

**THE ROLE OF FORMAL CONTRACT LAW AND
ENFORCEMENT
IN ECONOMIC DEVELOPMENT**

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I. INTRODUCTION

This paper addresses the role of formal contract law and formal contract enforcement institutions in economic development. Unlike most of the other papers presented at this symposium, its perspective is unabashedly, and indeed unapologetically, consequentialist: Does the existence of a formal contract law and enforcement regime significantly contribute to economic growth in developing countries?

We believe that the size of the stakes at issue warrant this perspective. About 85 percent of the world's population of 6.5 billion people live in developing countries on one-fifth of total world income; of them 1.2 billion live on less than \$1 a day.¹ While data on trends in income inequalities around the world are subject to varying interpretations, between-country inequalities seem clearly to have been growing, indicating that many developing countries have fallen further and further behind both developed countries and a small sub-set of developing countries in terms of relative income per capita.² While income per capita and growth thereof is not a comprehensive measure of development³, it is often a precondition to the realization of a variety of other development objectives.

Because the perspective of this paper is consequentialist, it is also (unlike any of the other papers at this symposium) necessarily empirical: What consequences in fact follow or are likely to follow from the actual or hypothesized adoption of one legal regime (in this case formal contract law and enforcement) over another? As the paper elaborates, two different hypotheses emerge from the literature on the central question posed in this paper, one of which takes the view that strong formal contract law and enforcement mechanisms are indispensable to economic development, while another hypothesis contends that much economic development is realizable through informal contracting mechanisms. Relating these two hypotheses to the central theme of this symposium - political theory and the role of private law - we attempt to address the respective roles of formal and informal contract law and enforcement institutions in economic development in scenarios involving different kinds of states: a) strong states with effective formal contract law and enforcement; b) weak states that lack

¹ Michael Todaro & Stephen Smith, *Economic Development* 47-53 (Addison-Wesley: 8th ed. 2003).

² Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* (2005).

³ Amartya Sen, *Development as Freedom* (1999) [hereinafter Sen].

such mechanisms; and c) highly interventionist, autocratic, or predatory states. A related issue that arises in this context is the extent to which it is possible for a state to adopt an effective formal contract law and enforcement regime (and protection of private property rights without which private contracting is impossible) without also adopting a particular type of political regime, e.g., democratic government. A further issue that arises in this vein is the extent to which political theorizing about the role and structure of private law (in our case, contract law) is universalizable or generalizable, or whether such theorizing is highly contingent on context-specific political, cultural, and social values and practices. Put more bluntly, at the symposium out of which the papers in this volume emerged, were symposium participants (all drawn from western and developed countries) talking to themselves or were they talking to the world?

We argue in this paper that at low levels of economic development informal contract enforcement mechanisms may be reasonably good substitutes for formal contract enforcement mechanisms, but become increasingly imperfect substitutes at higher levels of economic development involving large, long-term, highly asset-specific investments or increasingly complex traded goods and services, especially outside repeated exchange relationships.

Part II sets out the two principal hypotheses examined in this paper and their rationales. Part III examines existing empirical evidence that contract formalists rely on for their claim that formal contract law and enforcement institutions is a significant determinant of a country's economic development prospects, while Part IV reviews empirical evidence that the contract informalists point to to support the contrary claim. Part V briefly examines two cases of great contemporary development significance: the so-called "China enigma" and the "East Asian miracle," where high rates of economic growth have been achieved in most (but not all) cases in the absence of strong formal contract law and enforcement regimes. Part VI concludes the paper with a critical assessment of the empirical evidence to date supporting the two opposing hypotheses.

II. THE TWO HYPOTHESES

Drawing on an earlier law and development tradition associated with Max Weber,⁴ Douglass North advances the strong claim that, “*the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.*”⁵

The framework offered by the New Institutional Economics (NIE) approach, as exemplified by the work of Douglass North, suggests that a full understanding and explanation of the economic development of nations requires not only an acceptance of the premises of the neo-classical economic approach, but also a recognition of its inadequacies.⁶ Specifically, North embraces the idea of the individual as a rational, self-interested economic agent who responds to economic incentives. He then, however, suggests that the neo-classical approach is inadequate as an explanatory tool insofar as it fails to recognize explicitly that the decisions made by individuals are predicated on the information and institutions that are available to them.

Institutions, says North, are the “rules of the game in society,”⁷ which can be manifested in formal rules or informal codes of conduct and behaviour. North’s framework for understanding economic development is premised on the view that the rules and norms governing economic interactions are the most significant consideration in accounting for an economy’s success or failure. North’s emphasis on the role of institutions in determining economic performance leads him to suggest that the differential performance of economies through time can be explained in terms of the differential quality of countries’ institutions.

In similar vein, Williamson proposes that economic activity is best understood and explained by an “examination of the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures.”⁸ He argues that

⁴ Max Weber, *Economy and Society* (G. Roth & C. Wittich eds. 1968); see also David Trubek, *Toward a Social Theory of Law: An Essay on the Study of Law and Development*, 82 *Yale L.J.* 1 (1972).

⁵ Douglass North, *Institutions, Institutional Change and Economic Performance* 54 (1990) (italics added) [hereinafter North].

⁶ *Id.* at 112.

⁷ *Id.* at 1.

⁸ Oliver Williamson, *The Economic Institutions of Capitalism* 2 (1985).

neither spot market transactions nor transactions within vertically integrated firms require formal enforcement mechanisms because they entail minimal transaction costs.⁹ Conversely, the vulnerability experienced by at least one party to long-term, non-simultaneous transactions creates a significant need for a credible third-party enforcement mechanism. Credible third-party enforcement addresses the reluctance of private sector agents to participate in non-simultaneous economic transactions entailing significant sunk costs that ensues from a lack of assured protection of their economic interests. Williamson essentially contemplates a continuum of micro-economic activity. At either end of this continuum are types of activities that do not require a formal mechanism for contract enforcement, while in the middle lie economic activities that require some degree of external enforcement.

From this perspective, given the existence of transaction costs, individuals need assurances that those transaction costs will not negate the benefits they seek to derive from a transaction itself. Recalling that institutions are both the formal and informal “humanly devised constraints that shape human interaction,¹⁰” and that enforcement is an important factor in calculating transaction costs¹¹, North first identifies self-enforcement as the primary feature of contracts used in tribes, primitive societies, and close-knit small communities where information costs are low and repeat dealings are pervasive. He then points out the limit of self-enforcing contracts in a world of impersonal exchange, where individual specialization and exchange expansion in both time and space require additional contract enforcement mechanisms to assure compliance. These additional mechanisms, as suggested by North, include the exchange of hostages, ostracism of delinquent merchants, reputation, kinship ties, loyalty, common beliefs held by minority groups in hostile societies, and at times ideological commitments to integrity and honesty.¹² However, while these informal mechanisms can, depending on the costs of information, provide assurance of contract compliance, the dilemma posed by impersonal exchange without effective third-party enforcement still remains because of the persistence of “end game” problems in long-

⁹ Oliver Williamson, *The Institutions and Governance of Economic Development and Reform*, in *The Mechanisms of Governance* 322, 332 (1996) [hereinafter Williamson 1996].

¹⁰ North, *supra* note 5, at 125.

¹¹ *Id.* at 54 [in footnote 1].

¹² *Id.* at 55.

term relationships and costs of information.¹³ It is here that what North calls “credible, low-cost, and formal third party enforcement,” becomes important. To clarify what he means by “third-party enforcement,” North specifically states that this institution means “the development of the state as a coercive force able to monitor property rights and enforce contracts effectively.”¹⁴

North concludes that while the lack of low-cost, effective contract enforcement mechanisms is the most important contributor to economic inefficiency and low growth rates in the developing world,¹⁵ he goes on to state that there is no knowledge currently of how to create the state as a coercive force able to protect property rights and enforce contracts effectively without also risking abuse of its coercive power to the detriment of the rest of the society.¹⁶ Implicit in this claim is the presumption of a significant causal relationship between the economic implications and effects of third-party contract enforcement and an economy’s performance. Thus, in order to assess the validity of North’s claim, it is necessary to examine the empirical evidence upon which it is premised.

While the contract-formalist approach to development represented by North regards formal contract enforcement as fundamentally important for a nation’s economic development, an alternative school of thought has emerged that downplays the need for a formal third-party mechanism for contract enforcement. Rather, premised on empirical evidence that emphasizes the fundamental role played by social norms and networks in rendering private transactions self-enforcing, it is argued that many economic activities that foster economic development do not need a means of formal third-party enforcement.¹⁷ According to Avner Greif, “*the legal*

¹³ *Id.* at 55-58.

¹⁴ *Id.* at 59.

¹⁵ *Id.* at 54.

¹⁶ *Id.* at 59.

¹⁷ See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 *J. Legal Stud.* 115 (1992) [hereinafter Bernstein 1992] (examining the extra-legal contract enforcement mechanisms in the New York diamond industry), also see *infra* notes 68 and 69 and accompanying text; Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Codes Search for Immanent Business Norms*, 144 *U. Pa. L. Rev.* 1765 (1996) [hereinafter Bernstein 1996] (studying the self-enforcing private ordering in the American grain industry); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 *Mich. L. Rev.* 1724 (2001) (analyzing the private ordering in the American cotton industry); Avner Greif, *Contracting, Enforcement, and Efficiency: Economics Beyond the Law*, in Michael Bruno and Boris Pleskovic (eds.), *Annual World Bank Conference on Development Economics* 1996 239 (1997)

system does not govern—directly or indirectly—many exchange relations in historical and contemporary market economies as well as in developing economies.”¹⁸ Greif argues that in fact much of the world’s economic development occurred absent a legal system to govern private economic transactions.¹⁹

It is important to note that the contract-informalist perspective shares many of the theoretical premises upon which the contract-formalist understanding of development is founded—especially, those related to the motivations of the individual as a rational economic agent. In particular, it accepts that individuals need assurances that agreed-to transactions not be arbitrarily breached without a means of holding the breaching party responsible. Thus, this perspective does not discount the fundamental principle of neo-classical economics—that individuals need incentives. However, it differs from the contract-formalist approach insofar as it acknowledges that the existence of extra-legal socially or culturally determined norms can and do provide the assurance of stability and predictability necessary to induce people to participate in private transactions.

III. THE CONTRACT FORMALISTS: THE EMPIRICAL EVIDENCE

Although some development studies suggest that less-developed countries with poor property rights and contract enforcement mechanisms fail to attract foreign investment and sustain growth²⁰, these studies usually do not distinguish the respective roles of property rights protection and contract enforcement in this correlation. Moreover, in terms of institutional efficiency and effectiveness, the evidence provided in these studies does not seem to accord primacy to state

[hereinafter Greif 1997]; Marcel Fafchamps, *Market Institutions in Sub-Saharan Africa* (2004) [hereinafter Fafchamps]; Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 *J. Legal Stud.* 349 (1981) (discussing the business practices of ethnically Chinese middlemen in Malaysia and Singapore). Landa finds that the tightly knit, ethnically based business community facilitated a mutual trust that obviated any need to take measures to lessen uncertainty in transactions between the Chinese middlemen, while exchanges between the Chinese and indigenous non-Chinese were primarily cash (rather than credit) in order to reduce contract uncertainty. See also Janet Tai Landa, *Trust, Ethnicity, and Identity: Beyond the New Institutional Economics of Ethnic Trading Networks, Contract Law, and Gift-Exchange* (1994) (proposing a theory of informal contract enforcement institutions in achieving “ordered anarchy”).

¹⁸ Greif 1997, *id.* at 241 (*italics added*).

¹⁹ *Id.*

²⁰ See, *e.g.*, Dani Rodrik (eds.), *In Search of Prosperity: Analytical Narratives on Economic Growth* (2003) [hereinafter Rodrik 2003]; Avinash Dixit, *Lawlessness and Economics: Alternative Modes of Governance* 14 (2004) [hereinafter Dixit].

enforcement of contracts over alternative mechanisms of contract enforcement. Therefore, to test the validity of the North proposition, evidence that speaks directly to the independent effect of “unbundled” formal contract enforcement institutions on economic performance is needed.

The argument in favour of the need for third party contract-enforcement as a prerequisite to productivity and growth is tested by Clague, Keefer, Knack and Olson. They propose that “the extent to which societies can capture...those potential trades that are intensive in contract enforcement and property rights can be approximated by the relative use of currency in comparison with contract-intensive money (CIM),”²¹ which they define as the ratio of noncurrency money to the total money supply. It is important to note that the authors are careful to mention that they “are not suggesting that the greater use of...noncurrency monies causes better economic performance,”²² rather that “better institutions, especially with respect to contract enforcement, enable a society to obtain a wider array of (real) gains from trade.”²³ Their study thus uses CIM to test the types of governance (or institutions) that improve economic performance, rather than suggesting that CIM is itself a cause of that performance.²⁴

The authors then present seven brief case studies of the impact of changes in political stability and economic policies on the CIM ratio. Based on these case-studies, which the authors note are consistent with the results of some of their previous work, they conclude that “security of contract and property rights is greater under strong and secure autocrats than under those of short tenure or in [short lived] democracies and reaches the highest levels in lasting democracies.”²⁵ The question this conclusion raises, of course, is what is its significance or relevance for the argument advanced by North.

²¹ Christopher Clague, Philip Keefer, Stephen Knack & Mancur Olson, Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance, (4)2 Journal of Economic Growth 185, 188 (1999) (*italics in original*) [hereinafter Clague et al.].

²² Indeed, Russia’s “barter economy,” where cash payment in rubles is widely replaced by alternate means of payment such as barter and privately issued quasi monies, proves otherwise, as later discussion of Russia reveals.

²³ Clague et al., *supra* note 21, at 189.

²⁴ Because this endeavour involves a measurement of both the enforceability of contracts and the security of property rights, Davis cautions against the results being heavily relied upon by legal reformers. See Kevin Davis, What Can the Rule of Law Variable Tell us about Rule of Law Reforms?, 26 Mich. J. Int'l L. 141, 157 (2004) [hereinafter Davis].

