CONTRACT ENFORCEMENT AND ECONOMIC PERFORMANCE

Satu Kähkönen and Patrick Meagher
IRIS Center, University of Maryland, College Park

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ABSTRACT

What is the relative importance of state and non-state institutions of contract and contract enforcement for economic activity? In particular, what is the role of state institutions in governing transactions? In developed and in developing countries contracts are governed by a multitude of state and non-state institutions. Different societies are likely to have different institutions depending on their history, culture, and political system. Contrary to conventional wisdom, exchange governed by the state is not necessarily more efficient than exchange governed by non-state mechanisms. The relative efficiency of different contract enforcement mechanisms depends on the characteristics of the good to be exchanged, the cost of the use of the mechanism, and the predictability of the outcome. State legal institutions do, however, have an important role to play. They can facilitate exchange among anonymous individuals and firms and provide impartial and predictable enforcement of contracts.

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"A society cannot have much borrowing and lending or obtain many of the other gains from mutually advantageous trade unless individuals and firms have the right to make contracts with one another that will be impartially enforced."

Mancur Olson (1990)

"The inability of societies to develop effective, low cost enforcement is the most important source of both historical and contemporary underdevelopment in the Third World."

Douglass North (1990)

I. INTRODUCTION

Low-cost and impartial contract enforcement procedures are commonly held to provide a critical incentive for the formation of complex commercial agreements and, thereby, facilitate trade and economic growth. These procedures enhance predictability in the system by restraining opportunism among contracting parties. This reduction in uncertainty decreases the cost of exchange and promotes transactions.

A proper set of contracting institutions can also have powerful equality promoting effects. Fair, transparent, and low-cost enforcement of contracts can open the way for competition and for the participation of low- and middle-income people, and allow exchange among strangers by reducing the inherent risk in transactions. It enables individuals without connections to trade and make investments in their enterprises so that they can accumulate wealth. In countries with poorly developed contracting institutions, those with the lowest economic, gender, and ethnic status are most disadvantaged. Large and politically powerful interests are better able to operate despite the lack of regularized institutions, although also their activities are hampered.

What are these institutions? In general, institutions are understood as the rules that govern the economy and economic policymaking. They include the fundamental legal, political, and social rules that establish the basis for production, exchange, and distribution. Neoclassical economics takes for granted that the state legal system is the only institution relevant for contracting and contract enforcement and that its operation is perfect. This state system is comprised of the law of contract, other bodies of law that shape or impinge upon contractual ordering, and the courts and procedures involved in enforcing contracts.

The development of the Western world is often thought to have been based on impartial state institutions, and many perceive the lack of contract discipline in developing regions such as Africa as impeding the growth of enterprises.[1] However, even in the West, much contracting is informal; that is, it takes place outside state legal rules and procedures. For example, Macaulay (1963) found that social norms of fair dealing constrained the behavior of Wisconsin business firms as much as (in some cases, more than) the state-created law did. Also, Bernstein (1992) showed that the diamond industry has systematically rejected state-created law and created its own internal rules.

In general, information asymmetries, opportunism, and transaction costs limit the effectiveness of state institutions. Particularly in developing countries, state institutions share the overarching weaknesses of the public sector, and often do not provide for predictable contract enforcement. The

[1] See, for example, North and Thomas (1973).

new institutional economics argues that if state institutions are ineffective, non-state--that is, informal--institutions arise to govern the exchange. Non-state institutions of contract include social norms, customary law, alternative dispute resolution fora, and *ad hoc* mechanisms of reciprocity and collective punishment. Other social sciences also emphasize the role of non-state mechanisms in facilitating exchange. Economic sociology even dismisses the relevance of anonymous discourse and stresses the importance of personal trust in sustaining exchange.

The purpose of this paper is to examine the importance of various state and non-state institutions of contract and contract enforcement for economic activity and, in particular, to specify the role of state institutions in governing transactions. It will shed light on the following questions: What are the institutions and practices of contract? How important are state legal institutions? Which factors affect the choice of contracting arrangement? How can one measure the quality of a contract regime? How should policymakers think about state institutions relevant to business contracts and approach the task of reforming them?

Even though contracting and contract enforcement is commonly viewed to be critical for exchange and economic development, to this point little empirical work has been carried out on the issue. African scholars and others have repeatedly called for approaches to policymaking and institutional reform which are more grounded in African politics and economics than has traditionally been the case. As a response, a few recent studies have provided interesting empirical data on business practices and contracting, and linked these to the operation of state legal institutions.

