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GROWING A LEGAL SYSTEM, WITH SPECIAL REFERENCE TO THE POST-COMMUNIST ECONOMIES

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GROWING A LEGAL SYSTEM, WITH SPECIAL REFERENCE TO THE POST-COMMUNIST ECONOMIES: ABSTRACT

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Legal systems in the post-Communist economies are not well adapted to a market economy. In this paper, I use the tools of law and economics to analyze contract, broadly defined to include all voluntary exchange agreements. I show that there are real problems with this body of law, and that these problems are most severe in the case of Russia. I make three interrelated arguments: First, there is a substantial possibility of using private mechanisms such as reputations and self-enforcing agreements to facilitate exchange. Second, government can encourage the use of such mechanisms in such a way as to both assist private parties in engaging in exchange and also to economize on government resources. The most important such policy is a commitment on the part of government to enforce decisions of private arbitrators if parties voluntarily agree to use arbitration for dispute resolution. Third, government can incorporate the results of these private decision processes into the law when revisions of legal codes occur. I derive implications for efficient behavior of governments, private arbitrators, attorneys, trade associations, and private firms.

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I. INTRODUCTION: THE PROBLEM ADDRESSED

This paper is a normative application of law and economics scholarship to the problem of securing an efficient (wealth maximizing) method of enforcing agreements and thus facilitating exchange in the post-Communist countries.² I do not set forth the detailed tenets of explicit law; one point is that it is not useful or even possible for anyone to do so. Rather, the reference in the title to "grow" is deliberate: I discuss the policies which states can adopt that will allow the law to evolve efficiently. In this scheme, no one need decide *ex ante* what the outcome of the process will be. I do, however, indicate some broad principles of efficient contract law.³

While it is generally agreed that all law needs improvement in post-Communist economies, most writing by economists on the "Transition" has dealt with property law.⁴ The key issue addressed has been privatization.⁵

²I deal specifically with Russia, Hungary, Poland and the Czech Republic. I have visited these countries. However, I believe the general principles discussed would be more widely applicable.

³For a general discussion of what efficient contract law might look like see Richard A. Posner, *Economic Analysis of Law*, Little, Brown, Boston (Fourth Edition, 1992) Chapter 4, or Robert D. Cooter and Thomas Ulen *Law and Economics*, Scott, Foresman and Co., Glenview, Illinois, (1988), Chapters 6-7.

⁴See, for examples, Christopher Clague, "Introduction: The Journey to a Market Economy," in Christopher Clague and Gordon C. Rauser, eds. (1992), *The Emergence of Market Economies in Eastern Europe*, Blackwell, Cambridge, Mass. (1992); Janos Kornai, "The Postsocialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems," 82 *American Economic Review*, (May 1992) 1-21; John M. Litwack M. "Legality and Market Reform in Soviet-Type Economies" 5 *Journal of Economic Perspectives* (1991) 77-90; Henry Manne, "Perestroika and the Limits of Knowledge," 11 *Cato Journal* (1991), 207-214; William Niskanen "The Soft Infrastructure of a Market Economy," 11 *Cato Journal*, (1991), 233-238; and Jan Svejnar "Microeconomic Issues in the Transition to a Market Economy" 5 *Journal of Economic Perspectives*, (1991) 123-138.

⁵For a sampling of this literature see the articles in the collections edited by Christopher Clague and Gordon C. Rauser, eds. *The Emergence of Market Economies in Eastern Europe*. Blackwell, Cambridge, Mass., (1992); Michael P. Claudon, and Tamar L. Gutner, *Investing in Reform: Doing Business in a*

The major controversy in this literature has been the optimal speed of adjustment: Should there be a "big bang" (rapid immediate privatization) or should the transition proceed at a more modest pace?⁶ Relatively little scholarly attention from economists has been devoted to other branches of law.⁷

Changing Soviet Union. New York University Press. (1991); Bruno Dallago, Gianmaria Ajani and Bruno Grancelli, *Privatization and Entrepreneurship in Post-Socialist Countries: Economy, Law and Society*, St. Martin's Press, New York (1992); Shafiqul Islam and Michael Mandelbaum, *Making Markets: Economic Transformation in Eastern Europe and the Post-Soviet States*, Council on Foreign Relations Press, New York (1993); Michael Keren and Gur Ofer *Trials of Transition: Economic Reform in the Former Communist Block*, Westview Press, Boulder (1992); Paul Marer and Salvatore Zecchini, *The Transition to a Market Economy: Volume 1: The Broad Issues*, OECD, Paris (1991); and Laszlo Samogyi, *The Political Economy of the Transition Process in Eastern Europe*, Edward Elgar, (1993).

⁶For a non-technical discussion, see Peter Passell, "Dr. Jeffrey Sachs, Shock Therapist," *The New York Times Magazine*, 20, (June 27, 1993). Anders Aslund *Post-Communist Economic Revolutions: How Big a Bang?*, The Center for Strategic and International Studies, Washington (1992), and William D. Nordhaus, Merton J. Peck and Thomas J. Richardson "Do Borders Matter? Soviet Economic Reform after the Coup," 2 *Brookings Papers on Economic Activity*, (1991), 321-340, among others, are advocates of a relatively fast "big bang"; Peter Murrell in several papers has advocated a slower transition: "Conservative Political Philosophy and the Strategy of Economic Transition," IRIS Working Paper No. 7, University of Maryland (1991); "Evolutionary and Radical Approaches to Economic Reform, IRIS Working Paper No. 5, University of Maryland (1991); and "Evolution in Economics and in the Economic Reform of the Centrally Planned Economies," in Clague and Rausser, eds. *supra* note 5, pp. 35-53, as has Ronald L. McKinnon, "Spontaneous Order on the Road Back From Socialism: An Asian Perspective," 82 *American Economic Review*, 31-36, (May 1992).

⁷International Monetary Fund (IMF), The World Bank, Organization for Economic Co-Operation and Development, and European Bank for Reconstruction and Development. *A Study of the Soviet Economy*, Washington (1991), Chapter IV.7, indicate on at 249, that "The civil dispute resolution system has, as yet, received limited attention as a key component of basic market functions." In a series of articles Gray and co-authors have addressed issues of most types of law, including contract law, in many Eastern European countries: Cheryl W. Gray, "The Legal Framework for Private Sector Activity in the Czech and Slovak Federal Republic," World Bank Working Paper,

In this paper, I deal with the law governing transactions and exchange. These issues are quite important. For example, Douglass North, a leading economic historian studying growth of western economies, indicates that "How agreements are enforced is the single most important determinant of economic performance."⁸ North discusses the value of both formal (legal) enforcement of agreements and also the sort of informal mechanisms discussed below.

By "exchange and transactions", I mean more than what is considered in the legal literature as contract. I include the law dealing with all voluntary agreements. Although the paper focuses on contracts for exchange of goods, the principles developed apply more broadly. Securities law, the law of secured property, labor law and bankruptcy are all areas where parties form voluntary agreements and where the arguments of this manuscript are relevant. Indeed, even product liability law, which is commonly treated as tort (accident) law should be covered by contract.⁹ In general, contemporary western legal systems have erred by interfering excessively with freedom of contract. For legal systems of newer economies attempting to grow quickly, it is especially desirable not to commit similar errors. For example, in the postwar period, the highly successful Erhard reforms in Germany "...paid remarkably little attention to equity considerations. In marked contrast to the fashionable welfare state policies, the Erhardian reforms...limit[ed] social concern to the provision of a minimal, though comprehensive, social security

Washington (1992: "Czech and Slovak Republic"); Cheryl W. Gray, Rebecca J. Hanson and Michael Heller "Legal Reform for Hungary's Private Sector," World Bank Working Paper, Washington (1992: "Hungary"); and Cheryl W. Gray, Rebecca J. Hanson, Michael Heller, Peter Ianachkov, Daniel T. Ostas and Youssef Djehane "The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland," World Bank Working Paper, Washington (1991: "Poland"). Russell Pittman "Some Critical Provisions in the Antimonopoly Laws of Central and Eastern Europe," 26 *The International Lawyer*, 485-503 (1992), discusses antimonopoly law.

⁸Douglass North "Institutions, Ideology and Economic Performance," 11 *Cato Journal*, 477-488, (1991), at 481. For North's general view of the importance of institutions in an economy, see *Institutions, Institutional Change, and Economic Performance*, Cambridge University Press, New York (1990).

⁹Paul H. Rubin, *Tort Reform by Contract*, American Enterprise Institute, Washington (1993); George Priest, "The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law," 14 *Journal of Legal Studies*, 461-528 (1985).

net."¹⁰

Contract law is easier to reform than is property law because signing a contract is *ex ante* a positive sum, cooperative game. During the stage of negotiating a contract, the interests of the parties are symmetric and both seek the most efficient possible contract because this maximizes the surplus to be divided between them. For example, the parties would be expected to agree that in the event of breach due to a preventable occurrence, that party who could have prevented the breach most cheaply would be liable. This allocation of fault will reduce the costs of precautions and therefore increase the amount to be divided between the parties. There may be disputes about the division of the surplus-- the price term-- but there will be agreement about other terms.

If there is a dispute under the contract, then of course interests diverge, but there is at least one point in time when there is harmony of goals. For example, if there is a breach due to a preventable event, the parties may have an (interest motivated) factual dispute about who could have most cheaply prevented the event. Nonetheless, if a contract is signed in good faith (that is, if neither party plans *ex ante* to break the contract) then parties also have identical *ex ante* interests in methods of settling disputes *ex post*, when the contract has been broken. Both parties want the most efficient dispute resolution mechanism because this will again maximize the *ex ante* surplus to be divided between them. Of course, again, once a dispute arises, parties' wishes with respect to enforcement may differ, but there is a confluence of interests at the time of signing the agreement.

This commonality of interest is generally much weaker or lacking in other bodies of law. For example, in creation of property rights in the post-Communist economies, interests of most players diverge initially. Managers, workers and ordinary citizens all want for themselves ownership rights in existing businesses and, with respect to these rights, the issue of distribution is purely competitive. Therefore, even though there might be substantial gains from creation of property rights, it is difficult to form a coalition in favor of any one scheme. In tort law in general, the parties are generally strangers before the accident occurs, and so there is no room for *ex ante* agreement. Once the accident occurs, of course, interests are purely in conflict: each party wants the other to bear the costs of the accident.¹¹

¹⁰Holger Wolf "The Lucky Miracle: Germany 1945-1951," in Rudiger Dornbusch, Wilhelm Nolling and Richard Layard eds., *Postwar Economic Reconstruction and Lessons for the East Today*, MIT Press, Cambridge (1993), 29-58, at 37.

¹¹Robert C. Ellickson *Order Without Law*, Harvard University Press, Cambridge, (1991) analyzes tortious disputes in a context of existing

Those interested in law reform can use this symmetry of interests in contract to encourage efficient exchange and to design efficient contract law. There are three related points whose elaboration forms the heart of this paper. First, in many cases law itself will not be needed. There are many mechanisms available which private parties can use to make agreements self enforcing.¹² Second, the law can facilitate the use of these mechanisms. For example, the law can agree to enforce arbitration clauses in contracts if parties insert such clauses.¹³ This will result in settlement of many disputes without relying on the scarce resources available to the judicial system. Finally, public law can adopt the rules developed privately by arbitrators and others. This will speed up the process of development of the legal system and will ultimately lead to a more efficient system for reasons discussed below.

Obviously, a system of contract enforcement is more valuable if property rights are more clearly defined. Better defined rights facilitate exchange, and the value of exchange increases with the value of the rights. Nonetheless, in designing efficient contract law, it is *not* true that "everything depends on everything else." Even with the existing level of property rights definitions, large amounts of exchange takes place in the post-Communist economies. Individuals are not self sufficient. More efficient contract law can facilitate this existing exchange and encourage additional transactions, even under current circumstances.

As one Russian broker has told the *New York Times*, "Russian businessmen have gone ahead of the law, but goods have to move."¹⁴ This same story indicates that "The free market, in effect, is not waiting for a legal system. Deals march on, although the contracts that are bringing the new ventures to life might be difficult to enforce." If these contracts were easier to enforce, deals would march on faster and more deals would be done.

As privatization proceeds, more and more transactions will come under the scope of contract principles. If correct mechanisms can be adopted to

relationships, and shows that in this situation cooperation is possible and indeed the normal behavior observed. However, his universe -- disputes between adjacent landowners -- is not typical of the normal tort context, although it is typical of situations governed by nuisance law.

¹²Paul H. Rubin, "Private Mechanisms for Creation of Efficient Institutions for Market Economies," in Samoyi, ed., *supra* note 5, 158-170.

¹³"Probably some combination of private adjudication with ultimate state authority to back up its decisions is the most that a rapidly emerging free-market system can hope for." Manne, *supra* note 4, at 213.

¹⁴Lewis Uchitelle "The Art of a Russian Deal: Ad-Libbing Contract Law," *New York Times*, January 17, 1992, 1.

allow contract law to develop efficiently, then the law can evolve with the economy. At each step in the process, the law can be useful and valuable, and if the law is more efficient it will be more valuable.

Similarly, the process described here can proceed independently of the rate of privatization. If the process is rapid, then there will be more transactions to be covered by contract than if the process is slow. However, in either case the principles identified here are applicable. Indeed, as Olson indicates, there are even incentives for dictatorships to design efficient principles for private exchange, so that even if democracy should not survive in some countries, the principles discussed here might be relevant for policy makers.¹⁵ Democracies have stronger incentives, however, because efficient rights are relatively more valuable in democracies. Even communist countries have incentives for efficient contract law.¹⁶

One alternative to my proposal for gradual evolution of the law is a method of transforming contract law analogous to the "big bang." Some have suggested that the post-Communist economies adopt wholesale the commercial code of an existing market economy. Others may attempt to draft such a body of law *de novo*. In the next section I discuss these proposals and indicate why I do not believe they would be desirable. I also discuss the major alternative method of legal change, the adoption by legislatures of civil codes. While the countries of interest are generally code countries, there are some advantages to a common law process. One option is a use of a common law process until the laws and the underlying political systems have reached some level of equilibrium. If this option is chosen, there are advantages to a private as opposed to a public common law process.

In Section III I discuss the economics of contract law. An important function of this law is to reduce opportunism. I first discuss the theory of opportunistic behavior. I also provide some evidence that opportunistic behavior is occurring in the post-Communist economies.

There are private mechanisms available to individuals to avoid opportunism. These mechanisms are analyzed in Section IV. It is useful to characterize them as "unilateral" (actions a single party can take to certify his reputation) "bilateral" (actions two parties can jointly take to guarantee that neither will victimize the other) and "multilateral" (actions a group can jointly undertake to guarantee their reputations). I also discuss the limits to private actions in this section.

