitted to the Bank's Board in 1990.

Supporting legal and judicial reforms is not mentioned as such in the Bank's charter. But . . . experience has shown that such reform cannot be ignored in the processes of economic adjustment and development. The Bank's experience has confirmed that successful implementation of fundamental policy changes in the business environment and in the financial sector would normally require fundamental changes in the overall legal and institutional framework. The Bank's borrowers have thus been encouraged to address deficiencies in their legal systems which hamper the development process, such as the inappropriateness of laws (in terms of their failure to support the required policy changes and to introduce realistic incentives and remedies), ignorance of their content, uncertainty in their application, weak enforcement, arbitrariness in the exercise of discretionary power, inefficient court administration and slow and complex procedures (emphasis added).[30]

III. Dr. Shihata's Views of Development and the Law

Dr. Shihata not only worked to establish the legal basis of Bank financing of legal and institutional reform that modern development theory supports; he also thought deeply about these matters. He wrote and delivered many opinions, papers and lectures in the course of his duties at the World Bank, and beyond in the field of academia and at the meetings of practicing lawyers. Perhaps the most comprehensive explanation of his views on development and the law appeared in a presentation that he made to the OECD Symposium on the Rule of Law and Development of a Market Economy in the Russian Federation, held in Paris, France, in March of 1998. In that paper, he wrote of the importance of the rule of law:

Law is the formal instrument of orderly change in society. As such, it plays a pivotal role in the transition from a totalitarian to a democratic regime and from a command to a market economy.

There are basic requirements for the proper functioning of a market economy, which also constitute basic conditions of human progress. These include physical security, a minimum measure of stability and predictability, fair competition in a level playing field and a social safety net to protect the poor and vulnerable. The rule of law is a prerequisite for the attainment and preservation of these conditions.

The '*rule of law*' suggests that law is supreme and applies to all, including the sovereign. This concept is inherent in natural law ideals and divinely inspired legal systems. Aristotle equated it with the rule of reason. The supremacy of law was established in Islamic *shari'ah* in the 7th century. The same ideal was invoked by English writers in the 12th and 13th centuries to restrain the powers of monarchs. It was later articulated in the Massachusetts Constitution . . . of 1780 which spelled out the principle of separation of powers 'to the end the government may be a government of laws, and not of men' (emphasis added).[31]

30. SHIHATA, *supra* note 24, at 133.

31. IBRAHIM F.I. SHIHATA, THE WORLD BANK IN A CHANGING WORLD 187–88 (2000).

He continued:

> . . . the rule of law requires state actions and private behaviour to be based on legal norms that meet certain tests: These norms must be public, clear, impartial, general, prospective, and stable . . . [t]hey should not be secret, obscure, arbitrary, discriminatory, retroactive or subject to frequent and confusing changes . . . The implementation of the rule of law ideal . . . is not a process to be completed once and for all; it requires continuous legal reform.[32]

Dr. Shihata defined the rule of law as it applied to development in terms of *rules, processes* for making and enforcing rules, and *institutions*:

> The question of how law can be utilized to achieve economic revival in the short run and sustainable development in the long run addresses the key concept of the rule of law. This concept can be defined in many ways. In the context of the role of law in development, I would define it in terms of a system based on three pillars: the first consists of *objective rules*, which are not only known in advance but are actually enforced on all those addressed by them, and are subject to modification pursuant only to previously known procedures. The second consists of *appropriate processes* through which such rules are made and enforced in practice and are deviated from when necessary. The appropriateness of such processes obviously differs according to the culture and other circumstances of each country. . . . The third pillar of the rule of law . . . consists of *well-functioning public institutions* which are staffed by trained individuals, are transparent and accountable to citizens, are bound by and adhere to regulations, and apply such regulations without arbitrariness or corruption. An efficient and fair judicial system provides the institution which acts as the final arbiter of the rule of law (emphasis added).[33]

The World Bank, its members, and the international community were fortunate to have the benefit of Dr. Shihata's foresight and views at a critical stage of world history. His opinions helped to guide the World Bank in its tasks as the preeminent instrument of change and development when the underpinning of development theory was being revealed as no less than the sum total of civilized rules that must undergird society. Dr. Shihata wrote that the World Bank's Articles of Agreement are a treaty to its members and a constitution to the organization.[34] He gave the Articles the utmost respect, but he understood that they must be read as a constitution. Changing times required the suppleness of interpretation that is the due of a living constitution. It is no accident that he chose to title the three-volume set of essays and legal opinions that he left as his legacy The World Bank in a Changing World. He had lived through those times and contributed to their changes. As the interpreter of a constitution, he was in the fine tradition of a constitutional jurist. He would have agreed with Chief Justice Marshall, another interpreter of another constitution who was called upon to interpret its clauses at an early history of U.S. juridical development:

> A constitution, to contain an accurate detail of all the subdivisions of which its great powers will admit, and of all the means by which they may be carried into execution, would partake of the prolixity of a legal code, and could scarcely be embraced by the human mind. It would probably never be understood by the public. Its nature, therefore, requires, that only its great outlines should be marked, its important objects designated, and the minor ingredients which compose those objects be deduced from the nature of the objects themselves. . . . we must never forget, that it is a constitution we are expounding.[35]

32. *Id.* at 188–89.
33. *Id.* at 130–31.
34. SHIHATA, *supra* note 20, at 221.
35. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 4 L. Ed. 579 (1819).