²⁵ Clague et al., *supra* note 21, at 196.

Recall that North's claim is that lack of third-party enforcement is the most important cause of historical stagnation and economic underdevelopment. The purpose served by third-party enforcement is to provide stability and predictability as incentives to parties to engage in non-simultaneous exchanges. There are two things that need to be demonstrated in order to establish the validity of this claim. First, it must be demonstrated that the existence of a third-party enforcement mechanism will actually increase the volume of non-simultaneous transactions. Since the CIM ratio is a measure of the use of non-currency money to the total money supply, it is fair to characterize a rise in that ratio as evidence of an increase in non-simultaneous transactions because it does involve exchanges between parties without immediate payment on supply of the promised good or service. Thus, it would be reasonable to conclude, based on the evidence provided by Clague et al, that individuals are more willing to engage in non-simultaneous exchanges when there exists the political stability to allow the state to act as a credible third-party enforcer of contracts (although it is not clear that formal judicial enforcement is the only mechanism at the state's disposal).

Second, the validity of North's claim is further contingent on a demonstrated connection between an increase in non-simultaneous exchanges and economic development itself. To this end Clague et al. conducted regression analysis to find the correlation between CIM and investment and growth respectively. With regard to CIM and investment, a strong, positive and highly significant relationship between the two was found.²⁶ With regard to the relation between CIM and growth, while the initial regression did demonstrate a significant correlation, there was evidence suggesting reverse causality. On testing for reverse causality, the authors conclude that the apparent significant relation between CIM and growth is actually attributable to factors exogenous to CIM (such as currency depreciation, initial income, schooling, ethnic structure of population, and colonial heritage, etc.), rather than a function of CIM itself.²⁷ While the latter finding creates a legitimate challenge for those who argue in favour of credible third-party enforcement of contracts as a prerequisite for economic development, it does not negate the importance of the former. If the CIM

²⁶ *Id.* at 200.

²⁷ *Id.* at 203.

ratio does act as a legitimate proxy for the efficacy of third-party contract enforcement in attracting investment, then it is fair to conclude that there are legitimate economic benefits that derive from formal measures for contract enforcement. The lack of a clear causal relationship between CIM and investment and CIM and growth raises questions with regard to the type of economic activity that the existence of a third-party mechanism for contract enforcement facilitates. Specifically, it may be that absent other informal mechanisms and social norms that encourage repeat and/or long-term contractual relationships, formal means of contract enforcement themselves are mostly conducive to one-time only, non-simultaneous exchanges. Currently, however, empirical data is lacking to resolve this question.

Another cross-country study by Ross Levine, Norman Loayza and Thorsten Beck in the law and finance literature examines the role of financial intermediaries in facilitating economic growth, and how legal and accounting practices (including contract enforcement) affect financial development. In their regression analysis the dependent variable is the growth rate of real per capita GDP. The primary regressor is the level of financial intermediary development, but other regressors include a broad set of variables that serve to provide conditioning information. Levine et al. conclude, that “the degree to which financial intermediaries can acquire information about firms, write contracts, and have those contracts enforced will fundamentally influence the ability of those intermediaries to identify worthy firms, exert corporate control, manage risk, mobilize savings, and ease exchanges.”²⁸ Once Levine et al. conclude that there is a correlation between contract enforcement and financial development, it remains for them to establish a correlation between financial development and economic growth. To this end Levine et al. conduct cross-sectional analysis and find that “financial intermediaries that are better at ameliorating information and transactions costs induce a more efficient allocation of resources and faster growth.”²⁹ This leads them to concur with the conclusion of previous work by La Porta, Lopez-de-Silanes, Shleifer and Vishny³⁰ that “the legal and regulatory system will

²⁸ Ross Levine, Norman Loayza & Thorsten Beck, *Financial Intermediation and Growth: Causality and Causes*, 46(1) *Journal of Monetary Economics* 31, 35 (2000) [hereinafter Levine et al.].

²⁹ *Id.* at 62.

³⁰ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 *Journal of Finance* 1131 (1997) [hereinafter LLSV 1997].

fundamentally influence the ability of the financial system to provide high-quality financial services.”³¹

The primary reason why financial markets are particularly dependent on law and state institutions of contract enforcement is that financial contracts tend to be highly technical and complex and usually involve large amounts of financial assets. Therefore, financial contracting usually entails considerable transaction risks and needs stable and predictable contract protection and compliance assurance. Such guarantee is presumably best provided by effective formal contract law and related legal institutions, especially when rights of minority investors are vulnerable to managerial abuses and expropriation by majority investors.³² Viewing finance as a set of contracts, the broad “law and finance” literature suggests, on the basis of extensive empirical testing, that a country’s contract, company, bankruptcy and securities laws, combined with effective enforcement of these laws, fundamentally determine the rights of securities holders and the performance of financial systems.³³

Similarly, in a recent paper Dam reports additional empirical evidence from financial markets on the positive correlation between a strong effective judiciary as an important formal contract enforcement institution and economic development.³⁴ He cites a number of studies in this vein to suggest that “the degree of judicial independence is correlated with economic growth” and that “[b]etter performing courts have been shown to lead to more developed credit markets,” thus contributing to rapid growth of small as well as larger firms in an economy.³⁵ In particular, in the World Bank’s World Development Report of 2005, reports that within individual countries in Latin America, firms doing business in provinces of Argentina and Brazil with competent courts enjoy greater access to credit, while larger, more efficient firms in Mexico are found in states with better court systems. This is because better courts

³¹ Levine et al., *supra* note 28, at 35.

³² Thorsten Beck & Ross Levine, Legal Institutions and Financial Development, *in* Claude Ménard & Mary Shirley (eds.), *Handbook of New Institutional Economics* 251, 253 (2005) [hereinafter Beck & Levine 2005].

³³ *Id.* at 253.

³⁴ Kenneth W. Dam, The Judiciary and Economic Development, University of Chicago John M. Olin Law & Economics Working Paper No. 287 (March 2006) [hereinafter Dam, The Judiciary], *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892030.

³⁵ *Id.* at 1.

reduce the risks firms face and increase the firms' willingness to invest more.³⁶ By contrast, ineffective, poor-quality courts are incapable of addressing contract enforcement problems faced by private agents in their dealing with the state and public sector agents in economic transactions, as Dam vividly illustrates in the case of Brazil, where the government's "judicial liability" (i.e., unenforced judicial claims against the public sector) is reckoned to be roughly equal the country's public debt.³⁷ This deficiency of the Brazilian judiciary essentially levies a considerable tax on private sector agents because they can neither earn interest on their unrecovered assets pending court proceedings nor put these assets to other value-adding uses.³⁸ An equally detrimental consequence of ineffective courts with regard to creditor rights protection is that banks are forced to lend at extremely high interest rates due to their inability to foreclose on debts without the assistance of courts, which also means that vital infrastructure projects are stalled because investors are doubtful about the courts' ability to protect their rights in case of default.³⁹ Dam also cites the results of an empirical study on transition economies by Pistor, Raiser and Gelfer⁴⁰ in the law and finance literature to demonstrate the critical role played by "legal effectiveness," of which effective courts that can enforce private contracts is an essential indicator, in promoting financial market development by expanding market capitalization and private sector credit.⁴¹

There are two major drawbacks of the broad law and finance literature, as pointed out by Haselmann, Pistor and Vig.⁴² Firstly, most of the research done in this area uses aggregate macro-level indicators for financial market development such as the size of credit markets as a share of GDP, which make it difficult to disentangle the impact of legal change on different market participants.⁴³ Secondly, most of the existing research in this area compares countries with good legal institutions to those

³⁶ World Bank, World Development Report 2005: A Better Investment Climate for Everyone 86 (2004), cited in *id.*, at 2.

³⁷ Dam, The Judiciary, *supra* note 34, at 2.

³⁸ *Id.* at 2-3.

³⁹ *Id.* at 3.

⁴⁰ Katharina Pistor, Martin Raiser & Stanislaw Gelfer, Law and Finance in Transition Economies, 8(2) *Economics of Transition* 325 (2000).

⁴¹ Dam, The Judiciary, *supra* note 34, at 4.

⁴² Rainer Haselmann, Katharina Pistor & Vikrant Vig, How Law Affects Lending, Columbia Law and Economics Working Paper No. 285 (2005), at 1-2, *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=846665.

⁴³ *Id.* at 1.

with poor quality legal institutions by relating differences in legal institutions to various economic parameters, thus ignoring endogeneity concerns whereby economic performance may be caused not by changes in legal institutions but by omitted variables or unobserved differences between countries.⁴⁴

To partly rectify these methodological deficiencies in the broad law and finance literature, Haselmann et al. conduct an empirical study on the role of creditor rights protection law in bank lending in 12 transition economies in Central and East Europe, in which they focus on exploring the relationship between reform of bankruptcy law and collateral law on the one hand and macro-level behavioral changes by banks in their lending activities on the other hand. There are three major findings in their study. Firstly, law (in this case formal creditor rights protection under both bankruptcy and collateral law) does in fact promote lending by increasing lending volume over time,⁴⁵ thus suggesting a causal relationship between formal contract enforcement institutions and financial market development. Secondly, collateral law designed to protect individual creditors' claims is of greater importance for expanding bank lending than bankruptcy law aimed at establishing a collective enforcement regime.⁴⁶ In particular, in their sample countries that have undergone reforms of collateral regimes, bank lending is positively associated with the recognition of non-possessory security interests in movable assets (i.e., personal property as opposed to real property) as well as the establishment of an effective registration system to verify such interests.⁴⁷ Lastly, they also find that the biggest beneficiaries of legal reform with regard to creditor rights protection in the sample countries are foreign banks, especially foreign "greenfield" banks (i.e., newly established foreign banks in the domestic market as opposed to foreign banks that have taken over or acquired domestic banks to enter the domestic market), as indicated by their substantially greater increase in lending volume than that of incumbent domestic banks, regardless of whether they are privately or state owned.⁴⁸

⁴⁴ *Id.* at 2.

⁴⁵ *Id.* at 3 and 26.

⁴⁶ *Id.* at 3 and 27.

⁴⁷ *Id.* at 26-27.

⁴⁸ *Id.* at 3 and 28.

It is also worth pointing out that although the broad law and finance literature on the whole emphasizes the central thesis that legal institutions influence corporate finance and financial development, there are divergent views regarding the degree to which the legal system should simply enforce private contracts without doing much else (i.e., the “Coasian” view), and the degree to which the legal system should set up specific legal rules governing shareholder and creditor rights. The critics of the Coasian view contend that for private contracting in financial markets to work effectively, courts must enforce private contracts in an impartial and sophisticated way that is attentive to the technicalities and complexities of these contracts.⁴⁹ However, these critics go on to point out that, because this is often not the case in many developing countries with a weak judiciary, there is an advantage in developing company, bankruptcy and securities laws to provide a stable framework for organizing financial transactions and protecting the rights of minority shareholders and creditors.⁵⁰ One caveat on this emphasis on a larger role for legal institutions in governing financial contracting is that while the resultant standardization may improve efficiency by lowering the transaction costs associated with financial contracting, too much rigidity in the law may also hinder efficient customization of contracting.⁵¹

The most recent *Governance* study published by the World Bank seeks to trace the state of governance globally. The report identifies six institutional areas which are used both independently and collectively as governance indicators. Included in these six indicators is the rule of law, which is defined as “measuring the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.”⁵² On the rule of law specifically, the authors find ‘substantial causation’ with regard to the impact of improved rule of law on income levels. More generally, they find that one standard deviation improvement in collective governance indicators would lead to a two-to three-fold difference in income levels in the long run.

⁴⁹ Edward Glaeser, Simon Johnson & Andrei Shleifer, Coase versus the Coasians, 116 *Quarterly Journal of Economics* 853, 854 (2001).

⁵⁰ Beck & Levine 2005, *supra* note 32, at 254.

⁵¹ *Id.*

⁵² Daniel Kaufmann, Aart Kraay & Massimo Mastruzzi, *Governance Matters IV: Governance Indicators for 1996-2004*, World Bank (2005) at 3, *available at* <http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>.

Furthermore, when they isolate and remove reverse causality, they find the causation between governance and development remains significant.⁵³

A problem with these cross-country studies is that while they use certain indicators for the degree of contract enforcement or include contract enforcement as a constituent element, none of them examine contract enforcement as a variable in itself. Thus far, the study that has most specifically examined the strength of state enforcement of contracts, conducted by Djankov, La Porta, Lopez-de-Silanes and Shleifer, is known as the Lex Mundi Project.⁵⁴ This study measures and describes the exact procedures used by litigants and courts to evict a tenant for nonpayment of rent and to collect a bounced check. It provides cross-country data on the procedures involved in formal dispute resolution in each of the 109 countries involved in the study. The study offers comparative evidence with regard to the effectiveness of legal institutions in realizing the purposes they were created to serve. However, Davis suggests that while the results of the Lex Mundi project are useful to legal reformers they should not be relied upon as strict or accurate indicators of the relationship between contract enforcement and development. Davis's criticism relates the project's methodology, which aims to assess a state's vigour in enforcing contracts by collecting data on the processes involved in enforcing two particular types of contracts—tenant evictions and collecting on bounced checks. Davis contends that, at best, “the data can be described as measures of the enforceability of *particular types* of contracts...as there is no reason to presume that any given legal system treats all contractual claims similarly.”⁵⁵ At most, the study speaks to the ability of certain contract enforcement mechanisms to realize the purpose for which they were implemented. However, it does not provide any useful data on the contribution of contract enforcement to economic growth. Another problem with the Lex Mundi Project is suggested by Dam, who points out that the term “formalism” as defined in this project (i.e., procedural complexity in court proceedings) cannot fully capture the actual degree of judicial effectiveness across countries, especially between civil law countries and common law countries, and that the implicit judgment in this project that formalism was not efficient for the two simple types of cases – evicting

⁵³ *Id.* at 36-37.

⁵⁴ Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Courts, 118(2) *Quarterly Journal of Economics* 454 (2003).