¹⁵Mancur Olson "Autocracy, Democracy and History With an Appendix: An Abstract Model of Autocratic Versus Democratic Government," IRIS working paper No. 22, University of Maryland (1991).

¹⁶Heidi Kroll "Breach of Contract in the Soviet Economy," 16 *Journal of Legal Studies* 119-148 (1987).

In Section V I discuss in more detail the legal situation today in the Czech Republic, Hungary, Poland and Russia. In the first three countries, while there are flaws and law is not complete, nonetheless, there is a sound body of commercial law in place. In Russia, in contrast, the law is much weaker and much more work is needed. However, many of the problems seem to stem from insufficient central government power, so that differing levels of government cannot commit to honor agreements. I also discuss some institutions in the post-Communist countries which already undertake the private functions discussed above, or which are in a position to begin to do so.

Section VI examines government policy which can facilitate design of efficient transactional rules. It is useful to consider policy with respect to unilateral, bilateral and multilateral mechanisms. Policies are both positive and negative. There are things which government should do to facilitate exchange. There are also things governments should refrain from doing which hinder exchange. Both types of policies are discussed.

Section VII relates the informal mechanisms discussed earlier and the process of evolution of efficient rules. It is shown that a combination of formal and informal mechanisms may be the fastest way to achieve these rules. For example, drafters of legal codes can incorporate lessons learned about efficient law from the informal mechanisms into code revisions.

Finally, the last section summarizes the implications of the paper. There are implications for behavior of government, arbitrators, private trade associations, private attorneys and businesses.

II. ALTERNATIVE METHODS OF LEGAL CHANGE

In this section, I discuss the major alternatives to a common law, evolutionary process for legal change.

A. A "Big Bang" For Contract Law?

There are equivalents in contract law to the big bang proposals for rapid privatization of property. One is the suggestion made by several authorities that the post-Communist economies adopt entirely the civil code of some capitalist economy. For example, Dornbusch argues that establishing institutions (including legal system) is second priority (after establishing "rules of the game," meaning private property rights and freedom to transact). He suggests that countries should adopt the entire civil code, including corporate law, from a country such as Finland or the Netherlands.¹⁷

Such a code would be difficult to interpret for an economy with no

¹⁷Rudiger Dornbusch "Strategies and Priorities for Reform," in Marer and Zecchini, *supra* note 5, V. 1, 169-183. See also Axel Leijonhufvud (1993) "Problems of Socialist Transition: Kazakhstan 1991," in Samogyi, *supra* note 5, 289-311, at 304.

tradition of markets. Indeed, even translating the terms from Finnish or Dutch into Russian or Polish would be difficult. The terms are defined only by their use in a market economy and in actual existing transactions and decisions. Leoni discusses the difficulty of translating legal terms from one language to another because words are rooted in institutions which may be lacking in the second culture.¹⁸ Leoni's discussion is in the context of translating between languages used in relatively free economies; the problems would be exacerbated in trying to translate terms used in market economies to languages spoken in societies which have not had markets and the corresponding institutions for many years. Murrell¹⁹ makes a similar point by suggesting that a legal code has embedded in it large amounts of practical knowledge, so that a transfer would not be feasible.²⁰

Leoni also discusses the problems arising from the fact that it may seem possible to translate words which in fact have different meanings in different legal cultures. This would be a real problem. For example, the Russian "Arbitration Court" is the general court with business jurisdiction; the term "arbitration" is not the same as arbitration in English. "Commercial bank," "leaseholding property" and "stockholding" are all used differently in Russian law than in other jurisdictions.²¹ Other such inconsistencies would undoubtedly be found, but if they were found after the adoption of a code substantial problems could be created.

It takes three years for an American college graduate (who has grown up in a market economy) to learn in law school the meaning of U.S. law, and longer until this knowledge is useful in a practical sense. Businessmen must then rely on discussions with trained attorneys in order for the law to affect their behavior. To expect this to occur simply by adopting an existing code is not realistic.

Similarly, it would not be feasible for authorities to generate an entire body of contract law *de novo*. Reliance on "top down" law will not work. Laws passed by the legislature are filled with loopholes and are internally

¹⁸Bruno Leoni, *Freedom and the Law*, Liberty Fund, Indianapolis, (1961; 1991 Reprint), at 30-31.

¹⁹Peter Murrell, "Conservative Political Philosophy," *supra* note 6.

²⁰It has been suggested that a country could import judges and lawyers to operate such a code. This might solve some of the problems, but does not seem a practical alternative. Moreover, language problems would persist.

²¹Mark Tourevski and Eileen Morgan *Cutting the Red Tape: How Western Companies Can Profit in the New Russia*, Free Press, New York, (1993), at 167.

inconsistent.²² These problems are not a result of incorrect drafting by the legislature, and could not be corrected by better craftsmanship. A body of law such as contract law is in some sense organically grown over a long period of time. It has numerous components which must interact with each other and with other large complex bodies of law (securities law, corporate law, labor law, to name only a few.) As Hayek says, "The parts of a legal system are not so much adjusted to each other according to a comprehensive overall view, as gradually adapted to each other by the successive application of general principles to particular problems..."²³ Laws must also be adapted to existing institutions in an economy. For example, Schmid (1992) points out that contract law may adopt one set of risk sharing doctrines in a world where market insurance is freely available, but these institutions may not be desirable if such insurance markets are lacking.²⁴ For anyone or any group to be able to craft such a body of law is as likely as for a decision maker to be able to design a complex economy *de novo*. (It is of course the impossibility of this latter task which has caused the current situation in the relevant economies.)

When a complex statute (such as the recently approved Americans with Disabilities Act) is adopted in the U.S., it commonly takes some years of litigation before its meaning is fully clear.²⁵ While some blame this on poor drafting by the legislature, it is also true that no one can *ex ante* predict fully the meaning of such a major legal change and its relationship with other law. If American lawmakers with large staffs of experienced professional lawyers and input from many others cannot fully predict the implications of only one statute, how could we expect Russian or Polish lawmakers lacking experience in a private law environment to be able to craft an entire code?²⁶

Finally, it must be noted that advocates of wholesale adoption of another body of law appear to believe that the relevant countries were indeed

²²Kathryn Hendley "Legal Development and Privatization in Russia: A Case Study," 8 *Soviet Economy*. (1992), 130-157.

²³Friedrich A. Hayek, *Law, Legislation and Liberty; Volume 1: Rules and Order*. University of Chicago Press (1973), at 65.

²⁴A. Allan Schmid "Legal Foundations of the Market: Implications for the Formerly Socialist Countries of Eastern Europe and Africa," 26 *Journal of Economic Issues*, (1992), 707-732.

²⁵Julie C. Janofsky, "Whoever Wrote the ADA Regs Never Ran a Business," *Wall Street Journal*, March 15, 1993, A12.

²⁶See also Daniel T. Ostas, (1992), "Institutional Reform in East-Central Europe: Hungarian and Polish Contract Law," 26 *Journal of Economic Issues* 513-523 (1992).

starting from a position of no law. As will be seen below, no country is in this position. All have some sort of pre-existing contract law. Therefore, the choice is not between starting *de novo* or adopting a body of law. Rather, the choice is between modifying an existing body of law or adopting some other body of law. However, even if some other country's law were adopted, it would require modification. Such modification would be needed to tailor the law to local conditions (where these conditions include the lack of market institutions for many years.) Thus, in either case, the issue is the most efficient method of modifying some currently maladapted law. The proposals in this paper are useful for adapting a body of law, whatever its original source.

B. Common Law or Civil Code?

The two major methods of deriving the law governing private relations (property, contracts, tort) are common law and civil codes. Codes are passed by legislatures; common law is judge made law. In general, Britain and its former colonies (including the U.S.) use common law; most of the rest of the world uses legislative codes. The post-Communist countries are therefore basically code countries. Nonetheless, I argue here for at least a temporary use of common-law principles in these countries.

A major theoretical argument in favor of common law was due to Hayek.²⁷ Posner²⁸ has also made such arguments. Rubin²⁹ has provided a mechanism which would lead to common law efficiency. These arguments are summarized in Scully.³⁰ Here, I make a more limited argument. I argue that for the conditions in which the post-Communist countries now find themselves, a reliance for a time on common law like processes would be useful. This reliance would not preclude the use of codes, but, I argue, would be a useful supplement. Indeed, I argue below that a private common law like process would be even more useful.

The process of code drafting generally requires several valuable inputs. In particular, skilled lawyers (often, in advanced countries, academic lawyers) and time of legislatures are the major inputs. Generally, a commission of attorneys will draft a proposed code which will be submitted to the legislature. The legislature will then request comments from interested and politically

²⁷Hayek, *supra* note 23.

²⁸Posner, *supra* note 3.

²⁹Paul H. Rubin "Why is the Common Law Efficient?" 6 *Journal of Legal Studies* (1977) 51-63.

³⁰Gerald W. Scully *Constitutional Environments and Economic Growth*, Princeton University Press. (1992), Chapter 6.

relevant parties. This process may go through several iterations. In contrast, common law decisions are byproducts of the dispute resolution process. The argument here is that the relative price of legislators and skilled lawyers is higher in the post-Communist countries than elsewhere. Thus, whatever the optimal balance between common law and code in more settled countries, the optimal mix is more towards a common law process in the newer economies.

Consider first lawyers. In order to draft a code, what is needed is a lawyer with knowledge of local conditions and laws, but also with knowledge of western capitalist law. Obviously, law schools in communist regimes did not specialize in training such attorneys, and there are relatively few of them. Moreover, their scarcity means that today such attorneys have a high opportunity cost.³¹ Code drafting is not a high paid occupation: it is commonly done as part of academic responsibility. Moreover, governments in all countries studied are short of funds and not likely to be able to pay high wages to attorneys to draft such codes. This does not mean that private attorneys would refuse if asked to serve on code drafting commissions. Rather, it means that they would likely take longer to provide a draft than would otherwise occur. Thus, the first input into code drafting, attorney's time, seems scarcer in the post-Communist economies than would be true at an equilibrium.

Legislator time is also scarce. The relevant countries are in the process of creating new economic, political and social orders. For such efforts, new laws and legislation are necessary. For example, privatization is itself a major change requiring substantial legislative input. In Russia, as I write, the legislature is engaged in a major political battle with President Yeltsin over the Constitution of the country, and legal changes in codes are not high on the political agenda. Once this dispute is resolved, the Russian legislature (in whatever form it comes to exist) will be busy with major political decisions, such as determining the role of the various geographic and ethnic components of the country in the new state. Again, this means that if a code is proposed to a legislature by a commission, the legislature is likely to take a longer time in responding than otherwise.

Boris Topornin, Director of the Institute of State and Law of the Russia Academy of Sciences, has addressed this issue. He has indicated that the "first generation" of Russian laws, adopted in December, 1990, were

³¹I myself met with many such attorneys in several countries. Almost all of them were associated with major American law firms, and many who were not seemed able to engage in significant amounts of consulting for foreign businesses. Others seemed to be in prestigious positions with important government ministries.

"insufficiently clear" and "insufficiently systematic."³² In general, Topornin indicates that current Russian law is inadequate, and that during the Transition it will be necessary to change the law rapidly.³³ However, as of now (June, 1993) the first generation of laws is still governing in Russia. The legislature has simply been unable to pass a "second generation." Although Topornin indicates that Russian law is fundamentally a code system, he also agrees that it might be possible to "use the experience of the common law."³⁴ While he may be referring to the results of the common law process, nonetheless, using the actual process itself during the Transition might not be inconsistent with his arguments.

In this context, a major benefit of a common law process is that decisions and legal change occur as a byproduct of dispute resolution. Whenever a dispute is settled by an appellate court, then new law is made (if there is a written opinion.) Since courts naturally settle disputes, generation of common law is relatively cheap. The only cost is the cost of writing an opinion, as opposed to merely providing a decision.

In general, we may view the tradeoff between code systems and common law systems in terms of the rate of adaption of the law to changing conditions. Ideally, a code can achieve the optimum set of laws when it is first adopted. In contrast, the common law will never reach optimality. However, as soon as a code is passed, it begins to become obsolete, and its maladaptation becomes larger until a new code is adopted. The common law, on the other hand, is always somewhat maladapted, but its lack of adaption is limited because it is continually changing. In deciding which form of law is most desirable, a country must balance these two types of costs. Since in countries which are in legal disarray (such as the new economies), adoption of new codes takes relatively longer than in countries which are in equilibrium, the balance would shift relatively more towards a common law solution.

Moreover, while a shift to a common law like process would be a change for legal systems which are not accustomed to such a process, the change need not be permanent. For example, legislatures could announce that rulings by appellate courts would have the force of law until a new codification of the relevant body of law could be passed. These decisions could then be an input into the codification process, but only one input. Such a system would allow some of the benefits of a common law process without eliminating the legal traditions of the relevant countries.

³²B.N. Topornin, "The Legal Problems of Economic Reform in Russia," The David Hume Institute, Edinburgh, (1993), at 19.

³³Topornin, 25.

³⁴Topornin, 34.

C. *Private Law or Public Law?*

An even simpler reform would be to rely on a private common law system. Indeed, it might be possible to establish such a system with minimal state intervention. The state would need to agree to enforce decisions reached by arbitrators. If it were well known that the state would enforce such decisions, actual enforcement would seldom be required. If a party knows that the sheriff (or the Russian equivalent) will attach his assets if he does not pay, then most parties will pay. If such enforcement were available, arbitrators (or associations of arbitrators) themselves could announce that they planned to establish a common law like system and follow precedent in decision making.

Such a system would create some difficulties. In particular, once the system of precedents became established, then parties would generally not rely on the arbitrators. Just as most disputes under a common law system settle "out of court", so would we expect most disputes under an arbitration system with a body of common law precedents to settle without a formal hearing. However, this problem would be easily solved. The arbitration association could charge a fee for being named in an agreement as the final arbitrator of potential disputes.³⁵ It would refuse to arbitrate any dispute between parties who had not named it as the final authority. In this way, the arbitration association could be compensated for the public good provided when decisions were written.

Later, I discuss some benefits of arbitration. However, many benefits arise because the courts in many relevant countries are themselves in some disarray. In general, a major problem is the lack of skilled personnel -- lawyers and judges -- for dealing with commercial dispute resolution and contract enforcement. This is due to lack of experience with appropriate law and institutions. While the main principles of contract law in many of the relevant countries are consistent with a market economy, the "broad general principles have never applied directly to contracts between enterprises involved in the planning process."³⁶ "Thus, the civil courts have a very limited experience of commercial disputes, and almost no experience with the resolution of complex business matters."³⁷ Although current judges do not have the needed experience. "To date, no substantial steps have been undertaken that will provide training to judges on the handling of complex commercial cases and there have been no plans announced for the hiring and training of large number of new judges and other personnel that will be

³⁵Bruce L. Benson *The Enterprise of Law*, Pacific Research Institute, San Francisco (1990).