This paper shows that in developed as well as in developing countries contracts are governed by a multitude of both state and non-state institutions. Different societies are likely to have different institutions depending on their history, culture, and political system. Contrary to conventional wisdom, exchange governed by the state is not necessarily more efficient than exchange governed by non-state mechanisms. The relative efficiency of different contract enforcement mechanisms depends on the characteristics of the good to be exchanged, the cost of the use of the mechanism, and the predictability of the outcome.

State legal institutions do, however, have an important role to play. They can facilitate exchange among anonymous individuals and firms and provide impartial and predictable enforcement of contracts. They can also reinforce non-state contracting and enforcement methods by providing relevant information and screening mechanisms such as company and asset registries.

After this introduction, this paper proceeds as follows. The second chapter defines the concept of contract and state and non-state institutions of contract. The choice of contracting arrangement and the quality of a contract regime are explored in chapters three and four, respectively. The fifth chapter discusses the role of state legal institutions in contracting and the final chapter contains a few concluding remarks.

II. INSTITUTIONS GOVERNING CONTRACT

A contract coordinates exchange. It is a form of private ordering, whereby the parties set the terms of their relationship (the "law" governing their relationship). A definition of contract for purposes of the present study includes all of the following: *an enforceable promise, an exchange of value, and a clear understanding of mutual obligations and expectations*.[2]

The focus in this paper is on transactions among firms; that is, trade in goods and services. Some of these transactions are based on contracts, including written contracts, that are enforceable in court. Some contracts, in turn, are unwritten, and premised on non-state norms and enforceable through means other than courts and state agencies.

Firms enter a contract only if it is mutually beneficial. In deciding whether to enter the agreement, the firm takes into account the physical attributes of the goods to be exchanged, the distance in time and space between the *quid* and *quo*, and the identity of the other party.

Yet firms only enter a mutually beneficial contract if they expect the other party to comply with it. In the theoretical world of perfect markets contract enforceability is assured. The identity of the parties and the distance in time and place between the *quid* and *quo* do not impose any restrictions on the decision of whether to exchange and enter into a contract. Hence any mutually beneficial transaction is feasible. In reality, however, information asymmetries, opportunism, and transaction costs impede exchange. Hence, the decision to exchange and enter into a contract depends on the institutions that help alleviate those obstacles and costs, and ensure compliance with

[2] Barton, Gibbs et. al. (1983). The notion of contract used here would include certain legally-implied duties not based on explicit agreement, as well as undertakings such as options that are not strict exchanges and hence may not meet common law standards of consideration, but do meet civil law criteria of mutuality and exchange.

the terms of the agreement. In other words, the nature of the institutional framework, including the contract enforcement mechanisms available, plays a role in determining the transactions a firm is ready to assume.

Willingness to comply with a contract is assured only if an enforcement mechanism exists that penalizes the breach of contract. In the case of spot market transactions where the *quid pro quo* is instantaneous, goods and services are exchanged in cash or in kind and contracts are self-enforcing. There is thus no need for external enforcement mechanisms. By contrast, transactions involving intertemporal exchange are not self-enforcing and require external or third-party mechanisms for enforcement. In general, the more complex the economy, the more common is intertemporal exchange and the more important is the role of external contract enforcement.

The contract regime--the set of institutions that govern contracting and contract enforcement--consists of state and non-state institutions.[3] State institutions are those that first come to mind in any discussion of contracts and contract enforcement. These include contract law; other bodies of law and regulation that affect the construction and implementation of agreements such as financial, company, and competition law; and enforcement agencies, mainly the court system and to a lesser extent the bureaucracy. Non-state institutions include customary law and rules of social and commercial interaction based on a history of reciprocal dealing. They also include enforcement mechanisms such as traditional authorities, non-state dispute resolution bodies, collective punishment,

[3] For a more detailed discussion on state and non-state institutions that govern contracting, see Kähkönen and Meagher (1997). For a further discussion of this point in the context of policymaking, see Chapter V.

and self-help.[4] These state and non-state contract enforcement mechanisms are based on either guilt, coercion, or repeated interaction.[5]

Both state and non-state institutions rely to some extent on guilt, that is, on internalization of norms through socialization to sustain the legitimacy of the system in the eyes of the citizens, and to ensure a high level of compliance. However, the degree of internalization and ability to feel guilty varies among individuals and firms. Thus, an effective enforcement mechanism cannot be based solely on guilt.

