

THE ROLE OF FORMAL CONTRACT LAW AND ENFORCEMENT IN ECONOMIC DEVELOPMENT

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INTRODUCTION

THIS Essay addresses the role of formal contract law and contract enforcement institutions in economic development. Unlike most of the other essays presented at this symposium, its

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inquiry is unabashedly, and indeed unapologetically, consequentialist: whether the existence of a formal contract law and enforcement regime significantly contributes to economic growth in developing countries.

We believe that the magnitude of the stakes at issue warrants this consequentialist approach. Approximately eighty-five percent of the world's population of 6.5 billion people lives in developing countries while earning only one-fifth of the total world income; roughly 1.2 billion of those living in developing nations survive on less than one dollar a day.¹ While data on trends in income inequalities around the world are subject to varied interpretations, income discrepancies between countries have clearly been rising—an indication that developed countries and a small subset of rapidly developing countries have eclipsed many developing countries in terms of relative income per capita.² Although income per capita, and growth thereof, is not a comprehensive measure of development,³ it is often a precondition to the realization of a variety of other development objectives.

Because the perspective of this Essay is consequentialist, it is also (unlike any of the other essays at this symposium) necessarily empirical in its focus: what consequences follow, or are likely to follow, from the actual or hypothesized adoption of one legal regime (in this case formal contract law and enforcement) over another? As the Essay will elaborate, two different hypotheses emerge from the literature. One takes the view that strong formal contract law and enforcement mechanisms are indispensable to economic development, while the other contends that much economic development is realizable through informal contracting mechanisms. Relating these two hypotheses to the central theme of this symposium—political theory and the role of private law—we address the respective roles of formal and informal contract law and enforcement institutions in economic development. We do so through the use of scenarios involving different kinds of states: (1) strong states with effective formal contract law and enforcement

¹ Michael P. Todaro & Stephen C. Smith, *Economic Development* 47, 54 (8th ed. 2003).

² Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* 39–40, 44 (2005).

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

institutions; (2) weak states that lack such mechanisms; and (3) highly interventionist, autocratic, or predatory states. We also address the related issue of the extent to which it is possible for a state to adopt an effective formal contract law and enforcement regime (and to protect private property rights, without which private contracting is impossible) without also adopting a particular type of political regime. Our inquiry further addresses the extent to which political theorizing about the role and structure of private law (in our case, contract law) applies universally, or whether such theorizing is highly contingent on context-specific political, cultural, and social values and practices. Put more bluntly, at the symposium out of which the essays in this volume emerged, were symposium participants (all drawn from western and developed countries) talking to themselves, or were they talking to the world?

We argue that at low levels of economic development, informal contract enforcement mechanisms may be reasonably good substitutes for formal contract enforcement mechanisms. At higher levels of development, however, informal contract enforcement may become an increasingly imperfect substitute due to the presence of large, long-lived, highly asset-specific investments, as well as the prevalence of increasingly complex trade in goods and services that often occurs outside of repeated exchange relationships. Thus, in the context of contract enforcement mechanisms, the answer to one of the central questions in contemporary development debates—whether good institutions cause growth or whether growth causes good institutions—is nuanced.

Part I will set out the rationales for the two principal hypotheses examined in this Essay. Part II will examine existing empirical evidence on which contract formalists rely for their claim that formal contract law and enforcement institutions are a significant determinant of a country's economic development prospects. Part III, in turn, will review empirical evidence to which the contract informalists point in support of the contrary claim, including two cases of great contemporary development significance: the so-called "China Enigma" and the "East Asian Miracle." In both of these cases, high rates of economic growth have been achieved, often in the absence of strong formal contract law and enforcement regimes. The Essay will conclude with a critical assessment of the empirical evidence supporting the two opposing hypotheses.

I. THE TWO HYPOTHESES

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

The framework offered by the New Institutional Economics (“NIE”) approach, as exemplified by the work of North, suggests that a full understanding and explanation of a nation’s economic development require both acceptance of the premises of the neo-classical economic approach and also recognition of its inadequacies.⁶ Specifically, North embraces the idea of the individual as a rational, self-interested economic agent who responds to economic incentives.⁷ He then suggests, however, that the neoclassical approach is inadequate as an explanatory tool insofar as it fails to recognize explicitly that the decisions made by individuals are predicated on the information and institutions available to them.⁸

Institutions, says North, “are the rules of the game in a society” and can be manifested either in formal rules or in informal codes of conduct and behavior.⁹ North’s framework for understanding economic development is premised on the view that the rules and norms governing economic interactions are the most significant drivers of an economy’s success or failure. North’s emphasis on the role of institutions in determining economic performance leads him to suggest that the differential performance of economies through time can be explained in terms of the differential quality of countries’ institutions.¹⁰

⁴ The primary work in the field of “law and development” is Max Weber, *Economy and Society* (Guenther Roth & Claus Wittich eds., 1978); see also David M. Trubek, *Toward a Social Theory of Law: An Essay on the Study of Law and Development*, 82 *Yale L.J.* 1 (1972).

⁵ Douglass C. North, *Institutions, Institutional Change and Economic Performance* 54 (1990).

⁶ See *id.* at 112.

⁷ *Id.* at 108.

⁸ *Id.* at 108–09.