³⁶IMF *supra* note 7, at 247.

³⁷IMF, 251.

needed as the burden on the civil dispute-resolution system expands."³⁸ Moreover, business operators and even lawyers are not "Contract Literate" because of the nature of the functioning of the Soviet system.

As of now, Russian courts lack sufficient power.³⁹ Kornai indicates that Hungarian courts lack experience with a market economy and lack sufficient resources to adjudicate all disputes which arise in a market economy.⁴⁰ Gray, in her discussions of law in Poland, Hungary and the CFR, indicates in all cases that trained judges are lacking and that both the legal system and the population at large lack experience in a market economy.⁴¹

Aslund is even more pessimistic "To require the state to do anything means to ask the uninformed and corrupt for assistance... Therefore, the only defensible recommendation is that the role of the state should be limited to a bare minimum in the period of transition to capitalism."⁴²

The current situation in Hungary seems to have improved. The salary of judges has recently been raised, and apparently well qualified individuals are becoming and remaining judges. On the other hand, salaries for judges in Poland are low. Moreover, after three years as a judge, an individual can become a barrister, a much more lucrative position, so many judges leave the bench at this time. While the possibility of becoming a barrister may attract better qualified individuals into becoming judges, the net result will be less experienced judges.

Thus, there are severe difficulties in drafting and enforcing public law for contract enforcement. Moreover, the skilled resources which would be needed for this project might be better employed elsewhere. This is particularly true since it may be possible to go a fair way towards creation of such law through private mechanisms. The proposals set forth here rely much less on a formal judiciary than do proposals for more explicit public law, and may be easier to begin applying.

III. PURPOSE OF CONTRACT ENFORCEMENT

The key class of problems facing potential traders in a world with no

³⁸IMF, 255.

³⁹Hendley, *supra* note 22.

⁴⁰Kornai, *supra* note 4.

⁴¹Gray, *supra* note 7, "Poland", "Czech and Slovak Republics", and "Hungary".

⁴²Aslund, *supra* note 6.

legal contract enforcement are problems of opportunism.⁴³ I first discuss the theoretical nature of this problem. I then present some evidence that the problem does exist in the post-Communist countries.

A. *Opportunism: Theory*

In many transactions, one party will have performed his part of the deal before the other, who will then have an incentive to cheat. One key purpose of the law of contracts is to discourage such opportunism.⁴⁴ Examples of opportunism can be so crude as simply to refuse to make an agreed upon payment. More sophisticated forms of cheating include offering of high quality goods for sale and delivering low quality.⁴⁵ A firm may also put a trading partner in a position where the partner is dependent on the firm for some input, and then raise the price, an action called "holdup." The general form of opportunism is appropriating the "quasi-rents" associated with some transaction.⁴⁶

The main cost of opportunism when it cannot effectively be prevented is neither the cost of cheating, nor even the cost of precautions taken to avoid being victimized. Rather, it is the lost social value from the otherwise profitable deals that do not get done. For example, in economies with no contractual possibilities, transactors often deal with long term associates or relatives in order to have additional assurances of contractual performance.⁴⁷

⁴³Oliver E. Williamson *The Economic Institutions of Capitalism*, Free Press, New York (1985); Paul H. Rubin, *Managing Business Transactions: Controlling the Costs of Coordinating, Communicating and Decision Making*, Free Press, New York (1990).

⁴⁴Timothy J. Muris, "Opportunistic Behavior and the Law of Contracts", 65 *Minnesota Law Review* 527 (1981).

⁴⁵George A. Akerlof, "The Market For Lemons: Qualitative Uncertainty and the Market Mechanism," 84 *Quarterly Journal of Economics* 488 (1970).

⁴⁶Benjamin Klein, Robert Crawford, and Armen Alchian "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," 21 *Journal of Law and Economics* 297 (1978).

⁴⁷Janet T. Landa "A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law," 10 *Journal of Legal Studies* 349-362 (1981). For an interesting formal model of an ethnically based trading network with enforcement mechanisms, see Avner Greif, "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders Coalition," 83 *American Economic Review* 525-544 (1993). The Maghribi were 11th-century Jewish traders in the Mediterranean.

But this means that many potential transactions will not occur because otherwise suitable parties will not be in appropriate relationships and so cannot guarantee performance, even though such transactions would be value increasing. Similarly, if quality cannot be credibly promised, then consumers will not be willing to pay a higher price for allegedly higher quality goods and manufacturers will therefore not produce them.

There is another cost to the post-Communist economies of lack of contractual enforcement mechanisms. As Coase long ago pointed out, if transactions costs between firms are high, then more activity will occur within the firm and less in markets.⁴⁸ But lack of enforcement mechanisms means that firms will be relatively larger because more functions will be internalized. Many authorities have remarked on the inefficiently large size of firms in these economies, and have argued that breaking the firms into smaller parts would be desirable. However, until efficient contract enforcement mechanisms are available, the incentive for such restructuring will be reduced because managers can anticipate difficulties in using contract to achieve that coordination which is now achieved by command.

In general, less formal enforcement mechanisms can work better for shorter term transactions and for transactions involving smaller amounts of money. As the time horizon in a contract becomes longer or the amount at issue becomes larger, the value of formal enforcement increases. Thus, an additional cost of lack of enforcement mechanisms is the loss of long term investments and large investments which are deterred by the lack of enforceability.

To the extent that mechanisms can be designed and adopted which reduce or eliminate opportunism, then social wealth can be greatly increased.

B. Opportunism: Evidence

These problems all exist to a greater or lesser extent in the post-Communist economies. During the Communist period, informal small scale trading networks based on family, ethnicity, friendship, reciprocity, long term obligations, and barter supported trade.⁴⁹ Personal relations and trust are

⁴⁸Ronald Coase "The Nature of the Firm," *Economica*, n.s., 1937; reprinted in Coase, *The Firm, the Market and the Law*, University of Chicago Press, 1988, 33-55. The working out of the effects of this insight on vertical integration was in part due to Klein, Crawford and Alchian, *supra* note 46; see also Williamson, *Economic Institutions of Capitalism*, and Rubin, *Managing Business Transactions*, both *supra* note 43.

⁴⁹Maria Los "From Underground to Legitimacy: The Normative Dilemmas of Post-Communist Marketization," in Dallago, et al., eds., *supra* note 5, 111-142.

still important because contracts cannot be enforced through the legal system.⁵⁰ The importance of personal contacts in supporting exchange in Russia is a major theme of Tourevski and Morgan, a book written to provide practical advice to western businessmen considering investing in Russia. For example, "The crucial impact on the business sphere will still be the impact of the importance of the business connections with its system"⁵¹ Such networks are of substantial importance primarily in contexts where there are limited possibilities for more formal governance mechanisms.

There is evidence of inferior quality of goods produced in post-Communist economies. There is no recourse for disgruntled consumers, unhappy with the quality of goods.⁵² Courts deal primarily with criminal matters, and are unable to handle a large increase in complex civil litigation engendered by cooperatives (Russian private firms) and private markets. In one survey, 44% of respondents complained of low quality of goods and services produced by cooperatives.⁵³ If these respondents meant that they would be willing to pay higher prices for higher quality (a fact which cannot be determined from the reported question) then this indicates a market failure. Goldberg discusses quality efforts in consumer and other markets.⁵⁴ He indicates that several new legislative proposals for increasing quality are being considered. However, none of these involve proper incentives and none create proper reputation effects. A reliance on legislation to achieve goals which markets can better provide is evidence of a carryover in thought processes from the previous economic system.

One major survey found that people in ex-communist societies have less confidence about the future and are more likely to believe that institutions are likely to change than is true of people in capitalist societies.⁵⁵ This would

⁵⁰Simon Johnson and Heidi Kroll "Managerial Strategies for Spontaneous Privatization," 7 *Soviet Economy* 281-316, (1991).

⁵¹Tourevski and Morgan, *supra* note 21, at 8.

⁵²Louise I. Shelley "Entrepreneurship: Some Legal and Social Problems," in Dallago, et al., eds., *supra* note 5, 308-325.

⁵³Ruud Knaack "On the Efficiency of Soviet Cooperatives: a Critical Appraisal," in Dallago et al., eds., *supra* note 5, 343-355.

⁵⁴Paul Goldberg, "Economic Reform and Product Quality Improvement Efforts in the Soviet Union," 44 *Soviet Studies* 113-122. (1992).

⁵⁵Robert J. Shiller, Maxim Boycko and Vladimir Korobov "Hunting for *Homo Sovieticus*: Situational versus Attitudinal Factors in Economic Behavior," 1 *Brookings Papers on Economic Activity*, 127-194 (1992).

explain in part the unwillingness of owners of firms to invest in brand name capital, and is consistent with other behavior as well.

Burandt reports that an American firm was induced to invest in developing a promotional program involving the Soviet Space Station based on assurances that a particular group of Russians had exclusive promotional rights.⁵⁶ They did not, and the results of the promotion campaign were appropriated with no compensation. Burandt suggests that this was due to ignorance of business practices rather than intentional dishonesty, but the behavior is consistent with opportunism.

Foreign businessmen indicate that in doing business in Eastern Europe, they are cautious. For example, a firm will take longer to do a job so that less investment is at risk. It will also move more slowly in working with partners and subcontractors than would be true in a world with more legal certainty. Many foreign firms are investing in distribution networks in these countries, but not in manufacturing capacity. Part of the reason is the fear of loss of investment.

There is even evidence of the simplest forms of opportunism. Firms in Russia sometimes take money and provide nothing; at other times, they accept goods and then do not pay. Enforcement even in these cases is apparently difficult.⁵⁷ Uchitelle indicates that buyers operating on commodity exchanges often renege.⁵⁸ In Hungary two-thirds of the 700,000 lawsuits filed in 1991 involved debt collection.⁵⁹ Indeed, the most significant form of opportunism in the post-Communist societies may be simple failure to pay debts. In Hungary, bankruptcy law can be used for debt collection, but such mechanisms are less well developed in other countries.⁶⁰

There is also evidence that the structure of new private firms is due in part to uncertainty about contract enforcement. Many new firms in Russia are forming holding companies or using vertical integration in order to guarantee needed supplies. Indeed, one "consultant" indicated explicitly that this was the motivation for organizing a large firm containing many otherwise

⁵⁶Gary Burandt *Moscow Meets Madison Avenue: The Adventures of the First Adman in the U.S.S.R.*, HarperBusiness, New York, (1992), at 92.

⁵⁷See, for example, Alexander J. Buyevich J. and Sergey N. Zhukov "Dispute Resolution in Russia." *Law of the Newly Independent States: The Bottom Line* (Fall, 1992), at 11.

⁵⁸Uchitelle, *supra* note 14.

⁵⁹Gray et al., "Hungary", *supra* note 7.

⁶⁰The Czech Republic has just passed a bankruptcy law, but it is too early to determine if this will be effective as a debt collection mechanism.

independent firms.⁶¹ Many new firms are associated with existing state firms, again for the purpose of obtaining guarantees of contractual performance.⁶²

IV. PRIVATE MECHANISMS

Kronman examined the possibility of exchange in a regime with no legal contract enforcement, a "state of nature".⁶³ He identified several mechanisms which parties could use to facilitate exchange in such a regime. To a certain extent, conditions in the post-Communist economies represent a state of nature. It is also important to note that even in developed countries, explicit enforceable (and enforced) contracts are relatively unimportant for much exchange. To the extent possible (and it is a large extent) businesses rely on agreements and do not use enforceable contracts;⁶⁴ in the U.S. 75% of commercial disputes are settled privately through arbitration and mediation.⁶⁵ Moreover, most potential "disputes" never even reach this stage. Thus, the lack of enforceability in many circumstances will present less of a problem and imply less difference between developed and new economies than might appear. However, businesses in developed economies have learned (perhaps through trial and error) methods of doing substantial amounts of business without relying on contracts. Businesses in new economies will have less experience with such techniques.

This paper deals in part with private mechanisms for solving the problems associated with opportunism in transactions. Private mechanisms are limited in their power: they cannot achieve a first best optimum. Without efficient government enforcement, it will be impossible to exhaust all potential gains from trade. For example, long term investments and large investments

⁶¹Johnson and Kroll, *supra* note 50, at 293.

⁶²Johnson and Kroll at 303.

⁶³Anthony T. Kronman "Contract Law and the State of Nature," 1 *Journal of Law, Economics and Organization* 5-32 (1985).

⁶⁴Bruce L. Benson, "The Spontaneous Evolution of Commercial Law," 55 *Southern Economic Journal* 644-661 (1989); *The Enterprise of Law*, *supra* note 35; and "Customary Law as Social Contract: International Commercial Law," 3 *Constitutional Political Economy* 1-27 (1992); Kronman, "State of Nature"; Stuart Macaulay, "Non-Contractual Relations in Business," 28 *American Sociological Review*, 55 (1963); Rubin, *Managing Business Transactions*, *supra* note 43; Lester Telser, "A Theory of Self Enforcing Agreements," 53 *Journal of Business* 27 (1980); Williamson, *Economic Institutions of Capitalism*, *supra* note 43.

⁶⁵Benson, *Enterprise of Law*, at 2.

may be particularly discouraged when contract enforcement is uncertain.⁶⁶ Thus the arguments advanced here can be viewed as second best approaches to efficient transacting in a situation in which the state does not efficiently enforce contracts.

On the other hand, it is possible to underestimate the power of such mechanisms. Olson discusses trade in Communist regimes between managers where markets were explicitly illegal.⁶⁷ He indicates that reputations and self enforcing agreements were possible and useful to a certain extent, but less efficient than state enforcement. However, in a world where trade is legal but contracts are not enforced, there are more possibilities than in a world where trade is illegal. This is because agents need not rely only on secret mechanisms. For example, reputations can become public knowledge and this can give much more power to this tool.⁶⁸ Olson's point is still correct, but some deals will be done under current conditions that could not have been done under full Communism.

There are three classes of private mechanisms which can be used to make agreements credible. All three are based on reputations. I now discuss these mechanisms.⁶⁹

A. Unilateral Mechanisms

These are mechanisms which one firm by itself can use to commit itself to refrain from cheating. A common application of unilateral mechanisms will be to firms selling consumer goods. Sellers can be manufacturers, who will create reputations in the brand name of their products, or retailers, who will create reputations in the name of their store. The general principle -- that reputations can guarantee that the firm will not cheat -- will apply in the bilateral and multilateral context as well.