Coercion or force is used by the state systems, but is also used bilaterally in non-state systems where the system permits self-help or where there is no other enforcement mechanism. For example, coercion is often used in the case of illegal transactions, agreements between informal enterprises, and where third party intermediation is either too slow or not forthcoming at all due to inefficiency or corruption in the court system. In these cases, the enforcers might be thugs, mafia, or even the police.

Between businesses interacting repeatedly over time, a rule of reciprocity often holds, and compliance with contractual obligations, even where breach might be advantageous in the short term,

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4 One complication here is the fact that the state sometimes recognizes customary law, business custom, self-help, and alternative dispute resolution as legally proper and enforceable. One should therefore distinguish between states that do recognize these and states that do not, and understand the dividing line between practices that are enforceable in court from those that are not.

5 Cooter, (1996), Fafchamps (1996), Landa (1994).

is secured by the threat of dissolving a profitable long-term business relationship.[6] Obviously, the relationship must be worth preserving for the punishment of discontinuing interaction to deter breach. The value of continued transaction must be high enough to prevent non-performance.

In situations of repeated interaction, additional factors such as reputation and trust come into play. Business relationships are normally maintained with not one but a whole community of partners. At the level of the group, coordination takes place through the mechanism of reputation.[7] Information on an individual or firm's record of contract compliance is shared among the community, and hence breaches or egregious patterns of breaches can result in collective punishment, for example, the group's refusal to do business again with the offending individual.[8]

Empirical studies provide support for the claim that reputation promotes contract compliance. Reputation mechanisms of a wide variety of types have existed throughout history, and their use is by no means limited to small and homogeneous communities. Milgrom, North and Weingast (1990), Greif, Milgrom and Weingast (1994), and Greif (1996) show that reputation played an important role in facilitating trade in Europe in the medieval period. Judges in medieval Europe supplied information on the past behavior of traders, in effect providing a screening mechanism akin to the modern credit check or due diligence. Credit reporting is perhaps the primary example of an enforcement mechanism based on reputation in developed economies. It has its counterparts in developing and

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6 Macaulay (1963).

7 See, for example, Klein and Leffler (1981).

8 Fafchamps (1996), Landa (1994).

transition societies in, for example, rural moneylending and ad hoc credit-checks by state banks in former socialist countries such as Albania. Macaulay's (1963) study of businessmen in Wisconsin also confirms the importance of reputation as a non-state enforcement mechanism.

Personal trust and morality are also viewed as providing a basis for non-state contract enforcement when interaction between contracting parties is repeated. Empirical studies indicate that even very short personal interactions increase cooperation among individuals.[9] Arrow (1969) emphasizes the role of trust in contractual relations. According to him, the efficacy of alternative modes of contracting will vary among cultures because of differences in trust. Non-state contract enforcement in the networks of Chinese immigrants overseas is often cited as an example of non-state enforcement based on trust.[10] Similarly, internalized norms, or moral standards, enhance first-party enforcement of contracts.[11] Social rules and customs contain implicit agreements about proper behavior toward other individuals. These norms influence behavior and promote contract enforcement. Informal punishments such as gossip and ostracism are used to enforce these norms and promote rule and contract obedience.[12]

Strong group identity and built-in collective punishment mechanisms exist most frequently, at least in developing societies, in ethnically homogeneous business communities. Landa (1994)

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[9] Dawes and Thaler (1988).

[10] Redding (1995).

[11] Ellickson (1991), Landa (1994), Platteau (1994).

[12] Merry (1984).

studied the interaction of informal ethnically-based trade networks and state contract regimes in Southeast Asia. She found that ethnic trade networks, using mainly non-state means, screen potential trading partners based on in-group signaling devices which serve as proxies for expectations of contract compliance. This strategy is called the "calculus of relations." According to Landa, the ethnic boundary is crossed only when the cost of excluding outsiders exceeds the transaction cost incurred by transacting with outsiders.[13] Also according to Fafchamps (1996), once personalized business networks establish themselves through the use of reciprocity and collective punishment, the group's risk-aversion tends to stifle new business entry and competition.

To summarize, firms use both state or non-state institutions to govern and enforce their transactions. But what is the relative importance of these institutions? How does a firm decide which mechanisms to use in order to govern the exchange? The next sections attempt to answer these questions.