⁹ *Id.* at 3.

¹⁰ *Id.* at 3, 107.

In similar vein, Oliver Williamson proposes that economic activity is best understood and explained by “an examination of the *comparative costs of planning, adapting, and monitoring task completion under alternative governance structures.*”¹¹ He argues that neither spot market transactions nor transactions within vertically integrated firms require formal enforcement mechanisms, because both entail minimal transaction costs.¹² Conversely, the vulnerability experienced by at least one party to long-term, non-simultaneous transactions creates a significant need for a credible third-party enforcement mechanism.¹³ Credible third-party enforcement addresses the reluctance of private sector agents to participate in non-simultaneous economic transactions, which often entail significant sunk costs, due to a lack of assured protection of the parties’ economic interests. Williamson contemplates a continuum of microeconomic activity: at either end of this continuum are types of activities that do not require a formal mechanism for contract enforcement, while in the middle lie economic activities that require some degree of external enforcement.¹⁴

From the perspective articulated by Williamson and North, and given the existence of transaction costs, individuals require assurances that those transaction costs will not negate the benefits they seek to derive from a transaction itself. Recalling that institutions include both the formal and informal constraints that shape human interaction,¹⁵ and that enforcement is an important factor in calculating transaction costs,¹⁶ North first identifies self-enforcement as the primary feature of contracts used in tribes, primitive societies, and close-knit small communities—settings in which personal knowledge of transacting parties about one another is extensive, and repeat dealings are pervasive.¹⁷ North then points out the limits of self-enforcing contracts in a world of increasing impersonal exchange. In such a world, simultaneous exchange and repeat dealings are no longer the prevailing norm; thus, self-enforcing con-

¹¹ Oliver E. Williamson, *The Economic Institutions of Capitalism 2* (1985).

¹² Oliver E. Williamson, *The Mechanisms of Governance 332* (1996).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ North, *supra* note 5, at 4.

¹⁶ *Id.* at 54 n.1.

¹⁷ *Id.* at 55.

tracts become insufficient because there no longer exists a dense social network of interaction to enable transacting to take place at low cost.¹⁸ Instead, individual specialization and exchange expansion in both time and space require additional contract enforcement mechanisms to assure compliance. These additional mechanisms, North explains, include the exchange of hostages, ostracism of delinquent merchants, the threat of reputational loss, kinship ties, loyalty, common beliefs held by minority groups in hostile societies, and, at times, ideological commitments to integrity and honesty.¹⁹

Although these additional, albeit still informal, mechanisms can, depending on the costs of information, provide assurance of contract compliance, the dilemma posed by impersonal exchange without effective third-party enforcement still remains because of information costs and the persistence of “end game” problems in long-term relationships.²⁰ For this reason, North calls a credible, low-cost, and formal regime of third-party enforcement essential. One particular understanding of this assessment by North in contemporary development studies is that as developing countries’ economies become more fully integrated into the larger global economy, formal contract enforcement mechanisms assume a larger significance. North explains that “third-party enforcement” means “the development of the state as a coercive force able to monitor property rights and enforce contracts effectively.”²¹

North concludes that the lack of low-cost, effective contract enforcement mechanisms (in particular, effective state enforcement through coercion) is the most important contributor to economic inefficiency and low growth rates in the developing world.²² He then cautions, however, that no one has yet successfully proposed how to develop the state into a coercive force able to protect property rights and enforce contracts effectively without also risking abuse of its coercive power to the detriment of society.²³ Despite this caution, the last ten years or so have seen extensive efforts by

¹⁸ Id.

¹⁹ Id.

²⁰ Id. at 55–58.

²¹ Id. at 59.

²² Id. at 54.

²³ Id. at 59–60.

international agencies and external donors to promote rule of law reform in many developing countries and transition economies; these efforts are, in part, predicated on the instrumental, economic rationales espoused by North.²⁴ Is this prioritization warranted, at least on instrumental grounds?

While the contract-formalist approach to development taken by North regards formal contract enforcement as fundamentally important for a nation's economic development, an alternative school of thought has emerged that downplays the need for a formal third-party mechanism for contract enforcement. Relying on empirical evidence that emphasizes the fundamental role played by social norms and networks in rendering private transactions self-enforcing, scholars have argued that many economic activities that foster economic development do not need a means of formal third-party enforcement.²⁵ According to Avner Greif, for example,

²⁴ See generally Thomas Carothers, *The Rule of Law Revival*, *Foreign Aff.*, Mar.–Apr. 1998, at 95 (discussing generally the new fervor in rule of law reform in developing countries); Ronald J. Daniels & Michael Trebilcock, *The Political Economy of Rule of Law Reform in Developing Countries*, 26 *Mich. J. Int'l Law* 99 (2004) (suggesting political economy considerations as the primary impediment to rule of law reform in developing nations).