⁵⁵ Davis, *supra* note 24, at 159.

defaulting tenants and collecting bounced checks – may be misleading. This is because while higher degrees of judicial formalism are found most often in civil law countries, including many developing countries, in terms of procedures and requirements for court proceedings, it does not follow that common law countries with lower degrees of judicial formalism, especially wealthier countries, necessarily score higher in timely resolving these simple cases. For example, certain developed common law countries manifested unusual delay in the check collection case, such as 421 days in Canada and 320 days in Australia, compared to 40 days in Swaziland and 60 days in Belize with the same common law tradition.⁵⁶ Moreover, in Asia, civil law countries have shorter durations of court proceedings than common law countries in the Lex Mondī Project, indicating another deviation from the implicit judgment suggested by this project that common law countries have generally lower degrees of formalism – hence generally higher degrees of judicial effectiveness - than civil law countries.⁵⁷

A further problem in this vein is suggested by a study by Acemoglu and Johnson, which concludes that while enforcement of property rights correlates significantly with economic growth, financial development and investment, formal rules of contract have a significant effect only on the use of financial intermediation, and thus on the form of finance, e.g., the use of equity contracts vs. debt contracts by firms.⁵⁸ One consequence of inferior formal contracting institutions is that countries with such institutions have less developed stock markets, and firms in these countries may have more debt rather than equity financing, probably because debt contracts are cheaper to enforce.⁵⁹ The assessment by Acemoglu and Johnson of formal contracting institutions is that they only have a tenuous correlation with growth, investment, and the total amount of credit in the economy.⁶⁰

There are also country-specific studies that suggest the benefits of contract law in facilitating successful and profitable transactions. For instance, a study of enterprises in Russia by Hendley, Murrell and Ryterman concludes that law and legal

⁵⁶ Dam, *The Judiciary*, *supra* note 34, at 10.

⁵⁷ *Id.* at 11.

⁵⁸ Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113:5 *Journal of Political Economy* 949, 983-984 (2005).

⁵⁹ *Id.* at 953 and 983-984.

⁶⁰ *Id.* at 988.

institutions in relation to contract enforcement do add value to the Russian economy.⁶¹ They found that since Russia introduced significant reform of those legal institutions pertinent to the formation and enforcement of inter-enterprise agreements in 1991, there has been an increasing trend towards using the new *arbitrazh* court system to resolve contract disputes among Russian firms.⁶² However, despite the increasing inclination of Russian firms to resort to courts for contract enforcement, the reliability and effectiveness of the courts in enforcing judgments has been much debated. For example, the *arbitrazh* courts in Russia, which hear cases arising from commercial disputes, have been criticized for lacking the ability to meet litigants' basic needs of resolving standard business disputes, especially enforcing judgments.⁶³

But then, why firms go to courts at all, if the judgments cannot be effectively enforced? A plausible explanation is provided by Varese.⁶⁴ Drawing on rich empirical data on the operation of the Russian *arbitrazh* courts in handling cases involving contract disputes over non-payment, he discovered that firms that make up the majority of litigants in these cases are large enterprises which were formerly state-owned and were privatized in the 1990s, while small enterprises in the private sector generally shun the courts when it comes to contract enforcement. According to Varese, one possible reason for this disparity is that managers of large enterprises, which often are less efficient and competitive than smaller private enterprises, have stronger incentives to file cases with the *arbitrazh* courts as a “signalling” strategy. Even though knowing that favorable court judgments are not likely to be effectively enforced, these managers still go to courts when contract disputes arise because they want to be perceived as making efforts to recover bad debt in a legal way. By sending out such “law abiding” signals to both the market and the state, either their firms' losses resulting from managerial incompetence can be concealed and hence future transactional opportunities sustained, or firms can continue to receive bank loans and state subsidies. By comparison, smaller private enterprises, which usually face greater transactional uncertainty and risks of cheating and have shorter business time-

⁶¹ Kathryn Hendley, Peter Murell & Randi Ryterman, Law Works in Russia: The Role of Legal Institutions in the Transactions of Russian Enterprises, *in* Peter Murrell (eds.), *Assessing the Value of Law in Transition Economies* 56, 87 (2001).

⁶² *Id.* at 56 and 70.

⁶³ Kathryn Hendley, Growing Pains: Balancing Justice & Efficiency in the Russian Economic Courts, 12 *Temp. Int'l & Comp. L.J.* 301, 331 (1998).

⁶⁴ Federico Varese, The Russian Mafia: Private Protection in a New Market Economy 53 (2001).

horizons than large enterprises, tend to resolve contract disputes largely outside the courtroom, partly due to a lack of confidence in the courts' ability to enforce judgments in a timely manner.⁶⁵ The difficulty with timely enforcement of judgments often entails substantial adverse commercial implications in a transition economy struggling with macro-economic instabilities. Most critically, at a time of exceedingly high inflation rates, as experienced by the Russian population, even a short delay in recovering debt or payment through formal enforcement by "slow" courts can cause significant financial losses in real terms.

The main conclusion to be derived from this brief review of the literature on the relation between formal contract law and enforcement and development is that the existing empirical evidence specifically examining the correlation between a country's economic growth and the state as a credible third-party enforcer of contracts does not provide strong or unambiguous corroboration of the contract-formalist position beyond the truism that most rich countries have sophisticated formal contract law and enforcement regimes and many if not most poor countries do not (but this could equally be said of many other differences between rich and poor countries indicating little about what is a cause or what is a consequence of development).

IV. THE CONTRACT INFORMALISTS: THE EMPIRICAL EVIDENCE

The following studies of trade and contracting practices in both developed and developing economies provide empirical support for the contract-informalist perspective.

1. Developed Economies: Contracting in the Shadow of the Law

One of the first studies to advance the contract-informalist perspective is Stewart Macaulay's famous examination of the practices of American businessmen, in which he found an aversion on the part of the business community to formal legal

⁶⁵ *Id.* at 53-54.

mechanisms to enforce contractual terms or resolve contractual disputes.⁶⁶ According to Macaulay, social pressure and reputation are more widely used than formal contracts and enforcement in executing mutually beneficial agreements. Macaulay discounted the importance of formal contractual enforcement as a means of facilitating economic transactions, and instead introduced the idea of relational contracting as a method of contractual enforcement (although much ambiguity continues to surround the definition of relational contracts).⁶⁷

Lisa Bernstein's frequently cited study speaks to the ability of the norms of an ethnic network (the Hassidic Jews) to provide the stability in private ordering that facilitates business transactions without resort to the formal legal system.⁶⁸ Bernstein uses the customs of the New York diamond trade to suggest that reputation and trust can be used at a low enough cost to allow private transactions to take place outside the domain of the formal legal system.⁶⁹ It is interesting to note how the relationship between the New York diamond trade and the formal legal system changed as the industry's means of self-enforcement changed. In particular, Bernstein notes that as new individuals entered the diamond trade, many established traders began abandoning the long-standing practice of unwritten contract formation and shifting to written contracts (although matter courts in practice do enforce both written and unwritten contracts; and written agreements might be adopted to facilitate the imposition of non-legal as well as legal sanctions.⁷⁰) When the entire industry is comprised of a homogeneous group of individuals who all adhere to a single set of operational rules, there is little need to resort to external rules of order. However, once the trading floor began to diversify in its composition as new or unfamiliar agents entered the industry then the enforcement system changed. At this point, when a need develops to go beyond the ethnically derived extra-legal norms that govern the transactions of an industry and there exists a legitimate and credible legal order, it

⁶⁶ Stewart Macaulay, *Non Contractual Relations in Business: A Preliminary Study*, 28 *American Sociological Review* 55 (1963) [hereinafter Macaulay].

⁶⁷ See Charles Goetz & Robert Scott, *Principles of Relational Contracts*, 67 *Va. L. Rev.* 1080 (1981) [hereinafter Goetz & Scott]; Ian MacNeil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a Rich Classificatory Apparatus*, 75 *Nw. U. L. Rev.* 1018 (1980).

⁶⁸ Bernstein 1992, *supra* note 17.

⁶⁹ *Id.* at 98.

⁷⁰ See, e.g., David Charny, *Illusions of a Spontaneous Order: Norms in Contractual Relationships*, 144 *U. Pa. L. Rev.* 1841 (1996); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 *Harv. L. Rev.* 373 (1990).

seems likely that the practices of the latter will inform or determine new developments in the former.

There are other examples of informal contract enforcement mechanisms. As reported by McMillan,⁷¹ a New York cable television company, Paragon Cable, has developed a novel, and reportedly effective, strategy to recover overdue bills. Rather than cut off cable, it runs C-Span's "interminable political speeches, debates, and hearings" on all of its 77 channels until the subscriber pays up. He also notes that an American debt collection agency for fish wholesalers in Portland, Maine, began using the Internet to sell wholesalers credit information about buyers with a payment default record.⁷² A further example of self-governance as enforcement mechanisms is the internal rules and procedures for contract enforcement and dispute resolution of NYSE. The brokers trading on the stock exchange were able to regulate themselves through the sanction of expulsion – members who default on contracts were barred while non-members who renege on contracts with members were blacklisted.⁷³

2. Early International Trade: Contracting without State

An important study that speaks to the viability of informal economic practices in early trade is Avner Greif's study of the relations between the Maghribi merchants and their overseas agents in the Mediterranean during the late medieval Commercial Revolution. The merchants solved the contract enforcement problem by establishing a reputation-based institution, whereby information sharing and multilateral punishment enabled credible commitment *ex ante* and effective fulfillment of contractual obligations *ex post*.⁷⁴

Another study by Greif, Milgrom and Weingast on the merchant guilds in medieval Europe also examines contract enforcement mechanisms in early international trade. According to the authors, merchant guilds emerged during the late

⁷¹ John McMillan, *Reinventing the Bazaar: A Natural History of Markets* 56 (2002) [hereinafter McMillan 2002].

⁷² *Id.* at 57.

⁷³ *Id.* at 23.

⁷⁴ Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (forthcoming 2006), Chapter 3: "Private-Order Contract Enforcement Institutions: The Maghribi Traders Coalition" [hereinafter Greif 2006].

medieval period as an effective institution of contract enforcement, which allowed rulers of trade centers to commit to the security of alien merchants, thus contributing to the expansion of trade during this period.⁷⁵

Similarly, Dam observes that boycotts and reputation were the early European substitutes for the rule of law during the evolution of long-distance trade in Europe in the Middle Ages. He, however, points out that these informal solutions to the contract enforcement problem illustrate why the rule of law is essential to the efficient functioning of a modern economy, which is fundamentally different from early trade in terms of the complexity of goods and services involved.⁷⁶

There are additional examples of indigenous mercantile institutions of trust and commitment in the history of many developing countries that facilitated long-distance trade and credit. These informal institutions that addressed the problem of cooperation were based on multilateral reputation mechanisms and informal codes of conduct and enforcement, such as mercantile families and groups in pre-colonial and colonial India, Chinese traders in Southeast Asia, and Arab “trading diasporas” in West Africa.⁷⁷

3. Contemporary International Trade: Private Arbitration, Transnational Networks, and the Resurgence of Barter

One issue that is not adequately addressed in the literature on contract enforcement and development is the role of contract enforcement in contemporary international trade (the study by Berkowitz, Moenius and Pistor, discussed below, is a notable exception⁷⁸). In the arena of contemporary international trade, many informal contract enforcement mechanisms still prevail. A growing consensus in development studies is that long-term economic growth is significantly dependent on expanding

⁷⁵ Avner Greif, Paul Milgrom & Barry R. Weingast, Coordination, Commitment and Enforcement: the Case of the Merchant Guild, 102:4 *The Journal of Political Economy* 745 (1994) [hereinafter Greif et al. 1994].

⁷⁶ Kenneth W. Dam, Institutions, History and Economic Development, University of Chicago John M. Olin Law & Economics Working Paper No. 271 (2006), at 3-7.

⁷⁷ Pranab Bardhan, Institutions Matter, but Which Ones?, 13:3 *Economics of Transition* 499, 512-513 (2005) [hereinafter Bardhan 2005].

⁷⁸ Daniel Berkowitz, Johannes Moenius & Katharina Pistor, Legal Institutions and International Trade Flows, 26 *Mich. J. Int'l J.* 163 (2004) [hereinafter Berkowitz, Moenius & Pistor].

international trade and attracting large-scale foreign direct investment (FDI) from parties who do not share common ethnic, cultural or social characteristics.⁷⁹ Despite this recognition of the importance of international trade and FDI for development, however, as Greif points out little attention has been paid by NIE scholars to the impact on contract enforcement mechanisms brought about by the expansion of international trade.⁸⁰

In contemporary international trade, three non-state institutions of contract enforcement are utilized extensively to mitigate contracting problems arising from cross-border transactions: international commercial arbitration, transnational business and social networks, and barter/countertrade.

International commercial arbitration has emerged over the past two decades as a common mechanism for settling trade and investment disputes among private parties in different countries. Compared with public courts, the advantages of international commercial arbitration in enforcing contracts include flexibility, technical expertise, privacy, and confidentiality, all of which are important in satisfying the needs of private parties for low-cost, expeditious, and effective resolution of contract disputes.⁸¹ As a result, this mechanism for contract enforcement promotes international trade and investment, although it does not fully address some persistent forms of contractual uncertainty relating to the limits of the enforceability of international arbitration awards within national borders.

Rauch observes that transnational business networks and social networks that operate across national borders can help to alleviate two typical kinds of “informal trade barriers”- weak enforcement of international contracts and inadequate information about international trading opportunities -- thus promoting international trade.⁸² Examples include the “outsourcing” of software development by Indian engineers in Silicon Valley to regions like Bangalore and Hyderabad, and overseas Chinese networks in building trust where formal contract enforcement is weak or

⁷⁹ *Id.*

⁸⁰ Greif et al. 1994, *supra* note 75.

⁸¹ Walter Mattli, *Private Justice in a Global Economy: From Litigation to Arbitration*, 55:4 *International Organization* 919, 944 (2001).