A reputation is a valuable asset, and the value of the asset is lost if the

⁶⁶"Without solid contract law, it is a rare business executive, Russian or foreign, who is willing to risk investing, say, \$100 million to construct a modern appliance factory that will not generate revenue for a year." Uchitelle, *supra* note 14.

⁶⁷Mancur Olson "The Hidden Path to a Successful Economy," in Clague and Rausser, eds., *supra* note 5, pp. 55-75.

⁶⁸"There is already a blacklist of people with whom we don't deal anymore [because they have reneged on payment]" Uchitelle, *supra* note 14.

⁶⁹This material is based on Rubin, "Private Mechanisms," *supra* note 12.

firm cheats.⁷⁰ In the context of this analysis, a firm wants to be able to credibly commit to offering a given level of quality of goods for sale. Cheating is claiming to offer high quality goods but actually selling low quality. This can be profitable in the short run for the firm. Unless there is some reason not to do so, sellers will often cheat in this way. However, buyers, knowing that this form of cheating will occur, will not believe the firm's promise to offer high quality goods. Therefore, since some buyers would be willing to pay for high quality if they could be sure of getting it, there is a real social loss if the firm cannot credibly promise to offer high quality.

If a firm can invest in creating a reputation for high quality, then there will be a return on this investment. The investment will pay as long as the firm does not cheat. There are various unilateral mechanisms a firm can use to create a reputation. The key is to create some firm-specific capital which will become worthless if the firm cheats. Then this capital is the investment in reputation which guarantees that the firm will not cheat.

Advertising is one form of such investment.⁷¹ Advertising the brand name of the firm, even if the ads convey no additional information, indicates that the firm plans to offer high quality. If it does not, then the investment in advertising becomes worthless because consumers will no longer shop at the firm. There are other investments which can serve a similar function. Firms can invest in expensive signs or logos, which again become worthless if the firm cheats. Coca-Cola, in selling its product in Russia, is building custom made kiosks shaped like a Coke can.⁷² Law firms invest in expensive decor, which serves the same function.

Firms can also offer high quality items for sale at the price of low quality items for a time in order to induce consumers to try the product. The losses incurred are the investment. Consumers will try the product because they have nothing to lose even if the firm cheats (since they are paying the price for low quality). Once a reputation in a brand name has been created, it can be extended to additional products. Some western companies in selling in the post-Communist economies are selling at low prices in order to establish such reputations.

⁷⁰David M. Kreps, "Corporate Culture and Economic Theory," in James E. Alt and Kenneth A. Shepsle, eds., *Perspectives on Positive Political Economy*, Cambridge University Press, New York (1990); Rubin, *Managing Business Transactions*, *supra* note 43.

⁷¹Benjamin Klein and Keith B. Leffler "The Role of Market Forces in Assuring Contractual Performance," 89 *Journal of Political Economy* 615, (1981).

⁷²Laurie Hays, "Building a Market: Amid Russian Turmoil, Coca-Cola Is Placing A Bet on the Future," *Wall Street Journal*, April 6, 1993, 1, Col. 1.

Firms can also take advantage of reputations of trading partners. Reputations can be created at either the manufacturing or at the retail level. A retailer can benefit by carrying products of manufacturers with already established reputations. Conversely, a manufacturer can benefit by selling his product through a retailer who has established a reputation. If there is explicit contracting regarding reputation transfers, then the actions are bilateral (as discussed in the next section), but a firm can also unilaterally benefit from this mechanism.

However, while firms can privately invest in reputation creation, there appear to be some difficulties in the Eastern countries (and in particular in Russia) in this process. Traditionally firms here have valued secrecy, rather than the openness needed for reputations to work. "Very often Soviet participants take a closed or secretive position and the attempts to hide information can reach ridiculous levels"⁷³ and "Foreign investors need to be aggressive about getting information, because by inclination and long-standing habit, companies won't divulge it."⁷⁴ It is not clear why firms are excessively secretive, but such behavior can be counterproductive. One possible explanation is that in bargaining, firms have often been concerned with making sure that their partner did not make a profit, rather than with maximizing any measure of joint profits. As discussed below, this bargaining strategy may itself be due to short time horizons caused by uncertainty.

B. Bilateral Mechanisms

I deal with three issues relating to bilateral arrangements: self enforcing contracts, vertical relationships between dealers and manufacturers, and the use of "hostages." It might appear that contracts including private arbitration clauses would be relevant here, but as we see below, these fit better into the multilateral analysis.

1. Self Enforcing Agreements

The most important type of bilateral mechanism is the creation of what has been called a "self enforcing agreement."⁷⁵ This is an agreement between two firms which contains no external enforcement provisions. The agreement operates as long as it is in the interest of both firms to maintain it. For each firm, the value of the agreement is the value of the expected future business from maintaining the relationship. If a firm cheats, then it gains in the short run but loses the value of the future business.

⁷³Tourevski and Morgan, *supra* note 21 at 245.

⁷⁴Vladimir Kvint, *The Barefoot Shoemaker: Capitalizing on the New Russia*, Arcade Publishing, New York, (1993), at 79.

⁷⁵Telser, *supra* note 64.

As long as transactions can be structured correctly, then external enforcement is not needed. Correct structuring requires two major conditions. First, there must be no announced last period for the transaction. If there is a clearly specified last period, then a firm will have an incentive to cheat in that period because there is no future business to lose. But if both sides know that cheating will occur in the last period, then there is an incentive to cheat in the second to last period because there will be cheating in the last period anyway. But then in the second to last period... In other words, self enforcing contracts with specified termination dates "unravel" and are not stable.

Second, each party must make some return on the transactions which is somewhat greater than a competitive or normal return. The excess return must be large enough so that the present discounted value of the future profits (discounted both for time and for the probability that the sequence of transactions will end) is greater than the one time gain from cheating. If these conditions can be met, then contracts can be self enforcing with no requirement for external legal enforcement.

Uchitelle indicates that exactly this sort of contract is now occurring in Russia. "...two concepts -- mutual benefit and trust -- have come to play a major role in these early days of Russian capitalism. What these concepts come down to is this: If both parties to an agreement are benefiting from the deal, presumably they will not break the contract."⁷⁶

Nonetheless, there seems to be a tradition in Russia of hard bargaining. "Soviet Negotiators see business deal as fixed and finite entities. Only when ensuring that they end up with more and the negotiating partners end up with less do they feel the negotiations are successful"⁷⁷ and "One of the chief criteria for evaluating how foreign trade officials do their job is the discount they generate during negotiations, which is supposed to show how persistent and uncompromising they are as businessmen."⁷⁸ As long as this sort of bargaining occurs, it will be difficult to establish self enforcing agreements.

Burandt⁷⁹ discusses the formation of a joint venture for advertising between a Russian organization and the American advertising agency Young and Rubicam. He indicates that Young and Rubicam would price its services and pay the media "fairly" because the goal was to "establish ourselves as a reputable and leading company in this business for the long haul." On the other hand, "It wasn't atypical in the Soviet Union for organizations to overcharge customers and underpay suppliers." In other words, Burandt is

⁷⁶Uchitelle, *supra* note 14.

⁷⁷Tourevski and Morgan, *supra* note 21 at 246.

⁷⁸Tourevski and Morgan, 243.

⁷⁹*Moscow Meets Madison Avenue*, *supra* note 56 at 20.

arguing for prices which would make agreements self-enforcing, and such prices seem to be less common in Russia.

One costly way for exchange to occur is for individuals to trade only with close associates or with relatives. This pattern of trade was common under Communism. It is likely to persist unless and until institutions for dispute resolution become available. However, if the mechanisms can be generalized to additional trading partners, then there can be large gains.

2. Vertical Controls

An interesting class of bilateral transactions are between manufacturers and retailers of the product. There are various policies which manufacturers with brand name capital might want retailers to carry out. Some are: demonstrating and advertising the product; certification of quality; maintaining freshness; promoting the product to marginal consumers; maintenance of complete inventories; and refraining from "switching" customers to alternative product lines when consumers respond to manufacturers' advertisements.

There are numerous mechanisms which can be used to achieve these goals. These include: establishment of maximum or minimum prices at which goods can be sold (resale price maintenance); territorial restrictions, including exclusive territories; requirements that dealers carry only the brand of the manufacturer (exclusive dealing); and requirements of certain methods of retailing (such as shelf space requirements.) Manufacturers may also integrate directly into retailing or may establish franchises for selling their product. It is not my purpose here to discuss the business reasons for these restrictions; such discussions are available elsewhere.⁸⁰ These restrictions can be carried out as self enforcing agreements, with the threat of termination as the only sanction. There is no need for state enforcement of these types of arrangements. However, state hostility (as, for example, through much American antitrust law) can make such agreements non-viable.

Franchising might be particularly useful in the former Communist economies. There are many excessively large and excessively centralized enterprises. Splitting some of these entities into separate firms linked through franchise contracts could be a useful way of decentralizing without losing the benefits (if any) of a common brand name.

3. Hostages

One way for a firm to commit to not cheating is to offer a hostage to its trading partner. A simple hostage is some cash deposit which will be lost if the firm cheats. Such a hostage requires some outside enforcement, but not by the state. For example, the firms could jointly hire an attorney who would be empowered to decide if cheating had occurred and to award the payment

⁸⁰Rubin, *Managing Business Transactions*, *supra*, note 43, Chapter 6.

to the victim. Of course, there is a problem in trusting the attorney not to expropriate the hostage. However, firms might exist whose sole value is their reputation capital for enforcing such agreements and who therefore would not have an incentive to cheat in this way as long as their reputation were worth more than any one hostage. Law firms or investment banking firms might be able to perform this function. International firms might be particularly well suited for this role because they have established valuable reputations.

A more natural method is the creation of bilateral hostages. If firm A is dependent on firm B for some input, then firm A would have an incentive to put firm B in a position of being dependent on firm A as well. Moreover, firm B would have an incentive to be put in this position in order to be able to guarantee not to cheat. For example, firms making cardboard boxes commonly trade components with each other across geographic areas, and in this case neither firm can holdup the other without also putting itself at risk.

C. *Multilateral Mechanisms*

These are the most interesting class of adaptations, and the least well studied. A well defined multilateral arrangement involving a group of member firms can enforce honest dealing both between members of the group and between members and outsiders. The Law Merchant (the medieval body of commercial law) was exactly this sort of multilateral private legal system that enforced honesty by threats of reputation loss.⁸¹ The Law Merchant was then adopted into the English Common Law. Similar institutions survive today in advanced countries. The Better Business Bureau, for example, is a reputation guaranteeing device with properties similar to those of the Law Merchant. Many trade associations have codes of ethics with many of the properties of the Law Merchant.⁸²

Private contracts requiring arbitration of disputes require similar enforcement mechanisms. Much international commercial law is based on arbitration, with loss of reputation as the major sanction for breach.⁸³ I begin with an analysis of private arbitration which demonstrates the need for multilateral enforcement.

⁸¹Harold J. Berman, *Law and Revolution: The Formation of the Western Legal Tradition*, Cambridge, Harvard University Press, (1983); Benson, *The Enterprise of Law*, *supra* note 35; Paul R. Milgrom, Douglass C. North and Barry W. Weingast "The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs" 2 *Economics and Politics* 1-23 (1990).

⁸²Ivan Hill (Editor) *The Ethical Basis of Economic Freedom*, American Viewpoint, Chapel Hill, North Carolina (1976).

⁸³Benson, "Customary Law." *supra* note 64.

1. Arbitration

In a contract situation, arbitration may be feasible. The parties to a contract can specify in the contract that, in the event of a dispute, they will settle the issue through arbitration. Moreover, what is equally important, they can specify *ex ante* which arbitrator or forum they will use. Thus, if there are competing "court" systems, or competing groups of arbitrators, the parties can select the one they desire. Parties to contracts written in good faith will not expect to breach at the time of drafting the agreement, and will not plan on breach. Breach will occur only in the event of unexpected events, which can affect either side to the contract. Therefore, *ex ante* the parties will desire to select that forum for dispute resolution in which they expect to obtain the most efficient results, so that *ex ante* competition among arbitrators will favor those with a reputation for providing the most efficient (wealth maximizing) decisions.

Parties can also select the body of law which they wish to govern. Arbitrators can then enforce this law with respect to the contract. If it should turn out that one body of law is generally chosen by parties, then this will be evidence that this law might be the most efficient to be used as public law. Where law is not specified or relevant, arbitrators can use industry custom as a method of determining liability. Indeed, much common law and most commercial law is ultimately based on custom. This is one reason why we might expect arbitrators to be successful businessmen rather than attorneys.

We should note, however, that in the post-Communist societies custom is likely to be less useful as a basis for law than has traditionally been true. Those who write of custom as a basis for law⁸⁴ have in mind a situation in which trade is already occurring and a lawmaker arrives (or rises to power) and begins to use the existing customs as a basis for law; this is, for example, the approximate way in which the Law Merchant was incorporated into the commercial code. However, in the economies of interest, existing custom has evolved largely in circumstances in which trade was illegal and it was necessary to hide or disguise the terms and even existence of exchange. Thus, existing customs may be less well suited to adoption into formal law than has traditionally been true.

Indeed, those who were entrepreneurs under Communism may be true criminals today.⁸⁵ This depends on whether their skill was in engaging in trade and (at that time illegal) market transactions, or in engaging in illegal activities. Moreover, the custom of excess secrecy, mentioned above, would be counterproductive in a market economy. Nonetheless, customs developed

⁸⁴e.g., Benson, *The Enterprise of Law*, *supra* note 35.

⁸⁵Kvint, *supra* note 74 at 196-200; Tourevski and Morgan, *supra* note 21 at 210-211.

since the time of liberation on should be useful.

There is a limit to purely private arbitration, however. That limit is that the party who loses in a dispute has an incentive to ignore the decision. In countries with an established body of contract law, the solution is that the courts will often enforce the decree of the arbitrator. In a society where there is no court enforcement of such decrees, the only remedy is a reputation remedy. In small societies where reputation is common knowledge among all parties, then simple publicizing of cheating may work. However, in larger societies, where there are many trading partners, it may be necessary to devise more complex devices for private enforcement of arbitration decrees. This is the topic of the next section.

2. *Multilateral Enforcement Devices*

Consider a trade association with the following policies:

1. The association collects dues from all members. These dues are used to subsidize part of the costs of arbitration proceedings in which disputes among members and between members and customers or suppliers are resolved. Disputants also pay part of the costs.

2. Information is made available to all potential customers and suppliers regarding the list of members, so that it is possible for a potential customer to ascertain at low cost if a potential seller is a member of the trade association.