²⁵ See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 *J. Legal Stud.* 115 (1992) [hereinafter Bernstein, *Diamond Industry*]; *infra* notes 95–96 and accompanying text; see also Marcel Fafchamps, *Market Institutions in Sub-Saharan Africa* (2004) (reviewing empirical evidence suggesting that contract agreements in sub-Saharan Africa are highly dependent on social networks and personal trust); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 *U. Pa. L. Rev.* 1765 (1996) (studying the self-enforcing private ordering in the American grain industry); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 *Mich. L. Rev.* 1724 (2001); Avner Greif, *Contracting, Enforcement, and Efficiency: Economics beyond the Law*, *in* *Annual World Bank Conference on Development Economics 1996*, at 239 (Michael Bruno & Boris Pleskovic eds., 1997) (challenging the neoclassical theory that only legal contract enforcement facilitates exchange); Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 *J. Legal Stud.* 349 (1981) (discussing the business practices of ethnically Chinese middlemen in Malaysia and Singapore). Janet Landa finds that the tightly knit, ethnically based business community among ethnically Chinese middlemen in Malaysia and Singapore facilitated a mutual trust that obviated any need to take measures to lessen uncertainty in transactions, while exchanges between the Chinese and indigenous non-Chinese employed primarily cash (rather than credit) in order to reduce contract uncertainty. *Id.* at 350; see also Janet Tai Landa, *Trust, Ethnicity, and Identity: Beyond the New Institutional Economics of Ethnic Trading Net-*

“many exchange relations in historical and contemporary markets and developing economies are not governed—directly or indirectly—by the legal system.”²⁶ Greif argues that, in fact, much of the world’s economic development has occurred absent a legal system to govern private economic transactions.²⁷

It is important to note that the contract-informalist perspective shares many theoretical foundations with the contract-formalist understanding of development—especially the notion that the individual acts as a rational economic agent. In particular, contract informalists accept that individuals need assurances that agreed-to transactions will not be arbitrarily breached without a means of holding the breaching party responsible. Thus, this perspective does not discount the fundamental principle of neoclassical economics that individuals require incentives to act. This view differs from the contract-formalist approach, however, insofar as it acknowledges that the existence of extralegal, socially, or culturally determined norms can and do provide the assurance of stability and predictability necessary to induce participation in private transactions. We now turn to a review of the existing empirical evidence on which proponents of each of these hypotheses rely to support their claims.

II. THE CONTRACT FORMALISTS: THE EMPIRICAL EVIDENCE

Although some development studies suggest that less-developed countries with poor property rights and weak contract enforcement mechanisms “fail to attract foreign investment and sustain growth,”²⁸ these studies usually do not distinguish the respective roles of property rights protection and contract enforcement in this correlation. Moreover, in evaluating institutional efficiency and effectiveness relative to economic growth, the evidence provided in these studies does not seem to accord primacy to state enforcement of contracts over alternative mechanisms of contract enforcement.

works, *Contract Law, and Gift-Exchange* 164, 205 (1994) (proposing a theory of informal contract enforcement institutions in achieving “ordered anarchy”).

²⁶ Greif, *supra* note 25, at 241.

²⁷ *Id.* at 241–42.

²⁸ Avinash K. Dixit, *Lawlessness and Economics* 14 (2004) (citing Dani Rodrik, Introduction *to In Search of Prosperity: Analytic Narratives on Economic Growth* 8–15 (Dani Rodrik ed., 2003)).

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

The argument that third-party contract enforcement is necessary as a prerequisite to productivity and growth is tested by Christopher Clague and his colleagues. They propose that “the extent to which societies can capture . . . those potential trades that are intensive in contract enforcement and property rights can be approximated by the *relative* use of *currency* in comparison with contract-intensive money” (“CIM”), which the authors define “as the ratio of noncurrency money to the total money supply”²⁹ It is important to note that the authors are careful to mention that they “are *not* suggesting that the greater use of . . . noncurrency monies *causes* better economic performance;”³⁰ rather, they assert “that better institutions, especially with respect to contract enforcement, enable a society to obtain a wider array of (real) gains from trade”³¹ Their study thus uses CIM to test the types of governance (or institutions) that improve economic performance and does not suggest that CIM is itself a cause of that performance.

The authors then present seven brief case studies of the impact of changes in political stability and economic policies on the CIM ratio. Based on these case studies, they conclude “that the security of contract and property rights is greater under strong and secure autocrats than under those of short tenure or in transient democracies and reaches the highest levels in lasting democracies.”³² The question this conclusion raises, of course, is its significance or relevance for the argument advanced by North.

Recall that North’s claim is that lack of third-party enforcement is the most important cause of historical stagnation and economic underdevelopment in the Third World. The purpose served by third-party enforcement is to provide stability and predictability as

²⁹ Christopher Clague et al., *Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance*, 4 *J. Econ. Growth* 185, 188 (1999).

³⁰ *Id.* at 189. Indeed, Russia’s “barter economy,” where cash payment in rubles is widely replaced by alternate means of payment, such as barter and privately issued quasi monies, proves otherwise, as later discussion of Russia reveals. See *infra* notes 161–64 and accompanying text.

³¹ Clague et al., *supra* note 29, at 189.

³² *Id.* at 196.

incentives to parties to engage in non-simultaneous exchanges. Two points need to be demonstrated in order to establish the validity of this claim. First, the existence of a third-party enforcement mechanism must actually increase the volume of non-simultaneous transactions. Since the CIM ratio is a measure of the use of non-currency money to the total money supply, it is fair to characterize a rise in that ratio as evidence of an increase in non-simultaneous transactions, because it does involve exchanges between parties without immediate payment upon delivery of the promised good or service. Thus, one could conclude, based on the evidence provided by Clague and his colleagues, that individuals are more willing to engage in non-simultaneous exchanges when politically stable states act as credible third-party enforcers of contracts (although it is not clear that formal judicial enforcement is the only mechanism at the state's disposal).