⁸² James E. Rauch, *Business and Social Networks in International Trade*, 39:4 *Journal of Economic Literature* 1177, 1200 (2001) [hereinafter Rauch].

nonexistent. Means of deterring deviation include building “moral communities” and the threat of collective punishment.⁸³ As noted by Rauch, one important aspect of the role of transnational business and social networks in international trade is how they contribute to international technology transfer. He explains that this is because international technology transfer is not always an “arm’s-length” phenomenon: for firms in less developed countries (LDCs), a major, and perhaps dominant, source of technology transfer and transfer of managerial know-how comes from instruction by buyers in developed countries.⁸⁴ These buyer-seller relationships are usually long-term and thus fit the definition of business networks as repeated exchange mechanisms. Another such example of private contract enforcement through transnational business networks in international trade is provided by the intermediaries between Taiwanese shoe manufacturers and Western fashion houses. These intermediaries, usually in the form of trading companies, perform dispute-resolution functions in addition to their primary matchmaking functions by utilizing their informational advantages regarding both parties.⁸⁵

Also notably, recent research by Marin and Schnitzer reveals that there is a significant “resurgence” of barter/countertrade in international trade.⁸⁶ Merging contract theory and international trade theory, the authors offer efficiency-based explanations for the resurgence of barter in international trade and transition economies. In their view, the increasing use of barter in both international trade and transition economies is an optimal institutional response to contract enforcement problems in both settings.⁸⁷ Specifically, with regard to the problem of declining creditworthiness of many developing countries since the 1980s, especially in the aftermath of a series of regional financial crises, barter serves to mitigate uncertainty in enforcing trade agreements by providing a form of deal-specific collateral, thus substituting for both enforcement by supranational authorities and reputation-based self-enforcement.⁸⁸ Therefore, barter facilitates the transfer of technology and capital between developed and developing countries through forging the incentive to trade on

⁸³ *Id.* at 1177 and 1180.

⁸⁴ *Id.* at 1197-1198.

⁸⁵ McMillan 2002, *supra* note 71, at 46.

⁸⁶ Dalia Marin & Monika Schnitzer, *Contracts in Trade and Transition: The Resurgence of Barter* (2002) [hereinafter Marin & Schnitzer].

⁸⁷ *Id.* at 8.

⁸⁸ *Id.* at 6-7.

both sides when contractual uncertainty involving buyers' payment liquidity as well as sellers' exploitation of hold-up positions is significant.

While informal enforcement still tends to be the prevailing pattern for many transactions in international trade, an important study by Berkowitz, Moenius, and Pistor suggests new trends in the relationship between legal institutions and international trade flows.⁸⁹ They find that as economies move up the value chain to more complex exports, the quality of their domestic legal institutions is increasingly important for assuring contract enforcement. As corroborated empirically in their study, weak domestic legal institutions have adverse effects on the ability of indigenous firms to expand export trade in more complex goods and services.⁹⁰

4. Developing and Transition Economies: Contracting without the Shadow of Law, in the Shadow of a Predatory State, and under Dysfunctional Public Order

While for many commentators, contract enforcement problems and non-functional legal institutions more generally have become an important factor in explaining differences in the performance in developing and transition economies,⁹¹ it has also been widely recognized that it takes time for these economies to build such institutions. During this transition process, informal mechanisms may fill some gaps and permit some markets to function.

There is a growing body of literature on informal product and credit markets in developing and transition countries that shows the importance of reputation and family or ethnic networks as screening devices in selecting reliable partners in the absence of formal contract enforcement institutions. For instance, African businessmen of Asian descent interact primarily with others from the same ethnic

⁸⁹ Berkowitz, Moenius & Pistor, *supra* note 78.

⁹⁰ *Id.*

⁹¹ See, e.g., Marin & Schnitzer, *supra* note 86, at 10.

background⁹², and Russian managers deal primarily with commercial partners who are familiar from central planning days.⁹³

Some recent empirical results of research on the relationship between modes of contract enforcement and firms' finance patterns in developing countries suggest that where formal sources of finance are unavailable to or very costly for indigenous firms, informal contracting practices are a major channel for obtaining external, albeit informal, sources of finance. For example, in an empirical study of the impact of ethnicity on financing practices of Kenyan firms, Biggs, Raturi and Srivastava find that ethnicity does not affect access to formal sources of finance, but being a member of an ethnic group is significant in explaining access to informal sources of finance like supplier credit.⁹⁴ They explain this pattern by attributing the availability of informal sources of finance to information and contract enforcement mechanisms that work within ethnic groups but not across them. Informal finance through so-called "back-alley banking" is also pervasive in some East Asian economies such as China, Taiwan, and Korea as a primary source of financing growth in their private sectors.⁹⁵

Kähkönen, Lee, Meagher and Semboja provide another example of informal contracting practices in Africa that are an imperfect substitute for a formal contract enforcement regime.⁹⁶ Based on surveys and interviews of firms in Tanzania, the authors find that long-term patterns of mutual dependency in repeated interaction provide the primary guarantee of contractual discipline. They note:

... Transactions tend to be documented by simple purchase orders, and the use of legal counsel is rare. Firms' perceptions of the legal system are consistent with research

⁹² Tyler Biggs, Mayank Raturi & Pradeep Srivastava, *Enforcement of Contracts in an African Credit Market: Working Capital Financing in Kenyan Manufacturing*, Regional Program on Economic Development (RPED) Discussion Paper, World Bank (1996).

⁹³ Kathryn Hendley, Barry W. Ickes, Peter Murrell & Randi Ryterman, *Observations on the Use of Law by Russian Enterprises*, 13:1 *Post-Soviet Affairs* 19, 20 (1997).

⁹⁴ Tyler Biggs, Mayank Raturi & Pradeep Srivastava, *Ethnic Networks and Access to Credit: Evidence from the Manufacturing Sector in Kenya*, 49:4 *Journal of Economic Behavior & Organization* 473 (2002).

⁹⁵ See, e.g., Kellee S. Tsai, *Back-Alley Banking* (2002).

⁹⁶ Satu Kähkönen, Young Lee, Patrick Meagher & Haji Semboja, *Contracting Practices in an African Economy: Industrial Firms and Suppliers in Tanzania*, Centre for Institutional Reform and the Informal Sector (the IRIS Centre) at the University of Maryland Working Paper No. 242 (May 2001), available at http://www.iris.umd.edu/Reader.aspx?TYPE=FORMAL_PUBLICATION&ID=286c60b0-5ad8-4e0f-b927-f8669c7baad9.

showing a weakly established rule of law, wide judicial discretion, and outdated commercial laws. Not surprisingly, then, examples of fixed non-fungible investments and commercial credit for any appreciable length of time are rare.⁹⁷

As a result, firms in Tanzania often forego valuable international business opportunities due to the country's weak legal environment and the consequent contracting difficulties.⁹⁸ The weak rule of law also has a significant impact on firms' choice of contractual dispute resolution mechanisms, as the authors find that firms in Tanzania tend to bargain or renegotiate the terms of the contract with the other party rather than resort to legal means, because non-legal enforcement mechanisms are perceived to be more satisfactory and less disruptive of business relationships than legal ones.⁹⁹

Additional evidence of economic activity occurring in a business environment that operates outside a formal contractual framework is presented by Marcel Fafchamps.¹⁰⁰ Fafchamps uses survey and anecdotal evidence of African firms to evaluate the degree to which formal rules are used to facilitate or regulate transactions. He finds that Ghanaian and Kenyan firms face regular delivery and payment delays, yet such delays do not prevent them from engaging in repeat transactions. However, according to Fafchamps, imperfect compliance with contractual obligations does not stem from a cultural predisposition against formality in contract. Rather, it is a result of the recognition by the firms he interviewed that perfect compliance is an ideal out of reach of themselves, their clients and their suppliers: "lack of contractual discipline is thus largely a corollary of the prevailing level of economic development. Contract enforcement considerations have profound effects on the way firms deal with each other and with final consumers."

As pointed out by Greif, private contract enforcement is mostly likely to prevail when there is no state, when economic agents expect the state to expropriate rather than protect their property, or when the state is unwilling or unable to secure

⁹⁷ *Id.* at 1.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ Fafchamps, *supra* note 17.

property rights and enforce contracts.¹⁰¹ A typical example of the state being a predator (i.e., a “grabbing hand”) rather than a protector (i.e., a “helping hand”) can be found in the large “unofficial economies” widely observed in post-communist former Soviet Union states. This is partly a result of punitive or arbitrary taxation and weak protection of property rights that drives firms to hide assets and profits by “going underground.”¹⁰² Hernando de Soto also provides a revealing narrative of the informal sector in the Peruvian economy, where private production and transactions operate largely outside the formal legal system because of the severe impediments to and costs imposed on formal productive activities.¹⁰³

In this connection, it is important to distinguish between private ordering that entails “*opting out*” of the formal legal system (e.g., the New York diamond industry), and private ordering that is “*forced out*” of the legal system (e.g., the Peruvian private actors active in the informal sector and the unofficial economy in transition economies in the former Soviet Union bloc). According to Ellickson, the reasons for parties to opt out of the formal legal contract regime are associated not only with the costs of using courts to solve disputes but also with the “atmospheric critique” of market exchange held by members of an intimately close-knit community. In such a community, resorting to a formal legal regime to write and enforce contracts is regarded as “polluting the close relationship by implying that the parties do not trust each other enough to rely on informal exchange.”¹⁰⁴

A related issue that arises in this context is whether formal contract law and enforcement “crowds-out” or “crowds-in” informal contracting arrangements, i.e., whether formal contracting and informal contracting are substitutes for, or complements to, one another. For example, the widely noted paper by Gneezy and Rustichini on Israeli day care centres provides evidence of the “crowding-out” effect.¹⁰⁵ In the authors’ experiment, imposing a modest fine for parents who were late in picking up children from day care centres in Israel actually increased the incidence of this behaviour, thus crowding-out in some sense prior social norms that

¹⁰¹ Greif 2006, *supra* note 74, Chapter 1: “Introduction”.

¹⁰² See Simon Johnson et al., *The Unofficial Economy in Transition*, 2 *Brookings Papers on Economic Activity* 159 (1997).

¹⁰³ See Hernando de Soto, *The Other Path: the Invisible Revolution in the Third World* (1990).

¹⁰⁴ Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* 247 (1991).

¹⁰⁵ Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 *J. Legal Stud.* 1 (2000).

constrained parents to limit both the frequency and extent of late pick ups.¹⁰⁶ The same issue is also examined by Kranton and Swamy in their analysis of transplantation of legality and formalism from Britain to colonial India.¹⁰⁷ They find that while the introduction of civil courts to agricultural credit markets in the Bombay Deccan in the colonial period made it easier to enforce credit contracts, which in turn led to increased competition amongst lenders as well as wider availability and lower cost of credit to the Indian farmers, it also reduced lenders' incentives to subsidize farmers' investments in times of crisis, leaving them more vulnerable in bad times.¹⁰⁸ Thus, in this case, formal contract enforcement crowded out the insurance function previously performed by informal contracting and enforcement in a less competitive lending sector.¹⁰⁹ In the same vein, Scott also argues that based on experimental evidence formal contract enforcement often crowds out informal contractual relationships, at least in a range of contexts.¹¹⁰ This is because formal contracting and enforcement tends to undermine notions of "reciprocal fairness" upon which informal relationships are predicated, in part because parties insisting on formal contracts and enforcement mechanisms may be interpreted as signaling that they are non-reciprocitarians.¹¹¹ This observation, however, is partly contradicted by the experimental evidence presented by Lazzarini, Miller and Zenger, who find that by enforcing contractible exchange dimensions, contracts facilitate the self-enforcement of non-contractible dimensions.¹¹² They also find that this complementarity effect is particularly important when repetition is unlikely and thus self-enforcement is difficult.¹¹³ Therefore Lazzarini et al. argue that at least in non-repeat relationships, formal contract law and enforcement may have a crowding-in effect on informal enforcement mechanisms such as norms of reciprocity.

While optional private ordering usually does not imply dysfunctional public order and indeed is often rendered workable by an effective background formal legal

¹⁰⁶ *Id.*

¹⁰⁷ Rachel E. Kranton & Anand V. Swamy, The Hazards of Piecemeal Reform: British Civil Courts and the Credit Market in Colonial India, 58 *Journal of Development Economics* 1 (1999).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ Robert Scott, The Death of Contract Law, 54 *U. of Toronto L.J.* 382, 389 (2004).

¹¹¹ *Id.*

¹¹² Sergio Lazzarini, Gary Miller & Todd Zenger, Order with Some Law: Complementarity versus Substitution of Formal and Informal Arrangements, 20 *Journal of Law, Economics, and Organization* 261 (2004).

¹¹³ *Id.*

system to enforce contracts when necessary, forced private ordering is frequently a result of the unavailability of an effective formal legal system, and therefore in some circumstances can be highly inefficient and with detrimental effects for long-term institution building.¹¹⁴ Forced private ordering often finds its manifestations in economies in transition from central planning to markets, because these economies generally lack both functioning legal systems and a strong base of social trust to facilitate transactions.

For example, Vietnam is currently in transition from a planned economy to a market economy. McMillan and Woodruff find that Vietnam has virtually no commercial code and contract law to regulate transactions or settle disputes between private agents. Nor does its unreformed financial sector well serve small private businesses. There are also no sources of market information, such as trade associations or credit bureaus.¹¹⁵ However, its private sector is booming and has been a driving force in Vietnam's economic growth over recent years. To investigate this paradox, McMillan and Woodruff conducted a survey of privately owned manufacturing firms in Hanoi and Ho Chi Minh City. They found that business in the private sector often gets done through *ad hoc* strategies devised by entrepreneurs at the ground level. While more than 90 percent of the managers surveyed said the courts are of no use to them in resolving disputes, many entrepreneurs have adopted bottom-up substitutes for contract law and formal enforcement mechanisms. The managers' strategies for contract enforcement include relying on reputation and gossip to select partners, trying to avoid disputes by checking their customers' financial backgrounds and personalities with others who have done business with them, and meeting each other regularly in teahouses and bars to exchange information and discuss market opportunities.¹¹⁶ McMillan and Woodruff summarize the contracting practices of Vietnam private businesses as "contracting without the shadow of the law and only partly in the shadow of the future (i.e., the likelihood of repeat dealings based on reputation)."¹¹⁷ Here it is worth pointing out that many

¹¹⁴ Marin & Schnitzer, *supra* note 86.