3. If the decision of the arbitrator goes against a party and the party ignores the decision (e.g., refuses to pay damages as ordered by the arbitrator) then the party will be expelled from the association.

4. Therefore, if a party has been expelled, then when a new potential trading partner queries the association, he will learn that the seller is not a member, and will accordingly be able to avoid trading with the party, or will trade on different terms.

The structure of this mechanism corresponds to the Law Merchant mechanism.⁶⁰ Milgrom et al. provide a game theoretic analysis of this mechanism and show that the outcome is stable and will lead to efficient trading patterns.

This pattern also followed by many trade associations which engage in self policing.⁶⁷ (The ability to engage in self regulation in the U.S. may have been excessively restricted by the application of antitrust laws.) The "Code of Ethics and Interpretations of the Public Relations Society of America" calls for an investigation of allegations of misconduct, with expulsion and publicity as

⁶⁰Milgrom North and Weingast, *supra* note 81. It is similar to the mechanism used by the Maghribi traders; Grief, *supra* note 47.

⁶⁷Hill, *supra* note 82.

potential remedies. Moreover, this code includes interpretations based on actual cases, which form a "body of law."⁸⁸ Similarly, the Code of Ethics of the National Association of Realtors has a provision for expulsion of members who do not accept the finding of review boards.

This same pattern is followed by diamond "bourses" (diamond exchange markets) such as the New York Diamond Dealers Club, and by the World Federation of Diamond Bourses.⁸⁹ These associations generally provide arbitration proceedings, and the ultimate sanction for violation of an arbitrated agreement is expulsion, although sometimes formal law will be used as well. Information about violators is also made public. Better Business Bureaus (BBBs), private reputation enforcing groups in the U.S., also follow this procedure, although these organizations also provide information about non-member firms. A simple mechanism would be for member firms to display on their doors or in their advertising a logo indicating that they are approved by the BBB.

Trade associations and BBBs illustrate the types of organization of reputation guaranteeing associations which might be useful. Trade associations commonly include members of a given business, irrespective of geographic location. Conversely, BBB's include businesses in a particular area, irrespective of the nature of the business. The latter type of organization is more likely to be useful to guarantee reputations of those who sell to consumers; the former, of business transactors.

D. Limits to Private Mechanisms

While private mechanisms can support some exchange, there are limits to the power of these mechanisms. In general, we may assume that a party will behave opportunistically whenever it pays to do so. Explicit enforceable agreements can mean that opportunism will be prohibitively expensive. A court order or an enforceable arbitration decree can remove any profit from opportunistic behavior. Other mechanisms are less reliable.

Consider reputation or hostages as enforcement devices. If a trading partner cheats, the most that can be lost is the value of the reputation. This will mean that it will in general not pay for one party to a transaction to trust the other party with any sum worth more than the second party's reputation. This provides an upper bound to the amount which can be invested. Similarly, as returns occur further in the future, the present value is also smaller. This limits the length of time for which transactions can be committed. Such

⁸⁸Hill, 285.

⁸⁹Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry," 21 *Journal of Legal Studies*, 115-159 (1992).

problems may be more acute in new economies since relatively more enterprises are new and therefore have relatively low valued reputations.

Similarly, the amount which can be put at risk in the context of a self enforcing agreement is the value of the stream of quasi-rents (excess returns) generated by the stream of transactions. If more than this is put at risk, then it will pay for one party to cheat and expropriate the excess investment. Again, to the extent that there is greater uncertainty in new economies about future events than in more mature economies, the expected future values are less reliable and so self-enforcement mechanisms will support less exchange than would otherwise be the case.

This should not be taken to mean that such mechanisms are valueless. On the contrary, they are common, even in developed economies. However, it is important to realize their limits. Such mechanisms should be supported by formal enforcement devices whenever possible.

V. THE CURRENT SITUATION

It is not correct to view all of the post-Communist countries as starting from the same point. Of those countries specifically considered in this report, the Czech Republic, Hungary and Poland are much more similar to each other than any is to Russia. It is likely that the Baltic Republics (Latvia, Estonia, Lithuania) are similar to the first three countries, while the Ukraine and Belorussia may be similar to Russia. Some of the Asiatic republics (Uzbekistan, Turkmenistan, Kirghizstan, Tadjikistan) may be relatively less developed than Russia.⁹⁰ The exact ranking is not important; what is relevant is the observation that the countries considered may provide examples for others.

A. *The Czech Republic, Poland and Hungary*

The civil codes of the countries in the former Soviet Union are based on pre-Soviet European Civil Codes and "many of the principles are not

⁹⁰This rough ordering is consistent with a table in Tourevski and Morgan, *supra* note 21, at 114. This Table (which is based on an analysis from *Moskovskie Novosti*) does not explicitly rate legal systems, but does rate "Development of Infrastructure." The Table considers only former Soviet Republics, so that the Czech Republic, Poland and Hungary are not included. Kvint, *supra* note 74 at 207-8 provides a similar ranking. Ernst & Young has rated additional countries. In this rating, Poland, the Czech Republic and Hungary are rated first in "Business Infrastructure"; the Former USSR is rated significantly lower. Reported in Ryam Tutak, "Once preeminent for foreign investment, Hungary is now slipping in status." *The Budapest Sun*, May 13-19, 1993, at 6.

inconsistent with a market economy."⁹¹ In many cases, these have been adopted from pre-Communist codes. This is true of the Czech Republic, Poland and Hungary. These three countries have in place a set of basic contract laws.

Poland adopted a code in 1964 which was in turn based on a 1933 Code, but with various Socialist additions; these additions have themselves been removed in 1990.⁹² Thus, current Polish contract law is a 1933 western law. A Commission is currently redrafting this code in order to update it. In Hungary, current transactions are governed by those parts of the Civil Code originally written to govern small, noncommercial private transactions.⁹³ the Hungarian legal system appears to be the most well adapted for market transactions of the three countries considered.⁹⁴ The Czech and Slovak Federal Republics (CSFR) had more of the system adapted to Communism than most other countries, so that it had less law to build on than others. The CSFR adopted a new Civil Code and a new Commercial Code in 1991.

Thus, in many of the Eastern countries there now exist indigenous bodies of contract law. These are deficient in that they are either crafted *de novo* (CFR) or adapted from earlier law (Poland, Hungary.) Thus, none are fully adapted to contemporary business. For example, Polish limited liability firms were small family type businesses and there was little formal law dealing with larger business.⁹⁵ Nonetheless, beginning with the existing body of contract law and allowing modifications as discussed below is likely to be the most efficient and most expeditious way to achieve a body of contract law suited to market conditions in the post-Communist economies. Klishin⁹⁶ discusses such an evolutionary process, although state control was more powerful when he wrote than now.

It should also be noted that commerce can function with a relatively small body of contract law. Most terms of contracts are written privately by

⁹¹IMF, *supra* note 7, at 247.

⁹²Gray, "Poland," *supra* note 7, at 19.

⁹³Gray, "Hungary", *supra* note 7, at 34.

⁹⁴Paul Marer "Economic Transformation in Central and Eastern Europe," in Islam and Mandelbaum, eds., *supra* note 5, 53-98 at 59.

⁹⁵Gray, "Poland," *supra* note 7.

⁹⁶Alexei Klishin, "Economic Reform and Contract Law in the USSR," 28 *Columbia Journal of Transnational Law* 253-262 (1990).

the parties themselves; as Benson⁹⁷ points out, the parties actually make "law" by writing a contract. Explicit public law serves two functions in addition to enforcing private terms. First, it fills gaps: it covers situations which the parties did not anticipate. Second, it supplies defaults: if the law provides certain terms or indicates certain results, the parties to a private agreement can save resources by not directly dealing with these issues, or paying lawyers to deal with them. However, the major part of the contract is the result of private agreement. Thus, parties can engage in substantial amounts of contractually based commerce with little explicit "law" on the books.

Gray⁹⁸ provide a summary of the situation in Poland which seems to apply more generally:

Although the legal structure is generally satisfactory in most areas, practice is still uncertain in all areas. The generality of the laws leaves wide discretion for administrators and courts, and there has not yet been time to build up a body of cases and practice to further define the rules of the game. Although the courts are in general honest and are used by the population, they have little experience in economic matters. Judges are not well paid, and the best lawyers have a strong incentive to go into private practice. The wide discretion and general lack of precedent and competence create tremendous legal uncertainty that is sure to hamper private sector development.

B. Russia⁹⁹

Russia seems to have a less well adapted body of law than the first three countries. This may be because Russia was Communist for a longer time than the others, so that existing pre-Communist law is older than in the other countries and there is an additional generation since people have had actual exposure to markets. Moreover, at the time of the Revolution, Russia was less economically advanced than were the other countries when they became Communist, so that it had a less well developed body of capitalist law.

The major legal weaknesses do not seem to be in the area of contract law itself. There is a large body of Russian contract law used under the Soviet system to govern transactions between enterprises. This law differs from

⁹⁷Benson, *The Enterprise of Law*, *supra* note 35.

⁹⁸Gray, "Poland", *supra* note 7, at 2.

⁹⁹Much of this section is based on IMF, *supra* note 7, Chapter IV.7. Other important sources are Kvint, *supra* note 74 and Tøurevski and Morgan, *supra* note 21.

contract law in market economies. However, it is not as different as we might expect. "More surprising, perhaps, is the substantial convergence of contractual norms in Soviet and Anglo-American legal systems despite significant differences in the organization of capitalist and socialist economies."¹⁰⁰ Attorneys and businessmen in Russia indicate that difficulties in doing business are due more to uncertainty about government actions than contractual weaknesses.

There seem to be pervasive difficulties with the legal system which have the impact of weakening the ability of contract law to function. These difficulties apparently stem from the December, 1990 law "On Property in the RSFSR." This law was seriously incomplete, but the needed subordinate legislation was not passed because of political difficulties. Moreover, "There was no clear distribution of state property between the Federation and its member republics, districts, and regions."¹⁰¹ These problems in allocation of property rights and conflict between governmental units still plague the country today; examples are provided below. Moreover, it also appears that in Russia, more than in the other countries, there remain people in authority with some hostility towards the adoption of markets.

One example of forces leading to legal uncertainty in Russia is what has been called the "war of laws". Various levels of government may pass conflicting laws, and there is no mechanism for resolving such conflicts. This makes business planning difficult.¹⁰² "At the time of this writing, the problem of lack of clarity and uniformity exists at all levels of government and involves uncertainty concerning the location of authority to legislate and implement the laws, the nature and extent of the legislative and executive powers, and the appropriate means and methods for enforcement."¹⁰³ While the splitting of the Soviet Union into independent countries may have reduced these problems, it has not solved them all, and local laws are continually changing.¹⁰⁴ There are inconsistencies in rules and interpretations of various

¹⁰⁰Kroll, *supra* note 16, at 147.

¹⁰¹Topornin, *supra* note 32, at 17.

¹⁰²Peter J. Pettibone, "Working Group 3: The Emerging Legal Environment," in Claudon and Gutner, eds. *supra* note 5, 251-254 at 252.

¹⁰³IMF, *supra* note 7, at 226.

¹⁰⁴Ia Kuz'minov, "Soviet Economic Culture: The Legacy and the Paths of Modernization," 35 *Problems of Economic Transition* 5-24, (August, 1992), at 18-19.

ministries and departments of the RSFSR.¹⁰⁵ The multiplicity of fora for resolution of commercial disputes is more severe in economies which lack "a well developed body of commercial law."¹⁰⁶ There are over 800 ministries, and many of these can stop any given deal.¹⁰⁷

Only 8 percent of potential joint ventures begin operating.¹⁰⁸ Kvint estimates that 10 percent of the failures of joint ventures are due to legal problems.¹⁰⁹ Kvint also estimates that 28 percent of the failures are due to inability to find an appropriate partner¹¹⁰ and 20 percent to "financing".¹¹¹ These difficulties may be exacerbated by legal problems. For example, difficulty in finding financing may be caused by poor property rights definitions, or difficulty in foreclosing, making it difficult to use property as collateral. Finding a partner may be made more difficult because of contractual uncertainty. Thus, the legal system may be responsible for a greater percentage of failures than is immediately apparent. Sixteen percent of the failures are due to "bureaucratic problems"¹¹² which may also relate to legal uncertainty.

Tourevski and Morgan indicate several areas in which respondents to interviews (Russian and foreign businessmen) have indicated weakness in the law. Indeed, this weakness is a major theme of the book. For one set of examples, they cite¹¹³

1. Vague, contradictory, inconsistent formulations.
2. Dependence of the laws on ideological trends and tendencies.

¹⁰⁵V. Chernogorodskii and A. Tsyganov "Economic and Organizational Conditions for the Support of Entrepreneurship in Russia," 35 *Problems of Economic Transition*, 71-85, (August 1992), at 72.

¹⁰⁶IMF, *supra* note 7, at 254.

¹⁰⁷Kvint, *supra* note 74, at 26.

¹⁰⁸Kvint, 181. Tourevski and Morgan, *supra* note 21 at 65, indicate that 20-30 percent of licensed joint ventures operate successfully.

¹⁰⁹Kvint, 186.

¹¹⁰Kvint, 182.

¹¹¹Kvint, 221.

¹¹²Kvint, 221.

¹¹³Tourevski and Morgan, 166-7.

3. Isolated lawmaking, divorced from international legislation.
4. The conflict between laws which had been centralized and the republics, between the republics themselves, or between the republics and their autonomous territories. According to the prognosis expressed in the interview, this tendency will be increasing.
5. The instability of laws which are unclear and change from day to day.

New laws are passed with no thought to their consistency with existing law.¹¹⁴ Moreover, there are no legal provisions for ending joint ventures and allocating their property, so some potential transactors are reluctant to form such ventures.¹¹⁵ One strategy for dealing with such legal inconsistency is to enter the market on a small scale and observe what happens.¹¹⁶ Many foreign firms, for example, have small investments in Russia, often involving only retailing of products. To the extent that quicker or larger investments would occur if there were increased certainty, then the uncertainty is imposing real costs on the Russian economy.

Numerous examples of such inconsistencies can be presented. In one (randomly selected) week, the *Moscow Times*, a daily English language newspaper, reported the following examples of market interference and contractual uncertainty:

From April 9 to May 25, oil prices were controlled at levels well below market prices as a result of a politically motivated decree imposed before the election.¹¹⁷ As a result of the decree maintaining prices at the March 1 level, Moscow suffered severe gasoline shortages. Some refineries had refused to sell in Moscow; two refineries had closed down. Even though the price has been allowed to rise, the new controlled price is 75 rubles per liter, but mobile tanks have already been selling gasoline for 120 to 150 rubles per liter.¹¹⁸

A Korean-Russian joint venture has invested \$70 million in a timber project in eastern Russia since 1990. An environmental dispute went to the Russian Supreme Court which "failed to come to any concrete conclusion, sending the case back to the regional court." There has also been a

¹¹⁴Tourevski and Morgan, 168.