Second, the validity of North's claim is further contingent on a demonstrated connection between an increase in non-simultaneous exchanges and economic development itself. To this end, Clague and his colleagues conducted a regression analysis to find the correlation between, CIM and investment and CIM and growth, respectively. With regard to CIM and investment, the authors found "a strong, positive, and highly significant relationship between" the two variables.³³ With regard to the relation between CIM and growth, the initial regression did demonstrate a significant correlation, but the evidence suggested reverse causality. On testing for reverse causality, the authors concluded that the apparently significant relation between CIM and growth is actually attributable to factors exogenous to CIM (such as currency depreciation, initial income, schooling, ethnic structure of population, and colonial heritage), rather than a function of CIM itself.³⁴

While the finding regarding CIM and growth creates a legitimate challenge for those who argue in favor of credible third-party enforcement of contracts as a prerequisite for economic development, it does not negate the importance of the finding regarding CIM and investment. If the CIM ratio does act as a legitimate proxy for the efficacy of third-party contract enforcement in at-

³³ Id. at 200.

³⁴ Id. at 202-03.

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

Another cross-country study by Ross Levine, Norman Loayza, and Thorsten Beck in the law and finance literature examines the role of financial intermediaries in facilitating economic growth and also evaluates how legal and accounting practices (including contract enforcement) affect financial development.³⁵ In their regression analysis, the authors use as a dependent variable the growth rate of real per capita gross domestic product. The primary regressor is the level of financial intermediary development, but other regressors include a broad set of variables that serve to provide conditioning information.³⁶ Levine and his colleagues conclude that “[t]he degree to which financial intermediaries can acquire information about firms, write contracts, and have those contracts enforced will fundamentally influence the ability of those intermediaries to identify worthy firms, exert corporate control, manage risk, mobilize savings, and ease exchanges.”³⁷ Once the authors conclude that there is a correlation between contract enforcement and financial development, they conduct cross-sectional analysis to establish a correlation between financial development and economic growth. They find that “[f]inancial intermediaries that are better at ameliorating information and transactions [sic] costs induce a more efficient allocation of resources and faster growth.”³⁸ This finding leads them to support the conclusion of previous work by Rafael La

³⁵ Ross Levine et al., *Financial intermediation and growth: Causality and causes*, 46 *J. Monetary Econ.* 31 (2000).

³⁶ *Id.* at 44.

³⁷ *Id.* at 35.

³⁸ *Id.* at 62.

Porta and his colleagues³⁹ that “the legal and regulatory system will fundamentally influence the ability of the financial system to provide high-quality financial services.”⁴⁰

The primary reason why financial markets are particularly dependent on law and state contract enforcement institutions is that financial contracts tend to be highly technical and complex and usually involve large amounts of financial assets. Therefore, financial contracting usually entails considerable transaction risks and requires stable and predictable contract protection and compliance assurance, including the protection of minority investors’ rights (which are vulnerable to both managerial abuses and expropriation by majority investors).⁴¹ Such assurance is presumably best provided by effective formal contract law and related legal institutions. Viewing finance as a set of contracts, the broad law and finance literature suggests, on the basis of extensive empirical testing, that a country’s contract, company, bankruptcy, and securities laws, combined with effective enforcement of these laws, fundamentally determine the rights of securities holders and the performance of financial systems.⁴²

In a recent paper, Kenneth Dam reports additional empirical evidence from financial markets on the positive correlation between a strong and effective judiciary, acting as an important formal contract enforcement institution, and economic development.⁴³ He cites a number of studies to suggest that “[t]he degree of judicial independence is correlated with economic growth” and that “[b]etter performing courts have been shown to lead to more developed credit markets[,]” thus contributing to rapid growth of small, as well as larger, firms in an economy.⁴⁴ In particular, Dam cites the World Bank’s World Development Report of 2005, which

³⁹ Rafael La Porta et al., *Legal Determinants of External Finance*, 52 *J. Fin.* 1131, 1132, 1149 (1997).

⁴⁰ Levine et al., *supra* note 35, at 35.

⁴¹ Thorsten Beck & Ross Levine, *Legal Institutions and Financial Development*, in *Handbook of New Institutional Economics* 251, 253 (Claude Ménard & Mary M. Shirley eds., 2005) (citing Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 *J. Fin.* 737, 742 (1997)).

⁴² Beck & Levine, *supra* note 41, at 253.

⁴³ Kenneth W. Dam, *The Judiciary and Economic Development* (Univ. Chi. John M. Olin Law & Econ., Working Paper No. 287, 2d series, 2006), available at <http://ssrn.com/abstract=892030>.

⁴⁴ *Id.* at 1.

argues that, within individual countries in Latin America, firms doing business in provinces of Argentina and Brazil that have competent courts enjoy greater access to credit.⁴⁵ Similarly, the larger and more efficient firms in Mexico can be found in states that have superior court systems.⁴⁶ The World Bank report attributes these favorable economic outcomes to the factor that “[b]etter courts reduce the risks firms face, and so increase the firms’ willingness to invest more.”⁴⁷ By contrast, ineffective and poor quality courts are incapable of addressing contract enforcement problems faced by private agents dealing with the state and public sector agents in economic transactions.