¹¹⁵ John McMillan & Christopher Woodruff, Dispute Prevention without Courts in Vietnam, 15:3 Journal of Law, Economics and Organizations 637 (1999) [hereinafter McMillan & Woodruff 1999a]; see also John McMillan & Christopher Woodruff, Interfirm Relationships and Informal Credit in Vietnam, 114:4 Quarterly Journal of Economics 1285 (1999).

¹¹⁶ McMillan & Woodruff 1999a, *id.*

¹¹⁷ *Id.*

transacting strategies adopted by the Vietnamese entrepreneurs are not means of substituting informal for formal contract enforcement, but means of creatively substituting more nearly simultaneous exchange for long-term, impersonal contracting. In other words, through engaging in less contracting behavior, these private strategies seem to be an attempt to avoid rather than resolve the problem that formal contract enforcement is designed to address.

The situation of private contract enforcement in the transition economies in the former Soviet Union is also problematic. According to McMillan, in post-communist transition economies where a comprehensive system of commercial law, including contract law, has not been well established, substitutes for formal legal contract enforcement include repeated games and private coercion.¹¹⁸ For example, in Bulgaria, private firms have little trust in formal enforcement mechanisms, and they hesitate to deal with strangers and often require payment up front if they do.¹¹⁹ In Ukraine, banks' strategy in making profitable loans has been a careful screening process for selecting trustworthy borrowers, although this is done in an informal way – the bank owners usually choose borrowers who have personal contacts with them. Moreover, to reduce risks of default, the maturity of loans are usually short term; the threat of exclusion from future loans deter the borrowers from defaulting.¹²⁰ Indeed, as a general matter in transition economies firms choose to do business mostly with their customers and suppliers who had in the past already established a track record of repayment and fulfillment of contractual obligations.

Thus an important question arises: what alternatives are available to those transition economies that have neither effective formal contract law and enforcement institutions, at least during the period of transition, nor a solid base of social trust or so-called “social capital” in their history to substitute for law in facilitating business transactions? For countries with little history of functioning market institutions like Russia, and where social trust and efficient commercial norms have not existed, how can private agents enforce their contracts? Some responses have been attempted,

¹¹⁸ John McMillan, *Markets in Transition*, in David Kreps & Kenneth Wallis (eds.), *Advances in Economics and Econometrics: Theory and Applications: Volume II* 226, 227 (1996) [hereinafter McMillan 1996].

¹¹⁹ Cheryl W. Gray, *Reforming Legal Systems in Developing and Transition Countries*, 34:3 *Finance and Development* 14, 14 (1997) [hereinafter Gray].

¹²⁰ McMillan 1996, *supra* note 118, at 227.

which largely emphasize the role of informal contract enforcement mechanisms based on private or “privatized” coercion, such as private security agencies and mafia. The most salient common feature of such informal contract enforcement mechanisms is that they have emerged to address contract enforcement problems under a dysfunctional public order. In particular, the use of some private contract enforcement mechanisms is a bottom-up response to the reality of “contracting in the shadow of a predatory state.”

Perhaps the most revealing example of this kind is the large unofficial economy in Russia, which is estimated to account for over 40 percent of the Russian economy.¹²¹ The punitive and arbitrary tax code and its administration in Russia deters firms from operating within the law and forces them to go underground and resort to private means of contract enforcement. Because the majority of Russian businesses are probably in violation of various tax, customs, foreign exchange, or regulatory rules, they will not use the official legal system to resolve disputes for fear of exposure.¹²² A predatory state can also have negative implications for the utilization (or more accurately, the under-utilization) of otherwise effective private contract enforcement institutions. For example, although private arbitration commissions have been established as a contract enforcement mechanism on Russia’s commodity exchanges, such arbitration has not been widely used by traders to resolve contract disputes, because resorting to the arbitration commissions could expose their financial interests through information disclosure to the Russian state. This risk of contracting in the shadow of a predatory state has led traders to develop a preference for off-the-market contract enforcement through private enforcers, which essentially undermines the effective use of the arbitration mechanism and hence the purpose of realizing self-governance among the traders for which it was created to serve.¹²³

¹²¹ Jonathan R. Hay & Andrei Shleifer, Private Enforcement of Public Laws: A Theory of Legal Reform, 88:2 American Economic Review 398, 399 (1998).

¹²² *Id.* at 399; see also Bernard Black, Reinier Kraakman & Anna Tarassova, Russian Privatization and Corporate Governance: What Went Wrong?, 52 Stan. L. Rev. 1731 (2000) [hereinafter Black et al.].

¹²³ Timothy Frye, Contracting in the Shadow of the State: Private Arbitration Commissions in Russia, in Jeffrey D. Sachs & Katharina Pistor (eds.), *The Rule of Law and Economic Reform in Russia* 123 (1997).

Finally, the resurgence of barter in transition economies such as Russia is also a response to contractual problems under a dysfunctional public order.¹²⁴ As discussed earlier, barter in transition economies solves the problems of contract enforcement by serving as deal-specific collateral for trade credits when firms face liquidity constraints. The advantage of paying with goods rather than money is that they can be earmarked as property of the creditors.¹²⁵ However, barter also has long-term costs for transition economies' growth prospects. Specifically, it is likely to lead countries in transition to fall into an "institutional trap" that will hinder the establishment and development of a functioning banking system. This is because once barter and personalized exchange gets "locked-in," then it will persist over time even though it is a less efficient form of exchange (a form of path dependency). As a result, countries with a large and increasing exposure to barter trade will see the development of their financial sector lag.¹²⁶

V. TWO NON-STANDARD DEVIATIONS: THE "CHINA ENIGMA" AND THE "EAST ASIAN MIRACLE"

The so-called China Enigma and the East Asian Miracle can be viewed as two "non-standard" deviations from the North proposition, insofar as they present distinct growth models that do not appear to support the centrality of formal and rule-based state enforcement of contracts for achieving strong economic outcomes.

1. The "China Enigma"

China's almost consistent 9 to 10 percent economic growth rate for approximately two decades has attracted close analysis in development circles. The economic exceptionalism that renders the Chinese example so intriguing arises from the fundamental difference between its political, economic and legal regimes and those of the world's developed economies. China has an undemocratic and non-transparent political system, leading to relatively low rankings on most governance

¹²⁴ David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism*, at xiii (1999).

¹²⁵ Marin & Schnitzer, *supra* note 86, at 42-43.

¹²⁶ *Id.* at 179-180.

indicators, and yet its economic growth continues to outpace those of most developed and developing nations. The absence of a consistently enforced legal framework largely prevents the state from being the credible third party enforcer of contracts that North's argument suggests is necessary for economic development. Among various institutional weaknesses in the Chinese legal system, courts in China are generally known for lack of both professional competence and independence from political interference, and also suffer from local and departmental protectionism in adjudication and enforcement of judgments. In addition, judicial corruption is also regarded as a serious barrier to the realization of the rule of law in the Chinese society. Thus, within the context of this paper, the issue becomes how exactly the China enigma informs the debate over the role of contract law in promoting a nation's economic growth.

To situate the "China enigma" in context, it is critical to note that dependency on formal institutions for achieving economic growth is considerably lower in "catch-up" countries in transition from a low-income equilibrium to a state of rapid growth, than in countries moving from a middle-income equilibrium to higher levels of income.¹²⁷ In other words, different modes of growth at different stages of development may require different policies and depend on different levels of institutional quality. In this sense, China is a catch-up economy that can hugely benefit from emancipation of productivities in its economy after launching market-oriented reform, even though its institutional quality is less satisfactory for a developed economy at a higher plateau of the growth trajectory.

There are a number of competing explanations for China's economic success in an environment of weak rule of law. Of relevance to this paper are two widely accepted and in our view compelling arguments. The first is the "credible commitments" argument¹²⁸, which is closely associated with the "performance legitimacy" of the Chinese communist government. The second is the "informal/*de facto* property rights" argument, which is tightly linked to China's "market-preserving

¹²⁷ Rodrik 2003, *supra* note 20, at 17.

¹²⁸ The term "credible commitments" has been used by NIE scholars to identify mechanisms of governance associated with private ordering by which confidence in both contracting and investment respects can be inspired through actions of a farsighted state aimed at "communicating credible commitments" to private economic agents. See Williamson 1996, *supra* note 9, at 335-336.

federalism.” Both of these arguments have implications for the role of contract enforcement institutions in China’s growth.

According to the “credible commitments” argument, the “performance legitimacy” on which the Chinese communist ruling is based (rather than “procedural legitimacy”¹²⁹) requires that the government deliver positive economic outcomes driven by high growth rates to sustain employment expansion and raise the living standards of the Chinese population. One reading of the “credible commitments” argument is that there is an implicit social contract between the Communist Party and the Chinese population that the latter will not press vigorously for more democratic forms of government if the government delivers high levels of economic growth and prosperity. To deliver on this social contract, the Communist Party needs high levels of domestic and foreign investment to help build its regime legitimacy on economic performance. This means that it must acquire and maintain a strong reputation for respecting contracts entered into by domestic and foreign investors at least with government or its agency by not repudiating fecklessly contractual entitlements and indeed sanctioning government agencies or officials indirectly in various respects who do not respect them. Thus, the Communist Party, rather than the courts, is the principal assurance to domestic and foreign investors that their investments will not be subject to political encroachment or expropriation *ex post* (once costs are sunk).

The “informal/*de facto* property rights” argument attributes China’s growth to the incentives of managers in non state-owned enterprises, particularly the township and village enterprises (TVEs) controlled by local governments, to engage in profit-oriented production and transactions. Such incentives were created by the predictability that the state will not arbitrarily confiscate property and expropriate returns on investment through predatory taxation, even though there were no legally recognized private property rights.¹³⁰ As to the sources of the incentives of local governments not to engage in arbitrary confiscation and expropriation, it has been suggested that China’s fiscal federalism and regional competition in product markets have both led local governments to act in a “market-preserving” manner that is

¹²⁹ For a discussion of the legitimacy crisis in post-communist authoritarian regimes, see Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (1991).

¹³⁰ Donald C Clarke, *Economic Development and the Rights Hypothesis: the China Problem*, 51 *American Journal of Comparative Law* 89, 107 (2003).

conducive to market expansion and efficiency-enhancing enterprise reform.¹³¹ Because under China's fiscal federalism local governments face hard-budget constraints and need stable revenues from local enterprises to finance local affairs, they have strong incentives to secure property rights in local enterprises in order to promote their performance and increase their competitiveness in cross-regional markets. An additional source of incentives on the part of local government officials not to arbitrarily infringe upon property rights is the cadre evaluation system used by the communist party that sets criteria for the performance – hence the remuneration and promotion prospects – of local party cadres and government officials. Under this evaluation system, the most heavily weighted performance criteria typically emphasize promoting economic growth, collecting particular tax revenues and generating employment opportunities, which cannot be easily achieved without according local businesses a considerable degree of security in property rights.¹³² The “*de facto* property rights” argument essentially implies that contract enforcement institutions were not as critical as property rights protection in supporting China's growth, at least at early stages of the transition, insofar as the latter provided the much needed predictability to create private incentives to engage in efficiency-enhancing activities. Thus, this argument apparently discounts the primacy accorded to third-party contract enforcement by the North proposition.

However, the “*de facto* property rights” inducement for economic performance has a significant limitation. Williamson had early predicted that under China's relation-based governance setting for contract enforcement and property rights protection, necessary investment in leading-edge technologies would be reduced or stymied, because in such an institutional environment there is a significant risk involving the recoverability of large sunk costs in highly specific investments.¹³³ This prediction seems to be partly vindicated by recent reports that the technology content of Chinese exports is largely contributed by foreign-funded enterprises while

¹³¹ Yingyi Qian, How Reform Worked in China, in Rodrik 2003, *supra* note 20, at 314-318; see also Shaomin Li, Shuhe Li & Weiyang Zhang, The Road to Capitalism: Competition and Institutional Change in China, 28 *Journal of Comparative Economics* 269 (2000).

¹³² Donald Clarke, Peter Murrell & Susan Whiting, The Role of Law in China's Economic Development, The George Washington University Law School Public Law and Legal Theory Working Paper No. 187 (2006), at 26-27 [hereinafter Clarke et al.], *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878672.

¹³³ Williamson 1996, *supra* note 9, at 334-335.

indigenous firms suffer from lagging technological innovation due to severe underinvestment in R&D initiatives.¹³⁴

We note here also the rise in corporatism and clientelism as a means of introducing market-type mechanisms into economic interactions in the absence of an actual market.¹³⁵ Corporatism is an institutionalized relationship between government and trade and industry that incorporates economic activity into the governance structure. Nee and Su argue that that the economic activity resulting from the interaction between entrepreneurs and local government officials particularly is made possible by the role of social institutions.¹³⁶ In the case of China, institutional arrangements that support private property claims and promote repeated social exchange create the trust and cooperation that individuals require to participate in economic transactions. McMillan and Naughton make a similar observation that “[c]ontracts in China are less legal than relational. Businesspeople in China keep their promises (most of the time) not because they are required to by the law, but because...reneging on a ‘contract’ is likely to destroy the businessperson’s ability to do business in the future.”¹³⁷ As recent study by Clarke, Murrell and Whiting on the role of law in China’s economic development finds that informal contract enforcement mechanisms, such as negotiation, mediation, and self-enforcement through reputation and long-term relationships, are used extensively by Chinese businesses.¹³⁸

However, corporatism and clientelism in China can also create significant costs, often manifested in their “localized” or “regionalized” nature that is fundamentally harmful to the establishment of an integrated national market and the evolution of nation-wide commercial norms. This is because, as pointed out by Peerenboom, “[c]lientelist social networks are more likely to divide than to unite”.¹³⁹

¹³⁴ George Gilboy, *The Myth Behind China’s Miracle*, 83:4 *Foreign Affairs* 33, 35 (2004).