III. FACTORS AFFECTING THE CHOICE OF CONTRACTING ARRANGEMENT

A firm chooses the contracting arrangement, whether a legally-enforceable contract or an informal arrangement, including the enforcement mechanism, from among available options given the information available and the existing institutional environment. The efficiency of state and non-state arrangements, and thus the choice, depends on the characteristics of the transaction, the cost of using

[13] Landa (1994).

the mechanism, and the fairness and predictability of the outcome. The main characteristics of the transaction that affect the choice of governance arrangement are asset-specificity and frequency.

A. Asset-Specificity

Asset-specificity refers to how specific or custom-made is the good to be exchanged in the transaction. At one end of the spectrum are purchases of standard or fungible goods with a low degree of asset-specificity, and at the other are investments with a high degree of asset-specificity, which are of value only to the parties to the transaction. The more specialized the investment, the lower is its value in its next best use. This increases the risk of opportunistic behavior during both the performance and renegotiation of the contract.

Williamson (1985) and Klein, Crawford and Alchian (1978) consider asset specificity as the most significant factor affecting the choice of contracting and enforcement mechanism. Where the degree of asset-specificity is high, firms choose among (a) legally-enforceable contracts, (b) vertical integration, and (c) informal arrangements such as screening, coercion, or limiting transactions to existing relationships of trust.[14] As assets become more transaction-specific and the gains from opportunistic behavior increase, the complexity, and hence the cost, of contracting through state mechanisms goes up. At the extreme, to guarantee the timely delivery of goods and to prevent opportunistic behavior, these factors may lead firms to choose vertical integration of these

[14] Williamson (1985).

mutually dependent activities.[15]

Palay's 1984 study on railroad transport contracting provides evidence. Palay found that when standard boxcars could be used, agents depended on markets to enforce contracts through competition. However, in the case of chemical cars that could be used only with particular chemicals, vertical integration occurred--chemical companies would purchase and maintain their own railroad cars rather than rely on a supplier. In the case of railcars that were neither standard nor highly specialized, agents often built relationships of mutual trust and relied on non-state enforcement mechanisms even where their relationships were governed by complex contracts.

B. Frequency and Level of Dependence

The frequency of transactions refers to the length of the transactional relationship between the parties. At one end are one-shot, instantaneous, spot-market transactions while at the other are frequent and continuous transactions between the parties which at the extreme may lead to vertical integration of activities.[16]

Williamson (1994) has divided transactional relationships into three different categories according to the frequency and asset-specificity of the transaction: (1) arm's length, (2) mid-range, and (3) bilateral dependence. The frequency of interaction as well as the degree of asset-specificity

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[15] Coase (1937), Williamson & Winter (1991), Williamson (1985).

[16] Williamson (1985).

increases from category one through three.

In the case of a arm's length relationship, parties to the transaction tend to rely on competition as an enforcement mechanism since they can turn to alternative sources if they are dissatisfied. In these relationships, there is little dependency between parties. Transactions are commonly spot-market transactions and they are characterized by a low degree of asset specificity. Contracts are short-term and simple or absent.

In the case of a mid-range relationship, dependency between parties is present but not sufficient to make internal organization through vertical integration efficient should state institutions be working well. Transactions between the parties are frequent and the degree of asset specificity moderate. Spot-markets are inadequate for coordinating activity.

In mid-range relationships, the parties rely on long-term contracting. Contracts are written, complex and contract enforcement by state mechanisms takes on increased significance. At the beginning of the relationship, the parties often rely on state mechanisms to govern contracting, but over time, as the relationship strengthens and trust is built, the parties may switch to the use of non-state mechanisms. However, the existence of a legally-enforceable contract in the background may still play an important role in sustaining the relationship.

The studies of Macaulay (1963, 1985) and Macneil (1978) show that the presence of a continuing relationship increases the informality with which the parties to a contract solve their disputes. Members of close-knit groups create complex ties that enable them to police their bargains, since members are expected to continue to interact with one another.[17] In his study of Wisconsin businessmen, Macaulay (1963) observed that firms expected their counterparts to be in business for a long time, and buyers and salesmen expected their counterparts to be in their positions for a long time. Over time norms were developed within these groups that promoted self-enforcement of contracts. Court action was reserved for situations where the monetary stakes were high or the firm expected to terminate a business relationship.

Finally, bilateral dependence refers to transactions where the parties rely substantially on one another. Transactions between the 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 dependency is highest.