¹¹⁵Tourevski and Morgan, 73.

¹¹⁶Tourevski and Morgan, 39.

¹¹⁷"Gasoline Prices Free to Rise," *Moscow Times*, May 25, 1993, 2.

¹¹⁸Mikhail Dubik, "Moscow Hikes Price of Gasoline," *Moscow Times*, May 29, 1993, 11.

"worsening tax situation." While it was originally estimated that the venture would earn a profit by the fourth year, "under current conditions it could take seven to 10 years." Other potential investors are monitoring this situation closely.¹¹⁹

De Beers had signed a five year contract with the Russian diamond marketing agency; now, the "precious Metals and Stones Committee" is attempting to renegotiate this contract.¹²⁰

The Moscow city government changed the method of taxing land owned by joint ventures. Previously, tax was paid at the same rate as that paid by Russians (about \$3500 per hectare). Now, the rate will range up to \$465,000 per hectare, the rate paid by foreigners. The exact rate will depend on the degree of foreign ownership of the joint venture. "The new decree is the latest in a series of changes in tax and land-ownership laws that have made it difficult for foreign and Russian firms to lease property for office space and development in the capital. In recent months, for example, the City Council has annulled leases signed by the mayor's office and passed legislation calling for lease agreements to be renegotiated." These new tax rates mean that some past investments may not be profitable, and many would not have been undertaken.¹²¹

Other examples:

The Ministry of Foreign Economic Relations is creating an auditing board which will have the right to control or even shut down any independent entity engaged in foreign economic relations. This board will be able to question the business decision of entities subject to its control.¹²²

Russian customs officials and later the KGB seized automobile batteries produced by an American-Russian joint venture because of a technicality in the joint venture charter.¹²³

Customs officials refused permission for a Leningrad company to export scrap metal, even though the company had permission from the

¹¹⁹Hugh Fraser, "Hyundai Log Project Daunted by Troubles," *Moscow Times*, May 28, 1993, 12.

¹²⁰"State Seeks to Alter De Beers Contract," *Moscow Times*, May 29, 1993, 11.

¹²¹Geoff Winestock, "Land Tax Hits JV Projects," *Moscow Times*, May 27, 1993, 1.

¹²²Tourevski and Morgan, *supra* note 21, at 42.

¹²³Tourevski and Morgan, *supra* note 21, at 44-45.

Russian Federation.¹²⁴

A cooperative began to recover and process timber which sunk during the process of floating it downstream and which otherwise was wasted. Within six months, the government shut down the operation, so that the timber continues to rot.¹²⁵

A Russian magazine publisher contracted to trade waste paper for computers. However, it was denied a license to export waste. (Even if one ministry had granted such a license, approval of another would also have been required.)¹²⁶

Western oil companies might spend up to \$70 billion annually to develop Russian oil fields were it not for fears of opportunism.¹²⁷ Much of this opportunism is by the government, which seems to often change rules or increase export taxes in a way designed to opportunistically appropriate past investments. However, there is private opportunism as well. After one company had invested machinery for drilling for Russian oil, the firm controlling the pipeline which provided the only route to the sea doubled its rates.¹²⁸

The Raddison Corporation negotiated an agreement with the Kremlin to build a hotel in Moscow. However, once the property was completed, the Moscow city council demanded a partnership before allowing the hotel to open. Negotiations delayed the opening for about one year, and the city did get a partnership.¹²⁹

Even where investment does occur, investors are aware that contracts are subject to great political uncertainty. Elf Aquitaine, the French company, has signed a contract to explore for oil in Russia and Kazakhstan.¹³⁰ Other American oil companies have also signed contracts, but Elf's endeavor is the only one which is not part of a joint venture.

¹²⁴Tourevski and Morgan, 170.

¹²⁵Tourevski and Morgan, 209.

¹²⁶Kvint, *supra* note 74, at 194.

¹²⁷Ann Imse, "American Know-How and Russian Oil," *The New York Times Magazine*, March 7, 1993.

¹²⁸Imse, 57.

¹²⁹Bill Thomas and Charles Sutherland, *Red Tape: Adventure Capitalism in the New Russia*, Dutton, New York, (1992), at 147.

¹³⁰Agis Salpukas, "In an Oil Rush to the East, Elf Plays Pied Piper," *The New York Times*, June 27, 1993, F7.

Elf has the first of what is called a production agreement with Russia...but whether the contract will remain in effect as written remains uncertain.

It took Elf about a year to get the deal approved by the Russian Parliament, but whether this gives the contract any legal force is still murky, given the struggle between President Boris Yeltsin and some leaders of the Parliament.

...

A High official in the Tyumen Region, Russia's largest oil area, said there was a continuing tug of war between local officials and the ministers in Moscow over control of new ventures.

...

In such an atmosphere, Elf's straightforward contract could be bent out of shape.¹³¹

Ikea, the Swedish furniture company, did plan to invest in producing goods as well as selling in Russia. In 1988, Ikea agreed to renovate a dozen Russian furniture factories to produce furniture which it planned to sell in stores it planned to open by 1991. However, the plan failed when the U.S.S.R. collapsed. Ikea is involved in litigation and in an arbitration in Stockholm. Ikea's chief executive, Anders Moberg, has been quoted as saying "Terrible problems untangling various obligations between the old U.S.S.R. and the new republics have us much more cautious." Ikea now plans to invest in Poland, Hungary and the Czech and Slovak republics, but not Russia.¹³²

These examples indicate difficulties with the political system of Russia, rather than with the legal system itself. In order for such problems to be corrected, political reform is needed.¹³³ The sort of remedies proposed in this paper are only available in economies where decision makers have the power and will to impose reforms: they cannot be used where such will is lacking.

¹³¹Elf is 50 percent owned by the French government. This would change the risk preference of managers so that riskier activities might be more desirable. (Rubin, *supra* note 43, Chapter 4.) Normally, major stockholders would be expected to monitor such activity, but Elf's "management has been making its own decisions for many years --including its journey to the East -- with little supervision by the state."

¹³²Stephen D. Moore, "Sweden's Ikea Forges Into Eastern Europe," *Wall Street Journal*, June 28, 1993, B6E.

¹³³Robert Campbell, "Economic Reform in the USSR and Its Successor States," in Islam and Mandelbaum, eds., *supra* note 5, 99-142.

Political stability will support legal reform in another way. Part of the difficulty with law enforcement is undoubtedly due to uncertainty. Many of the mechanisms discussed here depend on reputations and on other long term investments (e.g., in self enforcing agreements). If parties believe that legal or property institutions are likely to change in the near future, they will be willing to invest less in such agreements. This may explain the widely noted tendency of Russian negotiators to drive excessively difficult bargains, discussed above. Such bargaining may mean that the Russian participants receive less long term returns from the agreement, but if parties have short time horizons this will be less significant.

Short time horizons may also explain some otherwise puzzling behavior of political authorities. If a political authority radically changes the tax rate faced by businesses, then this can be profitable in the short run because the jurisdiction can appropriate the quasi-rents from the completed investment. However, this policy has long term costs because other businesses will be less willing to invest in this jurisdiction. But a short time horizon means that the present value of the appropriated investments can outweigh the long term losses from lost future investments.

The famous Coase Theorem shows that with well defined property rights and sufficiently low transactions costs, the final use of resources is efficient and invariant with respect to initial rights assignments.¹³⁴ Most criticisms of the theorem have focused on the second condition, the magnitude of transactions costs.¹³⁵ However, the situation in Russia today is one in which the theorem may not hold because the first condition, the existence of well defined property rights, is not satisfied. The problem is not anarchy. Rather, it is the existence of too many governments, with lines of power insufficiently well defined between them. Property rights are not well defined because it is not clear who has the power to define them. The result is that resources will not be used efficiently. It is essential that this problem be solved for any degree of economic progress to be feasible.

The situation in Russia is perhaps typical of what Joseph Tainter indicates commonly occurs after the collapse of a complex society:

With disintegration, central direction is no longer possible. The former political center undergoes a significant loss of prominence and power. It is often ransacked and may ultimately be abandoned. Small, petty states emerge in the

¹³⁴Ronald H. Coase, "The Problem of Social Cost," 3 *Journal of Law and Economics* 1 (1960).

¹³⁵For example, Robert Cooter, "The Cost of Coase," 11 *Journal of Legal Studies* 1 (1982).

formerly unified territory, of which the former capital may be one. Quite often these contend for domination, so that a period of perpetual conflict ensues. The umbrella of law and protection erected over the populace is eliminated. Lawlessness may prevail for a time...but order will ultimately be restored.¹³⁶

Although the collapse of the Soviet Union fulfills many of the conditions discussed by Tainter, one may hope that Russia can avoid the most grim of these ramifications.

D. Some Possible Beginnings

There already exist agents in the post-Communist economies who could possibly perform the functions sketched out above, and some are apparently already doing so.

Cooperatives in Russia have formed two types of associations for lobbying purposes.¹³⁷ Some are geographically organized, and include businesses in a particular area. Others are essentially trade associations and include cooperatives in the same business sector. Associations of cooperatives these provide services to members, including legal assistance, and pursue a political program. Two major organizations are the USSR Union of Amalgamated Cooperatives (founded in 1989) and Union of Leaseholders and Entrepreneurs (1990).¹³⁸ Representatives of the cooperative movement were involved in decision making regarding legislation. Again, these structures correspond to the types of potential multilateral organizations discussed above, but there is no evidence that these organizations presently perform such functions.

One class agency which does perform exactly the functions identified

¹³⁶Joseph A. Tainter, *The Collapse of Complex Societies*, Cambridge University Press, New York, (1988) at 19-20. This is a fascinating study of collapse, and many of the conditions discussed are observed in the former Soviet Union in areas not relevant to the concerns of this paper. One weakness of the book is its prediction that "Collapse today is neither an option nor an immediate threat." (213). Moreover, although writing in 1988, Tainter considered and rejected only the possibility of collapse of Western Civilization; collapse of the Soviet Union was not contemplated.

¹³⁷Anthony Jones and William Moskoff *Ko-ops: The Rebirth of Entrepreneurship in the Soviet Union*. Indiana University Press, Bloomington (1991).

¹³⁸Anthony Jones "Issues in State and Private Sector Relations in the Soviet Economy," in Dallago, et al., eds., *supra* note 5, 69-88.

above is the "commodity exchange." These are trading centers, with many firms as members. Zhurek indicates that the International Food Exchange offers a variety of services, including "arbitration for the rapid settlement of trade disputes."¹³⁹ However, he also indicates that volume on this exchange is low. On the other hand, the Moscow Commodities Exchange did over \$500 million in business in May of 1991.¹⁴⁰

The Soviet Chamber of Commerce has begun performing an information function.¹⁴¹ This organization publishes a directory regarding foreign trade participants, including information about financial positions and business reputations. Other organizations perform similar functions.¹⁴² Some private organizations also provide such business information. The accounting firm of Ernst & Young has established a joint venture which provides information about various aspects of doing business, including information about "reliability of the partners"¹⁴³ and several other private ventures are providing such information.¹⁴⁴ However, in general, Tourevski and Morgan believe that there is a dearth of useful business information.¹⁴⁵ This has been exacerbated because for a time cooperatives (Soviet private firms) were forbidden from performing "middleman" functions.¹⁴⁶

VI. GOVERNMENT POLICY

So far, the discussion has been about private actions to create mechanisms for private enforcement. However, government can facilitate these mechanisms in various ways. Such facilitation can have two beneficial effects. First, by increasing the ability of agents to enter into agreements, the amount of beneficial transactions can increase. Second, by choice of proper policies, government can facilitate the creation of a body of precedent which

¹³⁹Stefan Zhurek, "Commodity Exchanges in Russia: Success or Failure," 2 *Radio Liberty Research Report* 41-44, (February 1993), at 42.

¹⁴⁰Thomas and Sutherland, *supra* note 129, at 136.

¹⁴¹Tourevski and Morgan, 49.

¹⁴²Tourevski and Morgan, 201-202.

¹⁴³Tourevski and Morgan, 103.

¹⁴⁴Tourevski and Morgan, 104.

¹⁴⁵Tourevski and Morgan, 52.

¹⁴⁶Tourevski and Morgan, 195.

can ultimately be used to create the beginnings of an efficient body of laws.

I have in mind the following rough institutional structure. There is a court system in existence. This system has some rough notion of contract law. It may, for example, believe in "freedom of contract" and in allowing voluntary private exchanges. However, there is not a complete body of contract law in place, so that decisions of the court system in resolving actual disputes will be somewhat uncertain. "It is entirely permissible to adopt a kind of skeleton law in the situation where the law on a given subject is being drafted and only the most general provisions are certain, on the basis that the answers to the more concrete questions can only emerge from practice."¹⁴⁷

In addition, it is likely that there are delays in reaching the court system. In a world of high inflation, these delays may be particularly costly if court awards are made in nominal currency units, which may be happening in Russia (private comment of Harold Berman). Unindexed contracts and court unwillingness to alter contractual terms were responsible for an epidemic of nonpayment in interwar Germany.¹⁴⁸ Thus, other mechanisms may be chosen where feasible.

In this section, I deal with two types of policies. Some policies will facilitate formation of private agreements. However, it is also possible for incorrect government policies to penalize conduct which is efficient. Based on past experience in the U.S., misuse of antitrust policies is particularly likely to be costly. Even in the U.S. antitrust has often erred and punished procompetitive conduct. In post-Communist economies, where there may be an excessive fear of "monopoly capitalism," such misuse may be particularly likely. Moreover, the current Russian antitrust statute contains provisions which could lead to inefficient rulings.¹⁴⁹ Antitrust laws in other countries also have provisions which could lead to inefficiency.¹⁵⁰

I analyze policy in the same tripartite framework used for analyzing private enforcement mechanisms.

A. Unilateral Mechanisms

The most important assistance governments can give to private firms for creation of reputation capital is a willingness to enforce property rights in

¹⁴⁷Topornin, *supra* note 32, at 26.

¹⁴⁸Holger Wolf, "Endogenous Legal Booms," 9 *Journal of Law, Economics, & Organization*, 181-187 (1993).

¹⁴⁹RSFSR House of Soviets, Moscow (March 22, 1991), "RSFSR Competition and Restriction of Product Market Monopoly Act" (Dialogue, SovData Dialine - SovLegisLine), pp. 29-41.