¹³⁵ Victor Nee & Sijin Su, *Institutions, Social Ties, and Commitment in China’s Corporatist Transition*, in John McMillan & Barry Naughton (eds.), *Reforming Asian Socialism* 132 (1996) [hereinafter *Reforming Asian Socialism*].

¹³⁶ *Id.*

¹³⁷ John McMillan & Barry Naughton, *Elements of Economic Transition*, in *Reforming Asian Socialism*, *supra* note 135, at 8.

¹³⁸ Clarke et al., *supra* note 132, at 38.

¹³⁹ Randall Peerenboom, *Networks and Their Relation to Rule of Law and Economic Growth in China*, draft paper (2006) (on file with authors) [hereinafter Peerenboom].

As a result, as far as contract disputes are concerned, local protectionism, coupled with agency protectionism, has been a serious impediment to effective enforcement of court judgments and arbitration awards through local courts (which are financed by local governments) when the winning party is from outside the local jurisdiction.¹⁴⁰ In recent years, this difficulty has also been experienced by foreign enterprises.¹⁴¹ While local and agency protectionism is one of the most cited reasons for difficulties in enforcing civil judgments in China, other factors also contribute to this problem, including widespread insolvency of debtor SOEs, courts' reluctance to use coercive measures in civil cases, the lack of finality of court proceedings, and inadequate overhead expenses at courts' disposal.¹⁴²

According to estimates by the head of the judgment enforcement division of the nation's highest court, the average rate for enforcing civil and economic judgments in China is 60% at the basic-level court, 50% at the intermediate-level court, and 40% at the provincial higher-level court,¹⁴³ meaning that roughly half of Chinese court rulings exist only on paper. Interestingly, while the Chinese public and legal community routinely identify difficulties in enforcing judgments as a major obstacle to effective administration of justice in the country, some western commentators wonder whether those reported enforcement rates are indeed "low" in a comparative sense.¹⁴⁴ For example, Clarke cites the enforcement problem in the United States as a reference point to query the relative level of severity of enforcement problem in China.¹⁴⁵ According to his report, a 1993 study commissioned by the New Jersey Supreme Court found that in eleven New Jersey counties surveyed for the year 1987, only 25% percent of writs of execution in civil cases (excluding small claims and landlord-tenant cases) were returned fully satisfied;

¹⁴⁰ The problem of difficulties in enforcing civil judgments in China has been extensively documented in both Chinese and English literature. See, e.g., Stanley Lubman, *Bird in a Cage: Legal Reform in China after Mao* 266-69 (1999); Minxin Pei, *Does Legal Reform Protect Economic Transactions? Commercial Disputes in China*, in Peter Murrell (eds.), *Assessing the Value of Law in Transition Economies* 180, 190-94 (2001); Donald C. Clarke, *Power and Politics in the Chinese Court System: the Enforcement of Civil Judgments*, 10 *Colum. J. Asian L.* 1 (1996) [hereinafter Clarke 1996]; *Half of China's Civil Court Rulings Remain on Paper*, Beijing Time, Mar. 13, 2004, *available at*: http://english.people.com.cn/200403/13/eng20040313_137390.shtml [hereinafter Beijing Time].

¹⁴¹ See, e.g., Stanley Lubman, *Law of the Jungle*, *China Economic Review* 24-25 (September 2004).

¹⁴² See, e.g., Clarke 1996, especially at 34-68 and Beijing Time, *supra* note 140.

¹⁴³ Clarke et al., *supra* note 132, at 42.

¹⁴⁴ *Id.*

¹⁴⁵ Clarke 1996, *supra* note 140, at 34.

in small claim cases the number was 37%.¹⁴⁶ However, due to the lack of comparable systemic data and diverse social realities between countries, the extent to which relevant numbers on judgment enforcement in China and developed countries such as the United States are comparable is not clear.¹⁴⁷ Questions about whether or not judgment enforcement rates in China are “low” aside, we nevertheless are inclined to consider the enforcement problem serious. This is not only because the official statistics on enforcement rates may not reflect the real situation given the possibility of under-reporting of the degree of enforcement problem by local courts, but also because even according to official estimates, the kind of contract dispute that is most likely to involve significant amounts of unpaid debt – banks vs. SOEs – only records an average enforcement rate of 12%.¹⁴⁸

Therefore, even though China has experienced dramatic growth in litigation over the past decade or so, leading some commentators to claim that Chinese courts “appear to play an increasingly significant role” in dispute resolution during the reform period,¹⁴⁹ the effectiveness of courts and the level of satisfaction with formal contract enforcement institutions among both domestic and foreign investors suggest significant deficiencies.¹⁵⁰ In addition to difficulties in enforcing judicial judgments, another pressing concern of litigants in contract disputes is the observed fact that when it is necessary for courts to adjudicate the substantive contractual rights and obligations, it is however not uncommon for Chinese courts to invalidate private contracts on formal grounds, thus frustrating the expectations of the parties to them.¹⁵¹

¹⁴⁶ *Id.*

¹⁴⁷ See, for example, *id.*

¹⁴⁸ Beijing Time, *supra* note 140

¹⁴⁹ Clarke et al., *supra* note 132, at 40. The authors report that contract dispute litigation accounts for the lion’s share of all economic dispute cases accepted by the courts during the reform era, increasing at an average annual rate of 20.1% between 1983 and 2001. Moreover, according to official statistics, over the past decade or so the number of legal professionals, has also seen dramatic growth, see *Zhongguo Falü Nianjian* (Law Yearbook of China), various years.

¹⁵⁰ While the judiciary in China has often been subject to criticism for failing to enforce the law in an impartial and effective manner, its commercial arbitration system, which is generally regarded as part of the formal contract enforcement institutions in China because arbitration awards need to be enforced through courts, also faces increasing dissatisfaction by foreign investors. See *e.g.*, Randall Peerenboom, China’s Long March toward Rule of Law (2002); Lubman, *supra* note 141; Jerome A. Cohen, Time to Fix China’s Arbitration System, 168 *Far Eastern Economic Review* 31 (2005).

¹⁵¹ The existence of this tendency of Chinese courts to invalidate private contracts is suggested by Professor Fang Liufang at China University of Political Science and Law, a respected expert on Chinese civil and commercial law, in his telephone conversation with Jing Leng on February 9, 2006. This assessment is also confirmed by Dr. Xie Hongfei at Chinese Academy of Social Sciences in his e-mail to Jing Leng dated February 16, 2006, based on information collected by Xie from some judges of

Notably, in China court-sponsored mediation is widely used to reach a settlement after commercial litigation commences. This mechanism often involves the participation of government officials when unmet contractual obligations may result in lay-offs or non-payment of wages by an enterprise in financial distress, and is reportedly susceptible to the influence of "*guanxi*" in both personal and organizational relationships, thus undermining the autonomy of contracting parties.¹⁵²

To understand why there has been a significant increase in the number of contract disputes filed with the courts despite the problems associated with both adjudication and enforcement processes, it should be noted that in China a number of private economic activities, many of which have expanded after economic reforms began to accelerate in the 1990s, are mandated by the law to take the form of formal contracting. These include the establishment of trading companies and foreign-invested enterprises, insurance contracts, bank loan agreements, transactions in real-estate, issuance of stocks, mergers and acquisitions of corporations, business partnerships, and so forth. This factor to a large extent explains the trend of a "more litigious society" in China from the supply side. Not only do private sector players go to court for contract enforcement more often, but state-owned commercial banks and state-owned enterprises, especially large enterprises, also constitutes a significant fraction of litigants in contract disputes for similar reasons that apply to large Russian firms, i.e., in order to signal that managers are not in a conspiracy with defaulting debtors to expropriate state funds or assets, especially in the context of serious problems of non-performing loans in the Chinese banking sector.

While the social institutions that have developed in China may be conducive to increasing the level of economic activity, it is important to note the actors involved. While the adoption and adaptation of market-derived structures into the Chinese economy have been conducive to foreign investment, the majority of it either comes from or is facilitated by investors from Hong Kong and Taiwan – overseas ethnic Chinese business networks (or *guanxi*). Indeed some estimates suggest that ethnic Chinese in Hong Kong and Taiwan have contributed roughly 80 percent of total FDI

the High Court of Beijing Municipality, Chaoyang District Court of Beijing Municipality, Intermediate Court of Liaocheng Municipality of Shandong Province, and High Court of Henan Province.

¹⁵² Clarke et al., *supra* note 132, at 41-42.

total in mainland China.¹⁵³ Mayeda suggests that the degree “of investment by non-resident Chinese indicates that foreign investors in China can take advantage of familiarity of ethnically Chinese business-people with the informal norms of Chinese business.”¹⁵⁴ According to Tracey and Lever-Tracey, “Chinese business tend to be conducted through a series of personalized networks based on friendship and trust, which are given substance by long-term relationships and reputations for trustworthiness and reliability, rather than in the open market place or in an institutional framework.”¹⁵⁵ When investing in mainland China, the Chinese diaspora usually take the first step of getting to know the local officials in the town or village they are considering investing in to establish initial connections, while existing connections within the diaspora through common origins of linguistic and geographical identities have also become a critical business advantage in fostering the expansion of connections. Linked connections and the resulting networking effect in turn buttress predictability and compliance in contract enforcement. Consequently, the enormous strength of the Chinese diaspora business network is the ability “to make horizontal linkages when the vertical hierarchical structures are not necessarily supportive of their business endeavors.”¹⁵⁶

In summary, the relationship between law including contract law and economic development in China seems to suggest reverse causality according to Clarke et al:

"Although the legal system has made great strides since the beginning of reforms and currently has a role of some significance in the economy, it is impossible to make the case that formal legal institutions have contributed in an important way to China's remarkable economic success. If anything, *economic success has fostered the development of law, rather than the reverse.*"¹⁵⁷

¹⁵³ Thomas Menkhoff & Solvay Gerke (eds.), *Chinese Entrepreneurship and Asian Business Networks* (2002) [hereinafter Menkhoff & Gerke].

¹⁵⁴ Graham Mayeda, *Appreciate the Difference: The Role of Different Domestic Norms in Law and Development Reform—Lessons from China and Japan* 53, draft paper (Year?) (on file with authors).

¹⁵⁵ See Noel Tracy & Constance Lever-Tracey, *A New Alliance for Profit: China's Local Industries and the Chinese Diaspora*, in Menkhoff & Gerke, *supra* note 153, at 71-72.

¹⁵⁶ *Id.* at 72.

¹⁵⁷ Clarke et al., *supra* note 132, at 51 [*italics added*].

Clarke et al. argue that while it is quite plausible that the “political, social, and economic equilibrium” in China over the last two decades upheld contract and property rights to some reasonable degree, the legal system was not by any means the central element supporting that equilibrium.¹⁵⁸ They conclude that the “rights hypothesis” advanced by Weber and North that views formal institutions of property rights protection and contract enforcement as prerequisite for development, clearly fails in the case of China.¹⁵⁹

2. The “East Asian Miracle”

According to Frank Upham, “[t]he experience of Asian economies demonstrates that strict judicial enforcement of property and contract rights is not necessary to economic growth.”¹⁶⁰ Specifically, the well-known “East Asian miracle” achieved not only by China, but Japan, Korea, Taiwan, Malaysia and other well-performing countries in the region has presented a critical challenge to rule of law orthodoxy.

Upham’s analysis of the development of the Japanese economy offers evidence that formal contract enforcement is not a prerequisite to a nation’s economic development.¹⁶¹ He cites the fact that through the second half of the twentieth century while Japan underwent dramatic economic development it simultaneously experienced a shrinking of its legal system, measured by a decrease in the number of individuals that work in the system and in the number of legal procedures undertaken.¹⁶² Upham, moreover, goes a step farther with regard to the role he accords to formal legal institutions. He contends that in some developing nations informal means of contract enforcement are not only a substitute for formal mechanisms, but in fact the introduction of externally derived formal institutions may undermine the success of existing economic activity facilitated by informal social

¹⁵⁸ *Id.* at 52.

¹⁵⁹ *Id.*

¹⁶⁰ McMillan 1996, *supra* note 118, at 229.

¹⁶¹ Frank Upham, *Mythmaking in the Rule of Law Orthodoxy*, Rule of Law Series, Democracy and Rule of Law Project at the Carnegie Endowment for International Peace, Working Paper No. 30 (September, 2002).

¹⁶² *Id.* at 23-24.

institutions and may disrupt or displace valuable indigenous institutions (the “crowding-out” hypothesis).

However, it is important to recognize the idiosyncrasies of the Japanese context that limit its generalization as a model for development. First, the Japanese population is extremely culturally homogeneous. While this homogeneity might allow for Japanese cultural norms of social interaction - specifically, cultural norms of integrity and reciprocity - to inform business relations and thus obviate a need for frequent formal contract enforcement, there are few developing countries today that have similarly homogeneous populations. Indeed, for many developing countries, ethnic, religious or cultural heterogeneity and factionalism is the rule rather than the exception.¹⁶³ Thus, there is limited practical scope for any argument that suggests that cultural norms of behaviour could act as a substitute for formal laws enforcing an entire nation’s regime of private ordering. A second factor that limits the generalizability of the Japanese experience is its consistently limited reliance on foreign investment relative to most other nations. The current consensus in development circles regards foreign investment as an indispensable means of facilitating most developing countries’ economic growth; it seems unlikely that many developing countries can afford to follow Japan’s example. Thus, while the Japanese experience does demonstrate that economic development *can* occur without state-enforcement of contracts, cultural and economic characteristics peculiar to Japan suggest caution in using single successful cases as evidence to discount the North position.