Dam also describes the case of Brazil, where the government’s “judicial liability” (that is, unenforced judicial claims against the public sector) is believed to be roughly equal to the country’s public debt.⁴⁸ This deficiency of the Brazilian judiciary essentially levies a considerable tax on private sector agents, because they can neither earn interest on their unrecovered assets pending court proceedings nor put these assets to other value-adding uses.⁴⁹ An equally detrimental consequence of ineffective courts for creditor rights protection is that banks are forced to lend at extremely high interest rates due to their inability to foreclose on debts without the assistance of courts.⁵⁰ As a result, vital infrastructure projects are not pursued because investors are doubtful about the courts’ ability to protect their rights in case of default.⁵¹ Finally, Dam cites the results of an empirical study on transition economies by Katharina Pistor, Martin Raiser, and Stanislaw Gelfer⁵² to demonstrate the critical role played by “legal effectiveness” in promoting financial market development by expanding market capitalization

⁴⁵ The World Bank, World Development Report 2005: A Better Investment Climate for Everyone 86 (2004).

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Dam, *supra* note 43, at 2 (citing Jonathan Wheatley, Why Brazil’s judicial system is driving the country nuts: A lack of will to alter a dysfunctional legal system is hampering development, *Fin. Times* (London), May 24, 2005, at 20).

⁴⁹ Dam, *supra* note 43, at 2–3.

⁵⁰ *Id.* at 3 (citing Wheatley, *supra* note 48).

⁵¹ Dam, *supra* note 43, at 3 (citing Wheatley, *supra* note 48).

⁵² Katharina Pistor et al., Law and finance in transition economies, 8 *Econ. Transition* 325, 356 (2000).

and private sector credit (where effective courts that can enforce private contracts are an essential indicator of such effectiveness).⁵³

Rainer Haselmann and his colleagues identify two major drawbacks to the broad law and finance literature.⁵⁴ First, most of the research in this context uses aggregate, macro-level indicators for financial market development, such as the size of credit markets relative to gross domestic product; the use of such metrics makes it difficult to “disentangle the impact of legal change on different market participants[,]” however.⁵⁵ Second, most of the existing research in this area compares countries with good legal institutions to those with poor quality legal institutions by “relat[ing] differences in legal institutions to various economic parameters.”⁵⁶ For example, some researchers have tried to explain the relationship between countries’ laws regarding creditor and shareholder rights and levels of development in banking finance and securities markets.⁵⁷ This approach ignores endogeneity concerns that economic performance may be caused not by changes in legal institutions, but rather by omitted variables or unobserved differences between countries.⁵⁸

In part to rectify these methodological deficiencies in the broad law and finance literature, Haselmann and his colleagues conducted an empirical study of the role of creditor rights protection law in bank lending in twelve transition economies in Central and Eastern Europe; the authors focused on exploring the relationship between reform of bankruptcy law and collateral law, on one hand,

⁵³ Dam, *supra* note 43, at 4. Similarly, Gillian Hadfield also emphasizes the importance of an effective and competent judiciary in adjudicating contract disputes. She argues that contract law on the books is not enough to assure contract enforcement; many other legal institutions are also necessary for structuring an effective law of contracts and supporting contractual commitments. These supporting legal institutions include courts and judges, lawyers, the legal environment in which contract law operates, and private dispute resolution mechanisms which complement formal contract law. See Gillian K. Hadfield, *The Many Legal Institutions that Support Contractual Commitments*, in *Handbook of New Institutional Economics*, *supra* note 41, at 175, 181–200.

⁵⁴ Rainer Haselmann et al., *How Law Affects Lending 1* (Columbia Law & Econ., Working Paper No. 285, 2006), available at <http://ssrn.com/abstract=846665>.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ See, e.g., Rafael La Porta et al., *Law and Finance*, 106 *J. Pol. Econ.* 1113, 1115 (1998).

⁵⁸ Haselmann et al., *supra* note 54, at 1.

and macro-level behavioral changes by banks in their lending activities on the other.⁵⁹ There are three major findings in their study. First, law (in this case, formal creditor rights protection under both bankruptcy and collateral law) does in fact promote lending by increasing lending volume over time,⁶⁰ thus suggesting a causal relationship between formal contract enforcement institutions and financial market development. Second, collateral law designed to protect individual creditors' claims is of greater importance for expanding bank lending than is bankruptcy law, which is aimed at establishing a collective enforcement regime.⁶¹ In particular, in the sample countries that have undergone reforms of collateral regimes, bank lending is positively associated with the recognition of non-possessory security interests in movable assets (that is, personal property, as opposed to real property); bank lending is also positively associated with the establishment of an effective registration system to verify such interests.⁶² Finally, in the countries they studied, the authors also found that the biggest beneficiaries of legal reform with regard to creditor rights protection were foreign banks; foreign "greenfield" banks,⁶³ in particular, benefited from legal reform, as indicated by their substantially greater increase in lending volume over that of incumbent domestic banks, regardless of whether they were privately or state owned.⁶⁴

It is also worth noting that, although the broad law and finance literature largely emphasizes the central thesis that legal institutions influence corporate finance and financial development, views diverge regarding the degree to which the legal system should simply enforce private contracts while doing little else (the Coasian view), and the degree to which the legal system should set up specific legal rules governing shareholder and creditor rights. The critics of the Coasian view contend that for private contracting in financial markets to work effectively, courts must enforce private contracts in an impartial and sophisticated way that is attentive to

⁵⁹ Id. at 2.