¹⁵⁰Pittman, *supra* note 7; Gray, *supra* note 7.

trademarks. Trademarks allow buyers to determine the quality of purchased goods and therefore enable sellers to invest in provision of high quality.¹⁵¹ The Russian antitrust law does prohibit unauthorized use of trademark.¹⁵² There is also a Russian Trademark law which allows civil damages as well as fines, but these are now too small to provide an effective deterrent. This law does not currently contain injunctive provisions.¹⁵³ At least one action, against counterfeit Levis, has been brought.¹⁵⁴ However, in one case a violation of an exclusivity agreement to export Stolichnaya vodka to Greece resulted on only a 300 ruble fine to the violator.¹⁵⁵

Czechoslovakia passed a trademark law in 1988. However, registration is slow and the law is untested.¹⁵⁶ Poland has a body of trademark law, but enforcement may be weak.¹⁵⁷ However, Wrangler jeans recently successfully sued a manufacturer of labels used in counterfeit products. The situation in Hungary is similar¹⁵⁸ although Hungarian authorities have recently destroyed 15,000 pirated cassettes to indicate that stricter enforcement of copyright laws is planned.¹⁵⁹

If counterfeiting and trademark infringement are not sufficiently penalized, then there will be reduced incentives for firms to invest in brand name capital. Given that law enforcement authorities apparently lack adequate resources to optimally enforce laws against counterfeiting, we may identify a second best solution. This is to allow firms whose products are the subject of counterfeiting to privately enforce rights to trademarks. Such firms would have the right to seize counterfeit goods and sell them on the market

¹⁵¹William M. Landes and Richard A. Posner, "Trademark Law: An Economic Perspective," 30 *Journal of Law and Economics*, 265-310 (1987).

¹⁵²RSFSR, *supra* note 149, at 34.

¹⁵³Julliette M. Passer-Muslin. "New Trademark Law," *East/West Executive Guide*, (Oct., 1992), 29-30.

¹⁵⁴"Fake Levis in Moscow," *Moscow Business Week*, December 3, 1992, 14.

¹⁵⁵Tourevski and Morgan. *supra* note 21, at 186.

¹⁵⁶Gray, "Czech and Slovak Republics," *supra* note 7, 9-10.

¹⁵⁷Gray "Poland", *supra* note 7, 8-9.

¹⁵⁸Gray "Poland", 19.

¹⁵⁹"15,000 pirate cassettes destroyed," *Daily News*, Budapest, May 14, 1993, 4.

(presumably after removing the counterfeit trademark.) It can be shown that this policy will not in general lead to optimal enforcement against counterfeiting but it is preferable to no or minimal public enforcement.¹⁶⁰ Some western movie companies (including MGM, Warner, Sony and Paramount) "have been training and financing full-time, private anti-piracy investigators" for enforcement in Hungary.¹⁶¹

Beyond this, governments can facilitate other investments in creation of valuable brand names. For example, advertising is one prominent method of such investment. Government owned radio and TV channels (if they cannot feasibly be privatized) should allow advertising. In Russia, as of now, "the three television stations are government owned and run very limited advertising."¹⁶² The Moscow city government passed a law requiring that as of April 1, 1993, one half of the words on all signs be in Russian (Cyrillac) script, and that the Russian words must be twice as large as the others; St. Petersburg has had a similar law since December, 1992.¹⁶³ Such a law is harmful for several reasons. First, it increases costs of advertising by requiring reconstruction of many signs. Second, it reduces the value of brand names since companies would have chosen to advertise in whatever way would be most informative to consumers and mandated changes in advertising will therefore provide less information. Finally, by indicating to potential advertisers that they are willing to arbitrarily and capriciously destroy part of the value of past advertising, the government is reducing incentives for future investments in brand names.

In enforcing laws against deception, authorities should be careful not to over regulate and deter provision of valuable information.¹⁶⁴ The antitrust law in Russia does have provisions regarding deception. These provisions are sufficiently open ended so that excess regulation is quite possible. There is a provision prohibiting "misleading consumers concerning the character, mode and place of manufacture, consumer properties, and

¹⁶⁰Richard S. Higgins and Paul H. Rubin "Counterfeit Goods," 29 *Journal of Law and Economics* 211-230 (1986).

¹⁶¹Ken Kasriel, "Clamping Down," *Business Central Europe*, May, 1993, at 28.

¹⁶²Tourevski and Morgan, *supra* note 21, at 105.

¹⁶³Joanne Levine, "Cyrill Rights," *Business Central Europe*, May, 1993, at 32.

---¹⁶⁴Paul H. Rubin, "Economics and the Regulation of Deception," 11 *Cato Journal*, 667-690. (1991).

quality of products."¹⁶⁵

Based on the U.S. experience, the major danger of over-regulation of advertising is the suppression of *true* information which regulatory authorities judge to be deceptive. One example is price advertising. A common form of such advertising is to claim "Regularly \$10, now \$5". Regulatory authorities often find such advertising deceptive if not "enough" sales have taken place at the \$10 price. However, this sort of regulation has the effect of reducing price competition and increasing prices paid by consumers. Regulators will also sometimes limit claims if advertisers do not pay sufficient attention to negative characteristics of products. This is sometimes called "deception by omission." However, in a market equilibrium there are strong incentives for advertisers to advertise negative characteristics of products (by claiming that the advertiser's product is less bad than others) and the market will disclose such information. Mandating disclosure is counterproductive and can actually reduce information available to consumers.

It is particularly important to note that advertising is most likely to appear deceptive in a market which is not in equilibrium. Advertising in this context can be a powerful force for moving markets closer to equilibrium if it is allowed to do so. In the post-Communist economies, all markets are likely currently out of equilibrium, and likely to remain so for some time. Moreover, consumers are likely to have relatively little experience or sophistication dealing with advertising. Thus, in the short run, much advertising might appear deceptive. However, excess regulation will reduce the rate of convergence of markets towards equilibrium, and increase the time it takes for consumers to learn how to effectively deal with advertising. Thus, over-regulation is particularly likely and particularly costly in these economies.

Indeed, although sufficient evidence to make a firm determination is lacking, there is some evidence that such over-regulation is occurring. Major firms (Saatchi & Saatchi, Unilever) have been fined in Hungary for offenses which do not appear to be serious. There are also efforts to increase advertising regulation in Poland and in the CFR.¹⁶⁶

Governments should keep in mind that an important incentive for provision of quality is the higher price a firm can command for higher quality. At times (and particularly until markets have adjusted) those firms providing high quality will earn high profits. These profits will serve as a signal to other potential entrants that provision of quality is worthwhile. However, authorities must be very careful not to reduce these incentives, for example by regulating (perhaps in the name of antitrust laws) prices charged. For

¹⁶⁵RSFSR, *supra* note 149, at 34.

¹⁶⁶E.S. Browning, "Eastern Europe Poses Obstacles for Ads," *Wall Street Journal*, July 30, 1992, B6, Col. 1.

example, Polish antimonopoly law prohibits charging "exorbitant prices" and the Antimonopoly Office can roll back prices.¹⁶⁷ Polish and Hungarian laws have the most explicit provisions for price control, and that the Russian and Czech and Slovak laws contain language which might be interpreted as allowing price controls.¹⁶⁸ As entry occurs prices will naturally fall, but there must be rewards (perhaps very high rewards) for entrepreneurs who first learn techniques valuable in a market economy.

B. Bilateral Mechanisms

There is relatively little government can do to facilitate bilateral agreements. Self enforcing agreements, for example, do not need government assistance.

There is, however, substantial danger that improper use of antitrust policy could hinder creation of bilateral arrangements. This fear is not based on pure speculation. In the U.S. improper antitrust policy has greatly hindered the creation of valuable vertical relationships between manufacturers and retailers. Recall that some of the mechanisms which manufacturers might find useful are: establishment of maximum or minimum resale prices; territorial restrictions on where retailers might sell, including exclusive territories; requirements that dealers carry only the brand of the manufacturer (exclusive dealing); and requirements of certain methods of retailing (such as shelf space requirements.) Manufacturers may also vertically integrate directly into retailing, and some may establish franchises. *All of these methods should be legal.*¹⁶⁹ Any contract between a manufacturer and a retailer should be strictly enforced by whatever enforcement mechanism is specified. Excessive regulation of these vertical relationships or limits on freedom of contract can reduce incentives for production of quality goods and harm consumers.

The antitrust law in Russia may err in not allowing sufficient vertical restrictions. There are restrictions on "writing discriminatory clauses into contract which put the other party at a disadvantage as compared with other business persons" and on "impeding other business persons in entering market (withdrawing from market)."¹⁷⁰ This could easily be interpreted as forbidding certain vertical practices, such as exclusive dealing. Decision

¹⁶⁷Gray, "Poland", *supra* note 7, at 26.

¹⁶⁸Pittman, *supra* note 7, at 501-502.

¹⁶⁹Richard A. Posner "The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality," 40 *University of Chicago Law Review* 6 (1981); Frank H. Easterbrook, "Vertical Arrangements and the Rule of Reason," 53 *Antitrust Law Journal* 135 (1984).

¹⁷⁰RSFSR, *supra* note 149, at 31.

makers will not be skilled at distinguishing between vertical and horizontal restraints, and are therefore likely to excessively regulate vertical restrictions.¹⁷¹

Other Antimonopoly laws have similar provisions. Czech law does not distinguish between horizontal and vertical restrictions.¹⁷² Polish law sometimes bans tied sales, resale price maintenance, and other vertical relationships.¹⁷³ Hungary has similar provisions.¹⁷⁴ Hungarian and Russian laws are in general relatively less hostile to vertical restrictions than the Polish and CFR laws, although the Polish and Hungarian law both ban tying arrangements independent of market share.¹⁷⁵

More generally, many of these laws apply only to firms with "dominant" positions, commonly defined as market shares of 30% or more. However, market shares are difficult to measure without sophisticated methods of defining markets. In U.S. antitrust enforcement, market definition is often the most difficult and contested part of an enforcement action. Thus, excessive enforcement is possible if decision makers define markets too narrowly, as is likely and as has traditionally been true of U.S. antitrust authorities. The Hungarian and CFR laws make it easier for a firm to be defined as a "dominant" firm than is true in Poland and Russia, although any of the laws could be interpreted as excessively enforcing rules penalizing dominance.¹⁷⁶

As mentioned above, one method of establishing credible commitments for bilateral relationships is use of hostages. These require reciprocal dealing between firms; the antitrust laws have sometimes penalized this sort of behavior. The Russian antitrust law forbids "imposing on the other party contractual terms which are disadvantageous to him or which are irrelevant to the subject-matter of the contract."¹⁷⁷ Other countries also forbid such practices. This can be interpreted as forbidding reciprocal transactions and the use of hostages. Again, there should be no such restriction. All reciprocal transactions between firms should be legal.

It does not appear at this time that the antitrust laws are being abused.

¹⁷¹IMF, *supra* note 7, at 283.

¹⁷²Gray, "Czech and Slovak Republics," *supra* note 7, at 22.

¹⁷³Gray "Poland," at 26.

¹⁷⁴Gray, "Hungary," at 41.

¹⁷⁵Pittman, *supra* note 7.

¹⁷⁶Pittman.

¹⁷⁷RSFSR, *supra* note 149, at 31.

Many businessmen and attorneys indicate that there is a potential for abuse, but there does not seem to be a record of such behavior. The Czech antitrust agency is located outside of Prague, perhaps to minimize the danger of such behavior. The Polish antitrust agency is in Krakow, not Warsaw.

C. Multilateral Arrangements

Governments have the greatest ability to be helpful with respect to multilateral enforcement mechanisms. Assistance can be provided to enable parties to benefit from such methods of enforcement. Moreover, if properly done, governments can use the results of multilateral processes to generate efficient law.

Arbitration is a natural method of dispute resolution. All the courts need do is credibly promise that they will treat decisions by arbitrators as specified in contracts as if they were court decisions. This will provide incentives for parties to include such clauses in their agreements. There will be three benefits to parties from such clauses.

First, a decision from an arbitrator is likely to be available with less delay than a decision from a court. Second, the parties can themselves choose arbitrators. In a world where judges may not have much experience with business disputes and where legal precedents may be weak, then it should be possible to choose arbitrators who will be more likely to reach efficient decisions. Arbitrators will be paid only if hired, and so will have an incentive to reach correct decisions because this will lead to future business. Moreover, parties can specify the amount to be paid to arbitrators. This means that arbitrators in more important (costly) disputes can be paid more, so that parties will have access to the quality of arbitrator appropriate to the value of the case.

Third, parties can choose the body of law or rules to govern in the event of a dispute. If the law in place is inefficient or vague, the parties can indicate that they will have their dispute governed by a different body of law, or by the rules of the arbitration association. This allows more flexibility in choice of law and means that it is more likely that an efficient law will govern.

Thus, a decision by the courts or a statutory announcement that the courts will honor and enforce arbitration agreements may be the single most powerful method available for achieving efficient short run decisions and also for generating efficient long run precedents. (For reasons discussed below, the law may want to announce that it will enforce arbitration agreements only if there is a written opinion from the arbitrator in addition to a decision.)

Enderlyn and Dziggel (1992, pp. 88-91) indicate that in the CFR, foreign trade ventures have the right to arbitration provided for in agreements

under any internationally recognized rules.¹⁷⁸ There is an Arbitration Court at the Czech Chamber of Commerce and Industry, but the parties may name other arbitrators in their contract instead. Rules of procedure are proposed by the Board and announced by the Federal Ministry of Foreign Trade in the Collection of Laws, so that arbitration procedures are given the force of law. Similar policies apply with respect to disputes between joint ventures and other Czech enterprises. Terms of contract govern. Also, Joint Venture Law allows choice of legal code other than Czech law. This set of policies seems well designed to achieve the goals discussed above with respect to investments involving foreign firms.

However, there is no such provision for arbitration regarding disputes between Czech firms. At one time, CFR had drafted a code allowing for arbitration of disputes between Czech enterprises, but this provision was not adopted and is not currently in place. It would be highly useful for such a provision to be adopted as soon as possible. Indeed, practicing attorneys in the Czech Republic have indicated that opportunism is common because of the difficulty of court enforcement, and have argued that enforcement of private arbitration clauses would be very useful.

Hungary also allows contracts to specify arbitration in the case of businesses operating with foreign firms.¹⁷⁹ Nonetheless, contracts between Hungarian firms do not allow for arbitration at this time. This may be less of a problem than would otherwise be the case since Hungarian courts seem to function fairly well.