Moreover, the merits of the Japanese experience in solving social disputes largely outside a formal legal system are also questioned by some critical observers. For example, by referring to the “dark side” of private ordering, Milhaupt and West point out that members of organized crime in Japan are active in such commercial areas as contract dispute mediation, real estate foreclosure, corporate monitoring, and

¹⁶³ See Pranab K. Bardhan, Method in the Madness? A Political-Economy Analysis of Ethnic Conflicts in Less Developed Countries, 25 *World Development* 1381-1398 (1997); Robert E. Klitgaard, Adjusting to Reality 169-229 (1991); William Easterly & Ross Levine, Africa’s Growth Tragedy: Policies and Ethnic Divisions, 14(4) *Quarterly Journal of Economics* 1203 (1997).

lending.¹⁶⁴ With regard to the relationship between this “dark side” of private ordering and the deficiencies in Japan’s public-order institutions for property rights and contract enforcement, they note: “[i]n Japan, the activities of organized criminal firms closely track inefficiencies in formal legal structures, including both inefficient substantive laws and a state-induced shortage of legal professionals and other rights-enforcement agents.”¹⁶⁵ Therefore, the Japanese model of contract enforcement through private ordering cannot be plausibly asserted to be optimal and without significant limitations, as Upham seems to imply.

Now we turn to the case of other countries in the “East Asian miracle,” examining how their economic growth was achieved without an orthodox model of the rule of law (with the notable exceptions of Singapore and Hong Kong, that attract strong rule of law ratings despite low democracy ratings), and in particular, how contract enforcement institutions have featured in this process.

In 1996, the Asian Development Bank (ADB) commissioned a comparative study on the relationship between law and economic development in Asia during a 35-year period of dynamic economic growth from 1960 to 1995. One of the issues examined in this study was the role of dispute settlement institutions in resolving commercial disputes and facilitating contract enforcement between non-state parties. One major finding relevant to this paper is the following:

Over the long term, rates for litigation concerning civil and commercial disputes increased in all economies. The available empirical data on the sample economies show a positive and statistically significant correlation between per capita litigation rates (which indicate the frequency and extent of the use by private-sector agents of formal dispute settlement institutions, such as courts) and several indicators for the division of labor (which can be viewed as a useful proxy for the level of economic development).¹⁶⁶

The above finding seems to support the “convergence hypothesis” proposed by the authors, which suggests that with increasing economic development, legal

¹⁶⁴ Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 *U. Chi. L. Rev.* 41, 41 (2000).

¹⁶⁵ *Id.*

¹⁶⁶ Katharina Pistor & Philip A. Wellons (eds.), *The Role of Law and Legal Institutions in Asian Economic Development: 1960 – 1995* 215 (1999) [hereinafter Pistor & Wellons].

institutions will perform increasingly similar functions throughout the world.¹⁶⁷ On the face of it, the North proposition appears to gain some support from this study, to the extent that the evidence presented here does indicate a positive link between formal contract dispute resolution and economic development in the sample East Asian countries. However, the ADB study does not control for other factors (such as human capital accumulation and good policies) that might have independently contributed to some Asian countries' growth, and instead treats the frequency and extent of the use of courts as an independent, exogenous variable in measuring its relationship with economic growth. It may well be the case that the increased use of the courts in commercial dispute resolution is a result, not a cause, of economic development that has expanded markets and broadened the range of economic interactions. In short, reverse causality is possible.

The recent trend towards a more litigious society in China, noted above, is also generally consistent with what has happened in other Asian economies as they have reached higher stages of growth. Even in previously "nonlitigious" Japan, recent data collected by Ginsburg and Hoetker indicate a rapid increase in civil litigation and resort to formal contract enforcement after various institutional constraints on the use of the formal legal system, such as the relative paucity of lawyers and costly trial procedures, were relaxed during the 1990s. They note that "as legal reform was proceeding, Japanese began to litigate more frequently."¹⁶⁸ Another interesting finding in their study is that the relationship between economic change and litigation seems to be "inverse" in that sustained economic downturns, as recently experienced by Japan, are likely to lead to the breaking of at least some long-term commercial relationships, thus resulting in more litigation.¹⁶⁹ This finding also seems to suggest reverse causality, running from structural changes in the economy to wider use of formal contract enforcement mechanisms. While of course we do not believe that more litigation causes economic growth (nor, does the ADB study suggest this), we are inclined to draw a general observation from the empirical evidence surveyed above that formal contract enforcement has tended to become more widely used at higher levels of growth in most of the East

¹⁶⁷ *Id.*

¹⁶⁸ See Tom Ginsburg & Glenn Hoetker, *The Unreluctant Litigant? An Empirical Analysis of Japan's Turn to Litigation*, 35 *J. Legal Stud.* 31 (2006).

¹⁶⁹ *Id.*

Asian economies.

From a political economy perspective, the most frequently offered explanations for the East Asian miracle generally attribute economic growth in these countries to the role of their respective governments in coordinating development and maintaining political as well as macro-economic stability, although these explanations vary in their accounts of exactly what role these governments played, ranging from the “market-friendly” view to the “developmental-state” view.¹⁷⁰ Of particular relevance to the discussion in this paper is the theory of “relation-based governance” advanced by Shuhe Li in explaining the “East Asian miracle” and the subsequent financial crisis in 1997-98.

According to Li, the relation-based governance model had been widely adopted by the East Asian economies over the past three decades, which was manifested in two salient phenomenon – (1) agreements are largely implicit, personal, and enforced outside of courts, and (2) government, banks, and firms have close relations.¹⁷¹ In coordinating economic activities, relation-based governance has both benefits (such as information and transaction costs advantages when the economy is characterized by long-term relationships and a small number of players), as well as costs (such as non-transparency and dampening private incentives to discover and experiment with superior coordination tactics),¹⁷² but at early stages of economic catch-up its benefits tend to outweigh its costs.¹⁷³

¹⁷⁰ See, e.g., World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (1993). Both the “market-friendly” view and “developmental-state” view regard markets as the initial basis for organization in private sector and recognize that market failures are pervasive in catch-up economies. What they differ fundamentally is in the solutions to market failures or imperfections: the “market-friendly” view regards private-sector initiatives and institutions as the primary remedy and the role of government as only complementary and limited to providing a legal infrastructure for market transactions and public goods, while the “developmental-state” view looks to government intervention as the solution. A third view – the “market-enhancing” view – later emerged, trying to explore a middle ground that reconciles the “market-friendly” view and the “developmental-state” view, and argues that the success of the East Asian economies was largely attributable to the role of government policy to facilitate or complement private-sector coordination at an early stage of development. See Masahiko Aoki, Kevin Murdock & Masahiro Okuno-Fujiwara, *Beyond the East Asian Miracle: Introducing the Market-Enhancing View*, in Masahiko Aoki, Hyung-Ki Kim & Masahiro Okuno-Fujiwara (eds.), *The Role of Government in East Asian Economic Development* 1, 1-2 and 8-11 (1997).

¹⁷¹ John Shuhe Li, *Relation-based versus Rule-based Governance: An Explanation of the East Asian Miracle and Asian Crisis*, 11:4 *Review of International Economics* 651-673 (2003) [hereinafter Li].

¹⁷² Bardhan 2005, *supra* note 77, at 527.

¹⁷³ Li, *supra* note 171, at 660-662; Bardhan 2005, *supra* note 77, at 516.

Specifically, under a relation-based governance environment, the government played an active role in organizing centralized finance through state-controlled banks and in encouraging and directing private and public investments to strategic firms and industries. Similarly, Rodrik and Bardhan both point out that in East Asian economies, coordination in economic activities was achieved not through a formal contract law regime, but through government (often bureaucratic) intervention, particularly in the areas of organizing corporate finance, capital formation, and acquisition of financial expertise in new industrial sectors in periods of large-scale reconstruction and acute scarcity of capital and skills.¹⁷⁴

This role of government proved conducive to economic growth in the East Asian countries, because it provided appropriate positive and negative incentives to economic agents in raising long-term finance for industrial development.¹⁷⁵ Contract enforcement in the financial sector, although not carried out in the courts, was still guaranteed by the state in a predictable manner. As a critical component of development-enhancing economic activities for catch-up economies, financial contracting in the East Asian countries was largely guided by a politically stable state with a strong commitment to economic development and an ability to process information and channel aggregate coordination in the financial market.¹⁷⁶ This again raises an important caveat for the transferability of the relation-based governance model to other developing countries: the East Asian experience in organizing centralized finance is hardly transferable to most developing economies in Africa, Latin America, and the former Soviet Union, whose governments have not demonstrated comparable ability to act as a catalyst and a coordinator in financial markets.¹⁷⁷

However, we do not take a strong position on whether or not the notion of a highly proactive developmental state was a precondition to the successful economic development of the East Asian countries (which has been at the centre of a long-standing debate between proponents of the “market-friendly” view and proponents of

¹⁷⁴ Dani Rodrik, *Getting Intervention Right: How South Korea and Taiwan Get Rich*, 10:20 *Economic Policy* 53 (1995) [hereinafter Rodrik 1995]; Bardhan 2005, *supra* note 77, at 517.

¹⁷⁵ Bardhan 2005, *supra* note 77, at 527.

¹⁷⁶ Rodrik 1995, *supra* note 174; Bardhan 2005, *supra* note 77, at 517.

¹⁷⁷ Bardhan 2005, *supra* note 77, at 518.

the “developmental-state” view). We emphasize here the role of political stability, and relatedly, macro-economic stability, in providing the assurances that both domestic and foreign investors need to make long-term investments, which is signaled in no small part by long-term commitment to development goals by the political regimes or elites in these countries.

Within the high-growth Asian economies, what are the implications of the Asian financial crisis of the late 1990’s for relation-based governance, which is claimed to be a major explanation for the “East Asian miracle”? As reported by Huang and Yeung, in the 1990s, ASEAN was already one of the regions most dependent on foreign trade and FDI. Therefore, the Asian crisis did not happen because the region lacked capital and export opportunities, but because poor corporate governance and rampant corruption led to massive wastage of capital and inefficiencies in the corporate sector.¹⁷⁸ The underlying cause for these economic and institutional deficiencies, according to Li, is the inevitable “self-perpetuating” nature of relation-based governance, which led to a turning point of these economies toward rule-based governance after they had completed the transition from catch-up mercantile states to industrialized economies.¹⁷⁹ The transformation of these economies from relation-based governance to rule-based governance, which stresses the role of formal law and contract enforcement institutions, began to get underway shortly before the Asian crisis. The institutional adjustments and vacuum left by the retreating relation-based governance but not yet occupied by the emerging rule-based governance had created increased uncertainties and risks in these economies, especially at a time when financial liberalization was accompanying this process. As a result, the Asian crisis erupted as a manifestation of the costs as well as dynamics of the transition from relation-based governance to rule-based governance in a competitive global economy.¹⁸⁰

¹⁷⁸ Yasheng Huang & Bernard Yeung, ASEAN’s Institutions are Still in Poor Shape, *Financial Times*, Sep. 2, 2004, at 17.

¹⁷⁹ Li, *supra* note 171, at 659.

¹⁸⁰ *Id.* at 665. Notably, it has been suggested that the remarkably quick turn-around of the Asian economies badly hit by the Asian financial crisis demonstrates the “strength” of informal institutions in their private sector, particularly the availability of informal finance provided by family and social networks. See Peerenboom, *supra* note 139.

In summary, the “East Asian miracle” seems to have partly amended the NIE proposition without disapproving its validity. It is in our view a “non-standard” deviation from the NIE proposition in that, on the one hand, it indicates that dramatic growth can indeed happen without a rule-based governance environment where formal contract law and courts are the primary channel of contract enforcement. On the other hand, it also lends limited support to the NIE insofar as it reveals that for catch-up economies, there is indeed a critical role for the state in providing predictability in economic transactions, especially with regard to its coordinating role in financial contracting and investment, even though these characteristics are not necessarily embodied in formal legal rules and enforcement. However, the Asian crisis acutely exposed the severe costs of relation-based governance at the turning point of the transition from mercantile states to industrialized countries. This has left the NIE proposition open to further refinement by incorporating the dimension of modes and stages of growth and their implications for contract enforcement institutions.

VI. CONCLUSIONS

Where does this review of these conflicting bodies of theory and evidence on the relative importance of formal and informal contract enforcement lead us? Our provisional reading of the evidence is that the proponents of contract formalism and the proponents of contract informalism can both point to supporting bodies of theory and empirical evidence but both risk overstating or at least over-simplifying their cases.

To take first the case made by contract formalists, it is clear that both in developed and developing countries many contracts are self-enforcing. In many cases, because of ethnic, religious or cultural ties, informal transacting norms arise and are enforced through informal, extra-legal sanctions. Even in the absence of such contracting networks, long term, incomplete contingent claims contracts are commonplace between arms’ length business parties in both developed and developing economies, and where these entail substantial investments in relationship-

specific assets there are strong incentives to maintain the relationship.¹⁸¹ Of course, even long-term relational contracts typically eventually come to an end, and depending on the nature of dependencies or interdependencies that they create are vulnerable to problems of hold up and opportunism (“end-game” problems) which can sometimes only be solved by complete integration by ownership between the parties involved (although this may not otherwise be efficient).

As noted earlier in this paper, Williamson argues that both spot market and hierarchical (corporate integration) transactions require little support from the formal legal system, whereas middle range transactions (long-term contracting) are particularly vulnerable in the absence of credible third party enforcement mechanisms.¹⁸² This claim can be thought of as implying a continuum of forms of economic coordination or cooperation with complete vertical integration at one end and spot markets at the other, with a large vacuum in the middle. However, even with respect to Williamson’s two polar cases, it is not the case that vertical integration can completely avoid the problems of a weak formal legal system. As a number of commentators have argued, and corroborated empirically, countries with poorer investor protection, measured by both the character of legal rules and the quality of legal enforcement, have smaller and narrower capital markets, especially when minority shareholders are subject to serious agency costs (opportunism) on the part of managers or controlling shareholders.¹⁸³ Moreover, employment contracts, including non-compete clauses, and collective agreements, often require some form of formal enforcement mechanism. In any event, as Williamson himself acknowledges, vertical integration may be less efficient than other forms of economic coordination that an effective formal contract regime may facilitate.