C. The Cost, Fairness and Predictability

The choice of the contracting and enforcement mechanism depends also on the cost of using it. The focus is not only on the costs (say, a court fee) that is incurred to get a contract enforced, but on transaction costs (for example, time spent in court, bribes, social detriment in escalating disputes) of getting a service. If transaction costs in the state system are high, individuals and firms will tend to rely on non-state enforcement, or on vertical integration where appropriate. Similarly, if individuals and firms find non-state enforcement costly due to their social distance or lack of track

[17] Fudenberg, Holmström and Milgrom (1990), Ellickson (1991).

record with partner firms, they resort to the use of state mechanisms or simply do not undertake some transactions.

Finally, the fairness and predictability of the outcome the contract enforcement mechanism offers also affects the choice. Courts may be unpredictable because contracts and/or laws are poorly written, because decisions are based on non-legal and uncertain criteria or because judges are incompetent or poorly informed. Under these circumstances, non-state dispute resolution mechanisms may be preferred because they may be speedy and arbitrators may be better prepared to interpret the issue in dispute.

In short, a firm chooses the contracting arrangement and enforcement mechanism taking into account the frequency of interaction, the degree of asset-specificity, the cost of using the mechanism, and the fairness and predictability of the outcome. It chooses the best arrangement from among the available options. The next question is: how efficient are the available arrangements, and hence the institutional environment with which they interact? How can one measure whether this contract regime--the existing state and non-state institutions governing contract--is efficiency-enhancing will be the topic of the next section.

IV. AN EFFICIENCY-ENHANCING CONTRACT REGIME

An efficiency-enhancing contract regime promotes trade and exchange by providing low-cost and impartial enforcement of contracts. If individuals and firms forgo transactions because of the lack of access to or the cost of contract enforcement, the regime is not promoting economic efficiency. The regime could be considered to be efficiency-enhancing if firms freely, and frequently, choose to enter into transactions with the following characteristics: long-term and forward contracts; high asset-specificity; transaction-specific financial arrangements; contracts involving large investments; contracts among strangers (contracts not limited to established relationships, cliques, ethnic or status groups); and a high level of contract compliance. That is, the quality of the contract regime influences asset-specificity and frequency of transactions.

Williamson's 1994 analysis suggests that the prevalence of complex, mutually dependent, asset-specific transactions and relationships in the mid-range could provide a rough indicator of whether the contract regime is promoting economic efficiency.[18] To the extent that mid-range transactions exist and cross boundaries of ethnicity and religion, national origin, geography, and firm size, the contract regime can be considered to be efficiency-enhancing.

As discussed in the previous section, these mid-range relationships rely on both state and non-state institutions of contract, depending in part on the length of the relationship. As Williamson (1994, p.18) states, if these contractual support systems are not present

> *"viable middle range transactions will flee to one of the poles--by moving to the spot market (attended by the sacrifice of asset specificity and resulting loss of productive value) or by moving to hierarchy (with the added bureaucratic cost load). A high performance economy*

[18] Williamson (1994).

will support transactions of all three kinds rather than force polar choices...The quality of an economy's contract laws and enforcement efforts (including its permissiveness, or not, toward private ordering) can thus be inferred indirectly by the evidence of hybrid contracting ..."

The study by Stone, Levy and Paredes (1992) provides interesting evidence for Williamson's conjecture from Brazil and Chile. The state legal and regulatory institutions, including contract enforcement mechanisms, are commonly held to be relatively complex and non-transparent in Brazil as compared to Chile. The study examined the impact of these state institutions on Brazilian and Chilean garment industries. It shows that the insecure contracting environment in Brazil led firms to (i) produce non-customized items (that is, low asset-specificity), or sell from stock or accept orders only for non-customized items; (ii) reduce the size of orders (or value of orders) to any one customer to diversify risk; and/or (iii) vertically integrate the activities. In other words, transactions in the Brazilian garment industry fled to either of the two poles: spot-market or vertical integration. By contrast, in Chile mid-range transactions were prevalent: firms produced customized items and exchange was based on long-term contracting.

Koford and Miller (1995) applied Williamson's model to Bulgaria. They surveyed 36 Bulgarian firms, looking for innovative contractual arrangements that they expected to arise in a situation of economic transition toward market relations. They found largely spot-market transactions, with several types of mechanisms dealing with price, quality, and enforcement issues. These ranged from informal "mutual hostage" situations and mafia-influenced enforcement to written contracts and court enforcement. Contract enforcement was commonly perceived as a problem and the state legal system was considered to be clumsy and unresponsive.