⁶⁰ Id.

⁶¹ Id.

⁶² Id. at 27–30.

⁶³ The descriptive term "greenfield" refers to newly established foreign banks in the domestic market, in contrast to foreign banks that have taken over or acquired domestic banks in order to enter the domestic market. See id. at 17.

⁶⁴ Id. at 2, 27, 30.

the technicalities and complexities of these contracts.⁶⁵ These critics note, however, that effective judicial enforcement often does not occur in many developing countries with weak judiciaries. Thus, “there are potential advantages to developing company, bankruptcy, and securities laws that provide a framework for organizing financial transactions and protecting minority shareholders and creditors.”⁶⁶ One caveat to this emphasis on a larger role for legal institutions in governing financial contracting is that, although the resultant standardization may render financial transactions more efficient by decreasing transaction costs, too much rigidity in the law may also hamper efficient customization of contracting.⁶⁷

While the broad law and finance literature tries to explore the specific dynamics of how legal institutions impact countries’ financial development, an emerging new field of research in contemporary development studies has expanded its inquiries into the relationship between governance or institutional quality and economic development more generally. For example, the most recent *Governance Matters* study published by the World Bank traces the state of governance globally.⁶⁸ The report identifies six institutional areas that are used both independently and collectively as governance indicators: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption.⁶⁹ The study defines the rule of law indicator as “measuring the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence”⁷⁰ and indicates that there is “substantial causation” between better governance (including improved rule of law) and higher income levels.⁷¹ More generally, the study’s authors find that “a one standard deviation improvement in [collective governance indicators] would lead to a two- to three-

⁶⁵ See Edward Glaeser et al., *Coase Versus the Coasians*, 116 Q.J. Econ. 853, 854 (2001).

⁶⁶ Beck & Levine, *supra* note 41, at 254.

⁶⁷ *Id.*

⁶⁸ Daniel Kaufmann et al., *Governance Matters IV: Governance Indicators for 1996–2004* (2005), http://www.worldbank.org/wbi/governance/pdf/GovMatters_IV_main.pdf.

⁶⁹ *Id.*

⁷⁰ *Id.* at 4.

⁷¹ *Id.* at 36.

fold difference in income levels in the long run.”⁷² Furthermore, when they isolate and remove reverse causality, they find the causation between governance and development remains significant.⁷³

While the authors use certain indicators for the degree of contract enforcement or include contract enforcement as a constituent element, none of these cross-country studies examines contract enforcement as an independent variable. Thus far, the study that has most closely examined the strength of state enforcement of contracts, conducted by Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, is known as the Lex Mundi project.⁷⁴ This study measures and describes the exact procedures used by litigants and courts to evict tenants for nonpayment of rent and to collect bounced checks. It provides cross-country data on the procedures involved in formal dispute resolution in each of the 109 countries examined. The study further offers comparative evidence regarding the effectiveness of legal institutions in realizing the purposes they were created to serve. In a comment on the Lex Mundi project, Kevin Davis suggests, however, that while the results of the study are useful to legal reformers, they should not be relied upon as strict or accurate indicators of the relationship between contract enforcement and development.⁷⁵ Davis’s criticism relates to the project’s methodology, which assesses a state’s vigor in enforcing contracts by collecting data on the processes involved in enforcing two particular types of contracts—tenant evictions and collecting on bounced checks.⁷⁶ Davis contends that, at best, “the data can be described as measures of the enforceability of *particular types* of contracts . . . as there is no reason to presume that any given legal system treats *all* contractual claims similarly.”⁷⁷ At most, the study speaks to the ability of certain contract enforcement mechanisms to realize the purpose for which they were imple-

⁷² Id.

⁷³ Id. at 36–38.

⁷⁴ For a complete description and analysis of the Lex Mundi project, see Simeon Djankov et al., *Courts*, 118 Q.J. Econ. 453, 459 (2003); see also Kevin E. Davis, *What Can the Rule of Law Variable Tell Us About Rule of Law Reforms?*, 26 Mich. J. Int’l L. 141, 159 (2004) (referring to the Djankov study as the “Lex Mundi project”).

⁷⁵ Davis, *supra* note 74, at 159.

⁷⁶ Id.

⁷⁷ Id. at 157.

mented. Moreover, it does not provide any useful data on the positive effects that contract enforcement has on economic growth.