Poland seems to have a well developed system of arbitration, and these provisions can be applied to contracts between domestic firms. Parties are allowed to specify whose law will govern and who will be the arbitrator in the event of a dispute. The Union of Polish Banks has established an arbitration court for disputes involving banks and their customers. The Polish economy is currently performing better than any other formerly Communist economy. Much of this is due to the productivity of Polish domestic firms since the country has received relatively little foreign investment.¹⁸⁰ While all the countries studied have efficient rules with respect to arbitration for dealings with foreign investors, Poland has the most efficient system for contract

¹⁷⁸Allyn Enderlyn and Oliver C. Dziggel, *Cracking Eastern Europe: Everything Marketers Must Know to Sell Into the World's Newest Emerging Markets*, Probus Publishing Co. Chicago, (1992), at 89-91.

¹⁷⁹Ellen H. Clark and John A. Stevenson "Legislative Survey: Laws Governing Foreign Investment: Hungary, Poland," *East Europe/Soviet Union Executive Guide*, 10, (July 1991).

¹⁸⁰Jane Perlez, "Poland's New Entrepreneurs Push the Economy Ahead," *New York Times*, Sunday June 20, 1993, F7.

enforcement involving domestic firms. It is interesting that Poland has the most favorable laws of all the countries studied and its economy is outperforming the others, although this observation is of course not proof.

Russia also has provisions for arbitration for agreements between Russian and foreign firms. However, apparently "the methods to enforce the execution of an award are not very effective."¹⁸¹ Nonetheless, it is recommended by Western legal experts that all corporate charters include provisions for arbitration. These should include provisions for the arbitrator, the location of the arbitration, and the body of law to be used. This authority also indicates that "[I]t is typical of the enabling laws of the emerging Eastern and Central European countries, that only broad outlines are provided in the statutes -- and a great deal is left to negotiations and contractual agreements."¹⁸² Russian courts will not enforce arbitration agreements between domestic firms. Rather, the courts will hear the dispute *de novo* if the arbitration decree is contested. This is consistent with the general interventionist tendencies of Russian authorities. Russian subsidiaries of foreign firms (as opposed to joint ventures) are treated like Russian firms, and therefore the courts will not enforce arbitration agreements between these firms and domestic firms. As a result, some foreign firms may form joint ventures when otherwise subsidiaries would be a preferable form of organization.

Trade associations and Better Business Bureaus (or their equivalent) can also serve as a source of regulation and contract enforcement. Much of this power is through private mechanisms and provision of information about reputations. There may be little scope for government assistance in this effort. It may be possible for government to certify the association itself, so that its announcements may have more force than otherwise. That is, government can guarantee the reputation of the organization which will guarantee reputations of its members. Government may also provide some payment to such organizations in order to induce them to undertake more careful investigations than might be in the pure private interest of their members. This is because members will not capture the full value created by the information provided, since information is in part a public good. However, this strategy is somewhat risky, and if it is chosen governments should have clear criteria for terminating relationships with associations if necessary. Moreover, restrictions on political activities of chosen associations would also be useful, else government may find itself in the business of subsidizing special interest lobbying organizations.

¹⁸¹Buyevich and Zhukov, *supra* note 57, at 12.

¹⁸²John H. Morton, "Documenting a Deal in Eastern Europe: Anatomy of a Russian Joint Stock Company," *East/West Executive Guide*, 2, 27-31, (August, 1992).

As with other mechanisms, there is a danger of misuse of antitrust law with respect to trade associations. In particular, it will sometimes be necessary to exclude some firms from the association in order to maintain quality. However, incorrect antitrust law can interpret such exclusion as being an anticompetitive boycott. Moreover, the Russian antitrust law requires that all such associations be approved by the antitrust authorities.¹⁸³ This could make formation of such organizations more difficult. Nonetheless, correct interpretation will be difficult, as such laws can indeed be used for anticompetitive exclusion. Such anticompetitive exclusion has apparently been practiced in Leningrad.¹⁸⁴

VII. CREATION OF EFFICIENT RULES

The private mechanisms discussed here can be used as the basis for an efficient body of law. I first discuss the mechanisms for such law creation. I then discuss some of the benefits of private law creation. In particular, private law may have some advantages over public law, at least as practiced in the U.S.

A. Mechanisms

One advantage of the set of institutions proposed here (and in particular of the multilateral institutions) is that these may actually lead to evolution of efficient rules. There are mechanisms which might lead a formal legal system to evolve efficient rules, but the power of the mechanisms is limited.¹⁸⁵ Competing jurisdictions and competition between judges may be the most efficient method of achieving efficient rules quickly.¹⁸⁶ Indeed, the common law adopted the law merchant in order to obtain the legal business (and associated fees) of merchants.

When parties are negotiating contracts, then they will consider methods of enforcement. Generally speaking, breach of a contract will occur only in

¹⁸³RSFSR, *supra* note 149, at 37.

¹⁸⁴IMF, *supra* note 7, at 279.

¹⁸⁵Paul H. Rubin, "Why is the Common Law Efficient?", *supra* note 29; "Common Law and Statute Law," 11 *Journal of Legal Studies* 205-223, (1982); Peter Aranson, "Economic Efficiency and the Common Law: A Critical Survey", in J.-Matthias Graf von der Schulenberg and Goran Skogh, *Law and Economics and the Economics of Legal Regulation*, Kluwer, Dordrecht, 51-84, (1986); William M. Landes and Richard A. Posner "Adjudication as a Private Good" 8 *Journal of Legal Studies* 235-284, (1979).

¹⁸⁶Landes and Posner, "Adjudication"; Benson, *Enterprise of Law*, *supra* note 35.

the event of unanticipated events, so parties cannot know *ex ante* the nature of breach, or the desired remedies. Therefore, the interest of parties *ex ante* is to choose those arbitrators who will maximize the *ex post* joint wealth of the parties -- that is, who will choose efficient rules for enforcement. For example, arbitrators are commonly successful businessmen, rather than lawyers, so that they will be familiar with business practice and industry custom. If these arbitrators then establish rules through announcing the reasons for their decisions, the rules will tend to be efficient. If they are not, then disputants in the future will choose different arbitrators. There will be strong pressures for arbitrators who use efficient rules.

Will the arbitrators establish rules, or will they only settle disputes? Landes and Posner argue that there is sometimes an inadequate incentive for arbitration to produce rules (as opposed to decisions) because the creation of rules does not benefit the parties who pay for dispute settlement.¹⁸⁷ That is, they argue that the parties to a dispute will want a settlement of the dispute, but not a rule. The rule is a public good whose private value is less than the cost to the disputants. This has been questioned by Benson who points out that the Law Merchant did produce rules which were later adopted into the common law. Moreover, Benson suggests that if parties contract in advance with arbitrators, then arbitrators have an incentive to make the rules they will use in the event of a dispute clear in order to facilitate settlement and reduce the number of cases actually arbitrated.¹⁸⁸ In the diamond example, arbitrators do not generally provide rules, but this is because parties prefer secrecy in this market. More recently, some bourses have begun publishing rules, but omitting the names of the parties to the transactions.¹⁸⁹

In fact, Landes and Posner indicate that there are circumstances in which rules will be created. If the arbitration is performed for an association, then rule creation is feasible because the association can collect dues and use these to pay for rules. The Law Merchant evolved at least in part in connection with trade fairs (one example is the Champagne Fairs) and therefore there was a possibility of creating efficient rules because all participants in the Fairs would have been willing to pay a share for such rule creation and the organizers could have charged a premium to support this outcome.¹⁹⁰ As suggested above, a useful method to generate rules would be for the state to agree to enforce arbitration agreements only if the arbitrator agrees to write an opinion.

¹⁸⁷Landes and Posner, "Adjudication."

¹⁸⁸Benson, *The Enterprise of Law*.

¹⁸⁹Bernstein, *supra* note 89.

¹⁹⁰Milgrom North and Weingast, *supra* note 81.

For private associations, dues could be used to supplement fees paid by disputants and therefore pay for rule creation and promulgation. The rules would benefit all members of the association, not merely those with a dispute at issue, and so members would be willing to pay dues to obtain such rules. We would also expect associations to develop efficient rules. Associations depend on members for dues. Firms would be more likely to join associations if the associations credibly promised them efficient rules. Customary rules used in an industry are a likely source of efficient precedents,¹⁹¹ and the mechanisms identified here are useful for generation of formal records of such customs.

B. Characteristics of Private Law

There will be other advantages of private law. Although it is not possible to describe the details of efficient contract law for each country at each point in time, some broad properties of such law can be described. This is particularly true since American contract law is in some respects inefficient, and it is possible to identify the areas of inefficiency.

In particular, law can err by refusing to enforce voluntarily agreed upon contract terms. In the U.S. and elsewhere today, courts brand certain types of contracts as being "against public policy." Such contracts may be considered "unconscionable." The courts claim that the parties had "unequal bargaining power" or that the relevant contracts were "contracts of adhesion." Such rulings are particularly common in contracts between individuals and business firms, but sometimes apply to other contracts as well. In these cases, courts will refuse to enforce the contracts.

None of these doctrines are economically desirable. In all cases, they make the parties to transactions worse off.¹⁹² All of these doctrines have been imposed by courts on parties who have signed contracts with provisions that, *ex post* (after breach, or after an accident) one of the parties has

¹⁹¹Robert D. Cooter, "The Structural Approach to Adjudicating Social Norms: Evolution of the Common Law Reconsidered," Working Paper, School of Law, University of California at Berkeley (1990); Richard A. Epstein, "The Path to the *T.J. Hooper*: The Theory and History of Custom in the Law of Tort," 21 *Journal of Legal Studies* 1-39 (1992).

¹⁹²For a discussion of the costs of one set of doctrines in the context of products liability, see Rubin, *Tort Reform by Contract*, and George Priest, "The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law," both *supra* note 9. For a discussion of their origin, see Paul H. Rubin and Martin J. Bailey "The Role of Lawyers in Changing the Law," Emory University Law and Economics Working Paper (1992).

regretted. If there is private enforcement of contracts, then courts will not adopt any such inefficient provisions: courts will enforce contracts as written. Thus, private enforcement will lead to a more efficient contract law than would public enforcement, if public enforcement follows the U.S. example.

Of course, there are some contracts which are inefficient. However, these are generally inefficient with respect to third parties. Two examples are contracts to fix prices and contracts to commit a crime. These sorts of agreements can be eliminated by other branches of law -- the antitrust laws and criminal laws. Moreover, since such contracts are illegal, the parties would want to keep them secret, and thus would not rely on the sort of private mechanisms discussed here, even if these mechanisms could lead to enforcement. Thus, with respect to those contracts which are economically efficient and socially desirable, it is likely that there would be some advantages to private enforcement relative to public enforcement. Indeed, the best of all worlds might be private determination of liability (as by arbitrators or trade associations) with public enforcement of the private decrees.

Two party contracts might be inefficient if one party to the contract is incompetent. This might apply to contracts with children or with the mentally incompetent on one side. Contracts will also be inefficient if there is fraud or duress (where duress is defined as involving force, not "unequal bargaining power"¹⁹³ or "unconscionability"¹⁹⁴). The medieval Law Merchant, a voluntary body of contract law, would invalidate a contract based on "fraud, duress, or other abuses of the will or knowledge of either party."¹⁹⁵ Thus, private law should be able to handle these problems of inefficient contract formation.

VIII. IMPLICATIONS

This paper provides suggestions for behavior for governments, arbitrators, private trade associations, private attorneys, and businesses in the post-Communist economies. I consider each.

Governments For governments, the major implication is that enforcement of private agreements to arbitrate disputes between domestic firms as well as between domestic and foreign firms is useful and desirable. This simple policy, which is followed in Poland but in none of the other countries, would be the most powerful device for quickly adapting the dispute resolution system for a market economy. Government might want to consider paying a small subsidy to arbitrators if they agree to write opinions, but this

¹⁹³Posner, *Economic Analysis of Law*, *supra* note 3, at 114-117.

¹⁹⁴Richard A. Epstein, "Unconscionability: A Critical Reappraisal," *Journal of Law and Economics* 293 (1975).

¹⁹⁵Benson "Spontaneous Evolution," *supra* note 64, at 649.

is of secondary importance. If arbitrators begin adopting a set of rules and precedents, then governments should consider these in revisions of commercial codes. Governments may also want to make provisions for a common law type process for the court system during times between revisions of codes.

Other government policies are mainly negative. Governments should refrain from excessive enforcement of antitrust laws, including regulation of vertical relationships, and laws against deception. Western economies established market institutions and developed large economies before such inefficient law enforcement became fashionable, and if new economies unduly burden themselves with such costly policies, growth might be retarded or even precluded. Of course, in the case of Russia, a strengthening of the central government is necessary so that it will be possible for government itself to credibly commit to policies facilitating growth.

Arbitrators If government will enforce arbitration decrees, then arbitrators can play a major role in the system. It should pay for some arbitration association to announce that it will establish precedents and decide cases based on these precedents. If this policy is successful and if parties begin using this association, then the association might begin to charge *ex ante* for being named in contracts as the arbitrator of choice. Law firms might find provision of such arbitration a valuable speciality.

Trade Associations Private trade associations can begin to play an informational role. Such associations can keep records of behavior of members of the industry and make this information available to potential transactors. This can be done for a fee paid by those seeking the information. Alternatively, the trade association can charge members for listing. Any firm not listed would then signal to potential partners that it was unwilling to be rated by the association. Trade associations can also establish formal arbitration procedures with enforcement through information and reputation mechanisms. Organizations such as Better Business Bureaus can perform a similar function for businesses (perhaps retail businesses) in a geographic location.

Attorneys Private attorneys advising firms can make use of information regarding reputations as it becomes generated. Attorneys can also include arbitration clauses in contracts for their clients. Indeed, attorneys could now include clauses indicating that arbitration will be used if arbitration decrees should become enforceable in the future. If certain arbitration associations begin to generate precedents and if these seem useful and efficient, attorneys can name these associations in contracts.

Businesses Businesses can make use of all of the information generated by the processes mentioned above. In addition, certain behaviors of businesses in post-Communist economies may be remnants of their past, and are now counterproductive. First, businesses should avoid excessive secrecy. The best way to guarantee performance is to establish a reputation for fair and honest dealing. Creation of reputations is by definition an activity which

requires information sharing, and excessive secrecy can hinder or stop this activity. Second, businesses should become more accommodating in their bargaining strategies. For agreements to be self enforcing, both parties must value the expected future benefits of continuing the sequence of transacting at more than the one time benefits of cheating. Businesses with long time horizons should realize this and allow trading partners to make a reasonable return on the stream of transactions.

While the transition from a planned to a market economy will take a long time, adoption of the policies suggested here can speed up the process and also increase wealth and thus consumer welfare during the transition period.