As mentioned, mid-range relationships rely on both state and non-state institutions to govern transactions. The prerequisite for many of the non-state mechanisms to function is, however, that the parties are not anonymous and transactions are frequent and continuous. In other words, they can be used to sustain mid-range relationships and transactions only after the parties have mutual trust.[19] According to Dasgupta (1988), trust between agents develops through reputation achieved by repeated interactions. But if individuals or firms are anonymous, how can they in the first place mitigate the risk of transacting with a stranger and start building a relationship of trust? How can one facilitate interaction? What role do state institutions play here and in supporting contracting? The next section will address these questions.

V. THE ROLE OF STATE INSTITUTIONS IN FACILITATING TRANSACTIONS

What can state institutions be expected to do in support of contracting? What impact, if any, do state institutions have on business contracting? Do they promote or inhibit complex commercial arrangements across spatial, temporal, and status distances?

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[19] Sako (1992) differentiates between three types of trust: contractual trust where there is "mutual expectation that promises made are kept"; competence trust where there is "confidence in trading partner's competence to carry out a specific task"; and goodwill trust where there are "mutual expectations of commitment to the relationship resulting in much give and take."

A. The Role of Law

Before turning to the role of state institutions in enforcing contracts and facilitating transactions, it is useful to review briefly what the role of law is in general in an economy. There are two major and divergent schools of thought on this issue: legal centralism and law and society.[20]

Legal Centralism

Legal centralism remains the dominant approach among legal scholars as well as economists writing about the law. The assumption that the state is the main source of rules and enforcement efforts is at the heart of legal centralism.[21] The state is seen as the sole source of order, and as having a monopoly on the implementation of law.

Legal centralism espouses a law-centered and law-leading approach to economic development. The premise of legal centralism is that law orders economic relationships and activities. Individuals and firms are assumed to know the law and adjust their behavior according to it. Behavior is assumed not to influence the law.

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[20] Legal centralism is the phrase Oliver Williamson (1983) has used to describe the main stream legal view of the place of law in a society. See Trubek and Galanter (1974) for an overview of the different schools of thought.

[21] See Friedman (1985).

In its crudest practical form, legal centralism presumes that laws are to be drafted by elite groups within the government so that they reflect the principles of justice, morality, and equality. There is little concern for economic efficiency or social realities in the drafting process. The modernization of the law is nevertheless viewed as a prerequisite to economic development in legal centralism.[22] Since the law is used to order economic activities, the state can reshape the economy and society by changing the legal framework.

Legal centralism ignores the fact that information is costly and imperfect and that humans have cognitive limitations.[23] It assumes that individuals know and obey the law. Surveys of popular knowledge, however, reveal that ordinary people know little of the law applicable to decisions in everyday life.[24] Legal centralism also ignores the existence of informal mechanisms that maintain economic and social order.

Law and Society

The law and society approach emphasizes the role of history, customs, and social factors in the development of law. In this view, law is in part comprised of, or at least continuous with, norms and mechanisms of social ordering that do not have their source in the state.[25]

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22 Trubek (1972), Galanter (1974).

23 Stigler (1961) Akerlof and Dickens (1982).

24 See, for example, Williams and Hall (1972) and Givelber, Bowers and Blitch (1984).

25 While this approach to law takes its name from the Law and Society movement that began at the University of Wisconsin in the 1960's, it is meant to include other schools of thought that apply social science methods to the law and take a broad view of the sources of law and law-like ordering.

The law and society view holds that non-state controls, like indigenous social norms and customs, always supplement, and often supplant, the state legal system in providing economic and social order. Social norms and self-help are acknowledged to play an important role in coordinating human affairs, and behavior is seen to be contingent at least as much on history and culture as on state law.[26]

The law and society approach emphasizes the "bottom-up" development of law. In the development of state legal systems, rather than simply transplanting laws from other countries, it maintains that the legal foundation should be built from the past, based on the prevalent social norms and customs. The keys to this exercise are the ideas, attitudes, values, and opinions about law held by the society.[27]

The bulk of the scholarly literature over the past 30 years supports the law and society view. For example, as discussed in earlier sections, empirical studies indicate that contract enforcement is not provided only by the state legal system in either industrial or developing countries. Non-state alternative dispute resolution mechanisms in many countries complement, or even replace, state mechanisms. The literature also indicates that, for the state legal system to be fully effective, it has to reflect societal norms and behavior, as enshrined in indigenous and non-state institutions.[28] If the law is not rooted in local culture, it will lack local "ownership," and foster lawlessness and empty

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[26] Ellickson (1991).