Dam suggests another problem with the Lex Mundi project: the term “formalism,” defined in this project as procedural complexity in court proceedings, cannot fully capture the actual degree of judicial effectiveness across countries, especially between civil law countries and common law countries.⁷⁸ He also suggests that the project’s implicit judgment that formalism was not efficient for the two simple types of cases studied may be misleading. He concludes that while higher degrees of judicial formalism, measured by the number of requirements for court proceedings, are found most often in civil law countries, including many developing countries, common law countries with lower degrees of judicial formalism, including wealthier countries, do not necessarily score higher in timely resolution of these cases.⁷⁹ For example, certain developed common law countries manifested unusual delay in the check collection case—421 days in Canada and 320 days in Australia, compared to forty days in Swaziland and sixty days in Belize, countries with the same common law tradition.⁸⁰ Moreover, in Asia, civil law countries have shorter durations of court proceedings than common law countries in the Lex Mundi project, indicating another deviation from the project’s implicit judgment that common law countries generally have lower degrees of formalism—and hence generally higher degrees of judicial effectiveness—than civil law countries.⁸¹

A study by Daron Acemoglu and Simon Johnson suggests a similar problem; the authors find that while enforcement of property rights correlates significantly with economic growth, financial development, and investment, formal contract rules have a significant effect only on firms’ use of financial institutions, and thus on the form of financing used in structuring deals.⁸² For example, countries with inferior formal contracting institutions have less developed stock markets, so firms in these countries may use more

⁷⁸ Dam, *supra* note 43, at 9–10.

⁷⁹ *Id.*

⁸⁰ *Id.* at 10.

⁸¹ *Id.* at 11.

⁸² Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 *J. Pol. Econ.* 949, 983–84 (2005).

debt rather than equity financing because debt contracts are cheaper to enforce.⁸³ Acemoglu and Johnson conclude that formal contracting institutions have a more limited effect on growth, investment, and the total amount of credit in the economy.⁸⁴

Various country-specific studies also suggest the benefits of contract law in facilitating successful and profitable transactions. For instance, a study of enterprises in Russia by Kathryn Hendley, Peter Murrell, and Randi Ryterman argues that law and legal contract enforcement institutions do add value to the Russian economy.⁸⁵ The authors found that since Russia significantly reformed those legal institutions in the years following the collapse of the Soviet Union, Russian firms have steadily increased their use of the new *arbitrazh* court system to resolve contract disputes.⁸⁶ Despite the increasing inclination of Russian firms to resort to courts for contract enforcement, the reliability and effectiveness of those courts in enforcing judgments has been much debated. For example, the *arbitrazh* courts have been criticized for their inability to effectively enforce judgments or meet litigants' other basic needs.⁸⁷

But then, why do firms go to courts at all, if the judgments cannot be effectively enforced? Federico Varese provides a plausible explanation. Drawing on rich empirical data on the operation of the Russian *arbitrazh* courts in handling cases involving contract disputes over non-payment, he discovered that large formerly state-owned firms, privatized in the 1990s, make up the majority of litigants in these cases; by contrast, small enterprises in the private sector generally shun the courts in enforcing contracts.⁸⁸ According to Varese, one possible reason for this disparity is that managers of large Russian enterprises, which often are less efficient and competitive than smaller private enterprises, have strong incentives to file cases with the *arbitrazh* courts as a "signaling" strategy. De-

⁸³ Id. at 953, 983–84.

⁸⁴ Id. at 988.

⁸⁵ Kathryn Hendley et al., Law Works in Russia: The Role of Law in Interenterprise Transactions, *in* Assessing the Value of Law in Transition Economies 56, 88 (Peter Murrell ed., 2001).

⁸⁶ Id. at 56, 70.

⁸⁷ Kathryn Hendley, Growing Pains: Balancing Justice & Efficiency in Russian Economic Courts, 12 *Temp. Int'l & Comp. L.J.* 301, 330–31 (1998).

⁸⁸ Federico Varese, The Russian Mafia: Private Protection in a New Market Economy 53–54 (2001).

spite knowing that favorable court judgments are not likely to be effectively enforced, these managers still go to courts when contract disputes arise because they want to be perceived as making efforts to recover bad debt in a legal way.⁸⁹ Sending out such “law abiding” signals to both the market and the state may afford these firms two possible benefits: either losses resulting from managerial incompetence can be concealed, and hence future transactional opportunities sustained, or they can continue to receive bank loans and state subsidies.⁹⁰ By comparison, smaller private enterprises—which usually face greater transactional uncertainty and have shorter business time-horizons than large enterprises—tend to resolve contract disputes largely outside the courtroom due to skepticism over the courts’ ability to enforce judgments in a timely manner.⁹¹ Difficulty in enforcing judgments in a timely manner often creates substantial adverse commercial results in transition economies struggling with macro-economic instabilities. Most critically, during periods of high inflation, even a short delay in recovering debt or payment through formal enforcement by “slow” courts can cause significant real financial losses.

The main conclusion to derive from this brief review of the literature on the relation between formal contract law and enforcement and development is that the existing empirical evidence specifically examining the correlation between a country’s economic growth and the state as a credible third-party enforcer of contracts suggests a strong correlation only in the financial sector: better contract enforcement appears beneficial in facilitating financial intermediation. This correlation does not provide strong or unambiguous corroboration of the contract-formalist position more generally, beyond the truism that most rich countries have sophisticated formal contract law and enforcement regimes and many, if not most, poor countries do not. This could equally be said of many other differences between rich and poor countries, indicating little about what is a cause or what is a consequence of development.

⁸⁹ Id. at 53.

⁹⁰ Id. at 53–54.

⁹¹ Id. at 54.

