Contract Enforcement

Most exchanges of goods and services involve a contract in either explicit or implicit form. From the simplest sale to leveraged buyouts of large corporations, the contract constitutes the agreed conditions under which an exchange takes place. Whether the exchange is defined in a written contract or takes place in an informal milieu, the implication is that there is practical means to impartially enforce the terms of the transactions.

Transactions are fundamental to economic activity, yet the theoretical treatment of transactions often does not coincide with the reality of the marketplace. Although economic analysis often assumes the contrary, contracts can be difficult to enforce, transaction costs can be significant, and all parties may not have the same information. Understanding the institutional framework of contract enforcement, and especially to what degree enforcement mechanisms are available, can improve the accuracy of economic analysis.

Contract Regimes

The contract regime is the set of institutions that govern contracting and contract enforcement and consists of state and nonstate institutions. State institutions include contract law, financial, company, and competition law, and enforcement agencies such as the court system and regulatory agencies. Nonstate institutions include customary law and rules of social and commercial interaction based on a history of reciprocal dealing. Nonstate enforcement mechanisms take the form of traditional authorities, dispute resolution bodies, collective punishment, and self-help groups. Firms use both state and nonstate institutions to govern and enforce transactions.

A firm chooses a contracting arrangement—whether a legally enforceable contract or an informal arrangement—and enforcement mechanism from among its available options. Choice among available options is driven by the characteristics of the transaction, the cost of using the mechanism, and the fairness and predictability of the outcome. The characteristics that most affect the choice of governance arrangements are asset specificity and frequency.
Asset specificity is defined by how specific (custom-made) or general (fungible) the goods or services are to be exchanged. The more specific the good or service, the lower is its value in its next best use. Higher asset specificity increases the opportunity for opportunistic behavior during performance of the contract. Where the degree of asset specificity is high, firms choose among legally enforceable contracts, vertical integration, and informal arrangements such as screening, or limiting transactions to existing relationships. Asset specificity is considered by many to be the most significant factor affecting the choice of contracting and enforcement mechanism.

The frequency of transactions is defined by the number of similar transactions between parties or the length of parties’ transactional relationship. At one end of the continuum are one-time instantaneous transactions; at the other end are frequent and continuous transactions that may, at the extreme, lead to vertical integration. When transactions are one-off and of low specificity, they can be characterized as arm’s length. When transactional relationships are continuous and highly specific, they can be characterized as embodying bilateral dependence. A third, mid-range category of transactions falls between the two extremes.

A firm’s transactions in the arm’s length category are dominated by the effects of competition. Either party can turn to other sources if it is dissatisfied, and there is no inherent need for any two parties to exchange with one another. Such transactions tend to be simple and do not require expensive enforcement mechanisms. The incentive for either party in such transactions is to perform as well as the competition.

Mid-range transactions involve a higher order of dependency between the parties because transactions are more frequent and more asset specific. These transactional relationships require a clear understanding between the parties to ensure the desired performance, and thus requires a written contract. Contracts, however, are effective only if some effective mechanism for enforcement is in place.

Finally, bilateral dependence involves transactions whereby the parties rely substantially on one another. Transactions between parties are frequent and continuous, and the degree of asset specificity is high. Hierarchical control through vertical integration becomes an efficient way to guarantee performance when dependence is highest. Vertical integration internalizes the contract enforcement costs to a single firm and reduces commercial risk.

While enforcement costs and the fairness and predictability of contract compliance are two important factors in a firm’s choice of contracting and enforcement mechanisms, firms that grow into mid-range transactional relationships need more complex contracts. Clearly, the absence of adequate contract enforcement mechanisms constrains firms from entering into mid-range transactions. In this context, a contract regime that reduces the costs of contract enforcement or improves the fairness and
predictability of enforcement outcomes would be efficiency-enhancing because it would expand trade and exchange.

Recommendations for Policy and Institutional Change

In countries lacking state contract enforcement mechanisms, three factors motivate policy and institutional change. First, long transactional relationships with high asset specificity require effective state institutions for contract enforcement even if many transactions can and do happen in spot markets through arm's length exchanges. Second, while transactions can proceed within communities on the basis of repeat business or personal relationships, such exchanges between communities are made much less risky through effective state institutions for contract enforcement. Third, as countries become more integrated into the international economy, inadequate mechanisms for contract enforcement will become problematic for the domestic market.

It is unrealistic to propose a fixed list of contract enforcement reforms or actions for African countries. The needs of each country differ and the potential for change varies. It is possible, however, to propose a list of initiatives that might have broad appeal across many African countries:

- Update contracting and related bodies of law, making them more supportive of the types of transactions that hold the most potential for any given country. Current bodies of law often date to the colonial or early postcolonial period and need to be reconsidered in view of current business patterns and the prevailing customs of the business community.
- Change the adjudication system as well as the laws on arbitration, alternative dispute resolution and civil procedure. Changes would help reduce the costs of adjudication and increase the range of third-party and collective contract enforcement options available to businesses. In particular, the business sector would realize large gains through development of commercial and small-claims courts.
- Ensure that countries’ legal systems recognize nonstate systems such as lien registries, credit reporting systems, the insurance industry, business and consumer information bureaus, and self-regulating bodies such as commodity and futures exchanges. Recognition could help achieve synergies between state and nonstate institutions and extend the reach of contract enforcement.
- In regard to the reform process, ensure that the development of reform packages takes account of the accumulated knowledge of domestic businesses. The involvement of stakeholders can spell the difference between achieving economic growth through institutional reform and producing another reform package with little chance of adoption and no chance for implementation.
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