[27] Friedman (1985).

[28] Cooter (1995), Dia (1996).

formalism. As a result, society will resist implementation of the law, and its enforcement will be difficult. When people perceive law as unjust or irrelevant, they disobey it. When they obey the law, they tend to do so out of fear of punishment. If the law reflects social norms and emerges from processes deemed legitimate, most people perceive law as just, and many people obey such laws out of respect.[29]

B. The Impact of State Institutions

What, then, is the importance of state institutions in business transactions?

First, state institutions play an important role in facilitating mid-range transactions among anonymous individuals and groups. If state mechanisms were absent and transactions were supported only by social ties, exchange would be feasible only among members of the same community or among non-anonymous people. As was discussed earlier, most non-state enforcement mechanisms require non-anonymity to work. Hence, the absence of state mechanisms would hinder transactions outside one's own community. State mechanisms, by reducing the uncertainty and risk of transacting with a stranger, however, can help anonymous individuals and firms to initiate relationships across communities.

Second, state institutions can provide for predictable, transparent, impartial, and low-cost contract enforcement. Not only can this lower the cost of contracting, but the certainty of

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[29] Cooter (1996).

enforcement and the threat of legal action can act as a check on opportunism. If this system is sufficiently reliable, legitimate, and known, it can encourage the internalization of legal norms and hence promote compliance with the contract through guilt or social pressure.

In fact, Cooter (1996) shows that state institutions can affect contract enforcement even where non-state enforcement methods are used by lowering the cost of non-state enforcement, and thus tipping the balance in favor of compliance. The state system can do this by providing a credible threat of enforcement through litigation and offering a means of enforcing the results of non-state dispute resolution. Examples of this would be court-ordered enforcement of arbitral awards or decisions of traditional authorities.

Some caveats are in order, however. First, this assumes that relevant state legal provisions and enforcement mechanisms are known to the business community. Legal knowledge is, however, uneven across business communities, particularly in Africa, where colonial-derived law is neither accessible nor viewed as legitimate across the society. Second, the impact of state law on non-state enforcement depends (or, in principle, should depend) on the quality of applicable legal provisions. If contract law or legislation governing the judiciary allows judges wide discretion to amend or nullify contracts, then the threat of enforcement by state means becomes less credible. If applicable state law is outdated, then economic actors may develop a tacit understanding that state courts should always be avoided. This, of course, undermines any effective state pressure in favor of non-state enforcement.

The third way in which state law can reinforce non-state contracting and enforcement methods is by providing relevant information and screening mechanisms. Reliable company and asset registries, and other public goods that the state could provide make reputation portable across space and time. State law can also facilitate the emergence of privately-owned registries and credit reporting systems that perform this role. Frye (1996) gives an example where state institutions could play a role in his examination of Russian commodity exchanges. In theory, commodity exchanges in Russia offer a forum for repeated interactions among players of certified trustworthiness, and hence provide a means of using reputation mechanisms to enforce performance. In practice, however, the institutional design of the exchanges prevents this. Information on prospective trading partners is not reliably provided. The cost of commissions drives the bulk of activity into off-exchange deals, and surveyed participants reported that some 30 percent of exchange contracts were breached.

Fafchamps's study (1996) provides support for some of these points on the role of state institutions. Fafchamps examined how commercial contracts are enforced in Ghana. He found that compliance with contractual obligations in Ghana is mostly motivated by the desire to preserve personalized relationships based on mutual trust. Enforcement of commercial contracts is problematic partly because there is no mechanism by which information about bad payers is widely shared among firms. As a result, each firm must screen every single firm it wants to deal with. This imposes additional costs and reduces firms' economic reach and versatility. State institutions could play a useful role here.

Ringo, Nditi and Mjema (1995) investigated some of these issues in Tanzania. They found that small enterprises in Tanzania view the courts as the most unsuitable forum for dispute settlement for two reasons. First, a court suit would tarnish one's image and lead to a loss of future business. Second, settling disputes in the court is the most expensive in terms of time, money and corruption. At the same time, Ringo, Nditi and Mjema claim that alternative dispute resolution mechanisms including mediation conciliation and mini-trials are still in their infancy in Tanzania. As a result, most small enterprises in Tanzania do not use legally-enforceable contracts but rely on informal arrangements which depend on friendship, mutual trust, kinship, or long-term business relationship.[30] Only those small enterprises that operate in sectors with established contractual practices such as public works, transportation of goods and insurance tend to rely on written contracts. It also appears that as the size of the enterprise increases, so does the use of formal contracts. According to Ringo, Nditi and Mjema, medium-sized enterprises in Tanzania use legally-enforceable contracts more than the small ones.