¹⁸¹ See, e.g., Ian MacNeil, *Contracts: Adjustment of Economic Long Term Relations Under Classical, Neo-Classical and Relational Contract Law*, 72 *Nw. U. L. Rev.* 854 (1978); MacNeil, *The Many Futures of Contract*, 47 *S. Cal. L. Rev.* 691 (1974); Lawrence Friedman, *Contract Law in America* (1965); Macaulay, *supra* note 66; Goetz & Scott, *supra* note 67; Paul Milgrom & John Roberts, *Economics, Organization and Management* 131-140 (1992); Robert Cooter & Thomas Ulen, *Law and Economics* 225-235 (Addison Wesley, 4th ed., 2004); Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *Journal of Political Economy* 615 (1981).

¹⁸² Williamson 1996, *supra* note 9.

¹⁸³ See e.g., LLSV 1997, *supra* note 30; Black et al., *supra* note 122; Beck & Levine 2005, *supra* note 32; Simon Johnson, *Coase and Corporate Governance in Development*, Villa Borsig Workshop Series (2000).

At the other pole, even spot transactions, *e.g.*, commodity contracts, may raise quality or product defect problems that require resort to the formal legal system, at least in the absence of industry or trade associations with their own codes of conduct, norms, and alternative dispute settlement mechanisms¹⁸⁴.

Between these two poles, as we have seen, Williamson exaggerates the importance of formal contract enforcement by ignoring the role of relational contracting as well as contract enforcement by private sector third parties such as credit companies, bourses, exchanges, arbitrators, and industry associations both in personal and impersonal relationships (just as he minimizes the importance of formal contract enforcement at the poles).

However, the contract informalists in turn risk overstating their case to the extent that they imply that most contracts are self-enforcing so as to render formal third-party enforcement unnecessary or unimportant for economic development. As noted above, long-term relational contracts may raise end-game problems that require resort to the courts to resolve. Moreover, in many contracts entailing large investments in non-salvageable assets (sunk costs), parties will still aspire to a fully specified, contingent claims contract, *e.g.*, large scale investments in infrastructure or complex technology. Often the investors, because of the specialized expertise required, will not be members of a common ethnic, cultural or religious network with counterparties to these transactions and will not wish to leave subsequent working out of contract details or enforcement to the vagaries of arbitrary domestic political, regulatory or legal processes. Circumstances that arguably have facilitated Japan's economic successes in the post-war years and more recently China's do not readily generalize to most other developing countries. As noted earlier, Japan is a remarkably culturally homogeneous society where reliance on informal social norms and sanctions may be particularly effective. In addition, Japan has been strikingly non-dependent on large-scale foreign direct investment for its economic successes. While China has in recent years relied on large infusions of foreign direct investment, much of this has come from ethnic Chinese business networks outside of China. It is also important to note that China's experience in attracting foreign investment cannot be

¹⁸⁴ See Bernstein 1996, *supra* note 17.

easily reproduced in other developing economies which do not have a huge population of overseas diaspora who are not only capital-rich but also willing to invest in their home countries. As pointed out earlier, for these countries long-term economic growth is significantly dependent on expanding international trade and attracting large scale FDI from parties who do not share common ethnic, cultural or social characteristics. Here the absence of effective formal contract enforcement mechanisms is likely to entail a number of adverse implications.¹⁸⁵

With regard to international trade, Rauch points out that despite their advantages in overcoming information barriers and mitigating contractual uncertainty, domestic networks in international trade also entail costs. They can constitute “informal trade barriers” by colluding to increase their market power and restricting foreign competition, as practiced by the Japanese keiretsu, Korean chaebols, and large business groups in Taiwan.¹⁸⁶ Similarly, Dixit notes that “[r]elation-based governance works well in small groups that are connected by extended family relationships, neighborhood structures, and ethno-linguistic ties, because such links facilitate repeated interactions and good communication.”¹⁸⁷ Yet while relational contracting does facilitate economic gains within such groups, it has the potential to create many externally experienced adverse effects. One economic weakness of exclusionary business networks is acknowledged by McMillan and Woodruff, when they note that it “sometimes harms efficiency by excluding new entrants from trading or by achieving price collusion.”¹⁸⁸ Gray notes a similar effect with ethnicity-based business networks insofar as they render it almost impossible for any individual not socially affiliated with the circle to break into it on a business level; and an inability to enter into long-term contracts can inhibit the adoption and development of complex technologies.¹⁸⁹ Thus it is no surprise that Greif observes that “reputation-based institutions that support personal exchange have a low fixed cost but a high marginal cost of exchanging with unfamiliar individuals.”¹⁹⁰

¹⁸⁵ See Berkowitz, Moenius & Pistor, *supra* note 78.

¹⁸⁶ Rauch, *supra* note 82, at 1183.

¹⁸⁷ Dixit, *supra* note 20, at 66.

¹⁸⁸ John McMillan & Christopher Woodruff, Private Order under Dysfunctional Public Order, 98(8) Mich. L. Rev. 2421, 2423 (2000).

¹⁸⁹ Gray, *supra* note 119, at 14.

¹⁹⁰ Greif 2006, *supra* note 74, Chapter 10: “The Institutional Foundations of Impersonal Exchange”, at 5, available at http://www-econ.stanford.edu/faculty/Greif_Institutions/GreifBook.html.

There exists another obvious trade-off of private ordering in a tightly knit community: transaction costs are low but production costs are high. This is because specialization and division of labor, which greatly enhance productive efficiency, are severely limited by the extent of the market defined by the personalized exchange process of a small community.¹⁹¹ As a result, as Dixit suggests, in a relation-based contract enforcement system, what may eventually emerge may be “diversified conglomerates whose component parts have nothing in common except common ownership by a closely knit extended family or similar network.”¹⁹² Aside from trade and production, relational contracting may also create high costs for corporate finance, because under such a system capital markets tend to be “compartmentalized” among linked firms through related borrowing and lending that may not be efficient.¹⁹³

Fafchamps notes that “[w]henver business communities are built along ethnic, religious, or gender lines, network effects result in apparent discrimination.”¹⁹⁴ Not surprisingly, he finds that an ethnic bias in assigning trade credit has been detrimental to entrepreneurs of African descent and favourable to entrepreneurs originating outside Africa.¹⁹⁵ Thus, while ethnicity-based business networks may provide the predictability that helps to facilitate certain economic transactions, such transactions may come at the cost of both unfairness to individuals outside that network and inefficiency from potentially mutually-beneficial exchanges forgone. Indeed, in the example of the Maghribi traders narrated by Greif, the coalition among traders that facilitated contract enforcement “was not dynamically efficient,” because the same factors that ensured its self-enforceability also prevented it from expanding in response to welfare-enhancing opportunities.¹⁹⁶

One strength of the analytic framework that Fafchamps develops in his study is the distinction (which we have adopted) between formal contract law in dysfunctional and functional legal systems respectively. He notes, for instance, that

¹⁹¹ Bardhan 2005, *supra* note 77, at 511-512.

¹⁹² Dixit, *supra* note 20, at 79.

¹⁹³ *Id.* at 80.

¹⁹⁴ Fafchamps, *supra* note 17, at 347.

¹⁹⁵ *Id.* at 368.

¹⁹⁶ Greif 2006, *supra* note 74, Chapter 3: “Private-Order Contract Enforcement Institutions: The Maghribi Traders Coalition”.

in a functional legal system relational contracting tends to complement the formal state-enforced contract framework, while in a dysfunctional legal system relational contracting acts as an imperfect substitute for a system of formal contract enforcement.¹⁹⁷

The mix of mechanisms that are likely to ensure both a fair and efficient domain of contracting in developing countries is obviously a function of highly context-specific factors, and defies easy generalizations. This caution has been strongly voiced in recent development literature that stresses the need to adopt highly context-specific analysis in studying institutions.¹⁹⁸ Two considerations may be of particular relevance to this exercise.

Firstly, as pointed out earlier, countries' growth modes and income levels matter, to the extent that catch-up economies starting from low-level economic equilibria have different demands for institutions from those of middle-income economies. As Rodrik argues, while the onset of economic growth does not require deep and extensive institutional reform, sustaining high growth in the face of adverse circumstances requires ever stronger institutions and the institutional requirements of growth in a middle-income country can be significantly more demanding.¹⁹⁹ Similarly, Klerman finds historically that economic growth often starts without strong courts and efforts to improve the quality of the judiciary are often the consequence, not the cause, of economic development; but if growth starts without good judicial institutions, economic growth may create a demand for quality courts at higher levels of development.²⁰⁰ Moreover, as noted earlier in this paper, new evidence from patterns of international trade also renders support for this discriminating treatment of institutional dependency. The findings of Berkowitz, Moenius and Pistor suggest how the nature of traded goods (more or less complex) can influence the relative

¹⁹⁷ Fafchamps *supra* note 17, at 72.

¹⁹⁸ Greif 2006, *supra* note 74, Chapter 11: "Interactive, Context-Specific Analysis"; Rohini Pande & Christopher Udry, *Institutions and Development: A View from Below* (2005); Francis Fukayama, *Development and the Limits of Institutional Design* (2006).

¹⁹⁹ Rodrik 2003, *supra* note 20, at 15-17; also Kenneth W. Dam, *China as a Test Case: Is the Rule of Law Essential for Economic Growth?* University of Chicago John M. Olin Law & Economics Working Paper No. 275 (2006), at 41 [hereinafter Dam, *China as a Test Case*].

²⁰⁰ Daniel Klerman, *Legal Infrastructure, Judicial Independence, and Economic Development*, USC Legal Studies Research Paper No. CO6-1 (2006); see also Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Do Institutions Cause Growth?*, 9 *Journal of Economic Growth* 271 (2004).

importance of formal vs. informal contracting.²⁰¹ This finding corroborates the view that the requirements of formal institutional quality become more demanding as economies move up the development curve.

Secondly, prevailing societal structures for organizing individuals' behaviors in the early stages of market development, such as the different modes of social interaction in communalist and individualist societies, also matter. The former tend to build more relation-based contract enforcement institutions that emphasize intra-group sanctions, and the latter tend to have more transactions across different groups supported by formal contract enforcement institutions.²⁰²

With regard to policy considerations, building contract enforcement institutions that support markets takes time.²⁰³ In this process of institutional evolution, alternative informal solutions, although "transitional" at particular stages of development, can serve value-adding and welfare-improving functions before formal institutional reform has taken hold and become effective. This is especially true for countries at early stages of industrialization, as the East Asian economies have demonstrated. It is not always necessary or desirable to transplant Western-style legal institutions from scratch; rather, it may often be desirable to work with available alternative institutions and to build on them.²⁰⁴ Thus, there is a legitimate justification for incorporating efficient indigenous institutions of contract enforcement into formal legal regimes, rendering formal and informal enforcement institutions complements rather than substitutes, and making the law more acceptable to the general population, hence facilitating its implementation on the ground.

We conclude with one final caveat: unduly discounting the importance of effective formal legal institutions, including the courts, in developing countries, whatever their role in facilitating a fair and efficient contracting domain, carries serious consequences for other non-instrumental values that any fully elaborated conception of development must surely embrace, including the various freedoms

²⁰¹ See *supra* notes 89 and 90 and accompanying text.

²⁰² Avner Greif, Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange, in Claude Ménard & Mary Shirley (eds.), *Handbook of New Institutional Economics* 727, 762 (2005).

²⁰³ MacMillan & Woodruff 1999a, *supra* note 115.

²⁰⁴ Dixit, *supra* note 20, at 4.

eloquently articulated by Amartya Sen in his book, *Development as Freedom*.²⁰⁵ Thus, for example, even if, as in China, the lack of effective formal contract enforcement has not to date been a major impediment to economic development (although some commentators contend otherwise)²⁰⁶, weak rule of law surely carries other significant costs in a more complete conception of development. It seems implausible to us to imagine rule of legal institutions that are seriously deficient in their public law functions but virtuous in their enforcement of private law. Moreover, to focus most rule of law reform efforts (as Posner advocates²⁰⁷) on property rights and contract enforcement is to engage a very narrow political constituency as proponents of reform and to forego the support of the much larger potential political constituencies to whom formal property rights and formal contract enforcement are of little immediate salience (and in some cases a source of potential antipathy), but to whom protection against abuses of basic civil and political rights is of general concern. In these respects, private and public law should be seen as necessary functional and political complements.²⁰⁸ We believe that the line between private and public law is largely illusory; private law ultimately depends on public enforcement of its norms through the application of force or coercion, if necessary by agencies of the State (as we have noted, inability to enforce civil judgments effectively is a chronic problem in many developing countries).

²⁰⁵ Sen, *supra* note 3.

²⁰⁶ See, e.g., Dam, China as a Test Case, *supra* note 199, at 40-41; Martin Wolf, Why Is China Growing So Slowly?, 146 *Foreign Policy* 50 (2005); Yasheng Huang, China Is Just Catching Up, *Financial Times*, Jun. 8, 2004. In China, for instance, manifestations of the consequences of inadequate formal contract enforcement institutions can be observed through the NPL problem in a fragile banking sector which threaten a systemic financial crisis, the persistence of capital-starvation experienced by the private sector due to unavailability of bank loans through formal contracting, wage arrears to rural migrant workers in foreign-invested firms due to weak legal protection of employees' contractual rights, and so forth. All these negative consequences carry significant social costs and could entail potential risks to growth and social stability.

²⁰⁷ See, e.g., North, *supra* note 5; Richard A. Posner, Creating a Legal Framework for Economic Development, 13 *World Bank Res. Observer* 1 (1998).

²⁰⁸ See Daniel A. Farber, Rights as Signals, 31 *J. Legal Stud.* 83 (2002); Amartya Sen, What is the Role of Legal and Judicial Reform in the Development Process?, Address before the World Bank Legal Conference (June 5, 2000), *transcript available at* www1.worldbank.org/publicsector/legal/legalandjudicial.pdf; Ronald Daniels & Michael Trebilcock, The Political Economy of Rule of Law Reform in Developing Countries, 26 *Mich. J. Int'l L.* 99 (2004).