VI. CONCLUSION: ISSUES FOR AFRICAN POLICYMAKERS

Contract enforcement plays a critical role in economic development. For example, in the survey carried out by Stone, Levy and Parades (1992) in Brazil, the respondents ranked ineffective contract enforcement and legal and regulatory systems as the most serious impediment to enterprise growth after policy uncertainty, price instability, taxation and labor regulation. Hence, it is important to assess contract regimes and the impact of state institutions on contracting in Africa. To find out to what extent state law is ordering firm behavior, one needs to explore to what extent written or

[30] Ringo, Nditi, and Mjema (1995).

unwritten contracts are used; whether these contracts are prepared with or without legal counsel; what other kinds of coordinating mechanisms--such as credit reports and collateral--are used; to what extent agreements are kept or breached and why are they breached; how breaches are treated and disputes are solved; to what extent lawsuits and the threat of them are used for enforcement, and to what extent other dispute resolution mechanisms are relied on.

Obviously, only state institutions can be changed directly through a reform by the state. However, changes in the state regime affect non-state practices and behavior in numerous ways. This is the case, for example, with negotiating "in the shadow of the law," the absorption of custom into the law, and instances where state legal institutions provide a fallback or last recourse in relationships chiefly structured through long-term relationships of reciprocity.

However, any attempt to complement or substitute for existing non-state contract enforcement with state institutions is a two-edged sword: it may bring benefits but at a cost. For example, Greif (1995) points out that new inter-group enforcement mechanisms can undermine existing intra-group mechanisms, which often depend on exclusivity: if, for example, court reform provides enforcement mechanisms that are equally effective for outsiders as for network members, then the benefits of group membership are no longer exclusive and the group could begin to break up. This appears beneficial or at least neutral. The question is whether other important group benefits are lost as well, and whether the new style of adjudication fosters exchange.

A related point is the extent to which non-state contract enforcement is preferable to a more rigid and predictable state system in countries at a low level of economic development and prone to economic shocks. In developing countries and particularly in Africa, macroeconomic shocks are common. If a shock has undermined a firm's client base and rendered it at least temporarily unable to pay its suppliers, strict contract enforcement could force the firm out of business. Considering how common this is likely to be in any situation of economic crisis and given the frequency of shocks, there is a legitimate question here for African policymakers of how strict contract enforcement should be. Policy choice here involves a tradeoff between predictability and the potential for a downward spiral of business failures at times of crisis. Studies show that flexibility, in the form of tiding debtors over or sending "good money after bad" through continued credit, is common and perhaps the norm among moderate-sized businesses in developing countries, and that the introduction of strict enforcement through courts could prove highly disruptive, at least until insurance markets are fully developed.[31] However, integration with the modern international economy requires predictable contract enforcement and, for reasons of investor confidence, access to international banking, and for negotiable instruments and securitization.

A set of potential policy options to be considered in African countries can be tentatively identified. Obviously, any program of policy and institutional change would have to be adapted to the specifics of a given country. However, among the possible initiatives that might have broad appeal are the following:

(1) Changes in the state law of contract and related bodies of law--to update them, make them more appropriate to and supportive of the kinds of transactions that hold the most potential

[31] Stone, Levy and Paredes (1992), Fafchamps (1996), Kranton and Swamy (1995).

for the countries involved. These bodies of law generally date to the colonial or early post-independence period, and need to be reconsidered in light of current business patterns and practices, and customs prevailing in the business community.

(2) Changes in systems of adjudication, laws on arbitration and alternative dispute resolution, civil procedure, and related areas--to reduce the costs of adjudication and increase the spectrum of third-party and collective contract enforcement options available to businesses. Commercial courts and small-claims courts have been suggested in past studies.

(3) Legal recognition and perhaps other kinds of support for systems such as property and lien registries, credit reporting systems, insurance, business and consumer information bureaus, self-regulating organizations such commodity and futures exchanges. Such policy initiatives could take advantage of the synergies between state and non-state institutions, hence extending the reach of contract enforcement and related public goods.

Finally, the *process* of carrying out any such reforms is critically important. Whether that process takes account of the views and accumulated wisdom of African businesses can make the difference between spurring private sector and producing another stillborn reform package.

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