III. THE CONTRACT INFORMALISTS: THE EMPIRICAL EVIDENCE

The following studies of trade and contracting practices provide empirical support for the contract-informalist perspective. We review empirical evidence relating to contracting practices in contemporary developed economies, in early and contemporary international trade, and in contemporary developing and transition economies. We also pay special attention to the so-called “China Enigma” and the “East Asian Miracle,” where dramatic rates of economic growth have been achieved, often in the absence of credible formal third-party contract enforcement mechanisms.

A. Developed Economies: Contracting in the Shadow of Law

One of the first studies to advance the contract-informalist perspective is Stewart Macaulay’s famous examination of the practices of American businessmen, in which he found an aversion on the part of the business community to using formal legal mechanisms to enforce contractual terms or resolve contractual disputes.⁹² According to Macaulay, social pressure and reputation are more widely used than formal contracts and judicial enforcement in executing mutually beneficial agreements.⁹³ Macaulay discounts the importance of formal contractual enforcement as a means of facilitating economic transactions, and instead introduces the idea of relational contracting as a method of contractual enforcement (although much ambiguity continues to surround the definition of relational contracts).⁹⁴

Lisa Bernstein’s frequently cited study on the New York diamond trade speaks to the ability of the norms of an ethnic business network (that of Orthodox Jews) to provide the stability in private ordering that facilitates business transactions without resort to the

⁹² Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *Am. Soc. Rev.* 55, 61 (1963).

⁹³ *Id.* at 63.

⁹⁴ For more in-depth study of relational contracts, see generally Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 *Va. L. Rev.* 1089 (1981) (arguing that relational contracts are motivated by cost-minimizing incentives when risks cannot be identified with certainty *ex ante*) and Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a “Rich Classificatory Apparatus,”* 75 *Nw. U. L. Rev.* 1018 (1981) (comparing relational transactions to the neoclassical microeconomic model based on discrete transactions).

formal legal system.⁹⁵ Bernstein uses the customs of the New York diamond trade to suggest that reputation and trust can be used at a low enough cost to allow private transactions to take place outside the domain of the formal legal system.⁹⁶ It is interesting to note that the evolving relationship between the New York diamond trade and the formal legal system affected the industry's self-enforcement system. In particular, Bernstein notes that after the first lawsuit against the New York diamond club, the organization adopted procedures to reduce its exposure to lawsuits or antitrust inquiries.⁹⁷ When an entire industry is comprised of one homogeneous group that adheres to a single set of operational rules, there is little need to resort to external rules of order. When the ethnic composition of the diamond trading floor began to diversify as new and unfamiliar agents entered the industry, however, the enforcement system changed.⁹⁸ This change supports the hypothesis that in the presence of a credible formal legal regime, when the need develops to go beyond the ethnically derived, extra-legal norms that govern the transactions of an industry, it seems likely that the formal law will inform or determine new developments in those extra-legal norms.

Examples of informal contract enforcement mechanisms abound. As reported by John McMillan, Paragon Cable, a New York cable television company, has developed a novel and effective strategy to recover overdue bills: rather than cut off cable, it runs C-Span's "interminable political speeches, debates, and hearings" on all of its channels until the subscriber pays up.⁹⁹ Another example of self-governance as an enforcement mechanism is the

⁹⁵ See Bernstein, *Diamond Industry*, supra note 25, at 140–41.

⁹⁶ Id. at 138, 157.

⁹⁷ Id. at 156; see also David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. Pa. L. Rev. 1841, 1841–42 (1996) (emphasizing the importance of viewing a non-legal system in the context of the legal regime upon which it rests); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 373, 378, 426–46 (1990) (discussing at length the legal regulation of relationships governed by non-legal sanctions).

⁹⁸ Bernstein, *Diamond Industry*, supra note 25, at 143, 154–57. In particular, Bernstein explains how formal law has increased its intervention into the extralegal contractual regime of the diamond industry over recent years, especially through the introduction of legally enforceable contracts and the expansion of legal representation in the industry's internal arbitration proceedings.

⁹⁹ John McMillan, *Reinventing the Bazaar: A Natural History of Markets* 56 (2002).

New York Stock Exchange's traditional internal rules and procedures for contract enforcement and dispute resolution: brokers trading on the stock exchange "regulate[d] themselves on the sanction of expulsion. Members who defaulted on contracts were barred. Non-members who reneged on contracts with members were blacklisted."¹⁰⁰ Thus, even in developed economies, it is clearly the case that many transactions rely on extra-legal norms and practices for contract enforcement.

B. Early International Trade: Contracting Without State

An important study that speaks to the viability of informal economic practices in early trade is Avner Greif's study of the relations between the Maghribi merchants and their overseas agents in the Mediterranean during the late medieval Commercial Revolution. The merchants solved the contract enforcement problem by establishing a reputation-based institution, whereby information sharing and multilateral punishment enabled credible commitment *ex ante* and effective fulfillment of contractual obligations *ex post*.¹⁰¹

Another study by Avner Greif, Paul Milgrom, and Barry Weingast of medieval merchant guilds also examines contract enforcement mechanisms in early international trade. According to the authors, merchant guilds emerged during the late medieval period as effective institutions of contract enforcement, which, *inter alia*, allowed rulers of European and Middle Eastern/North African trade centers to assure alien merchants of the security of their

¹⁰⁰ *Id.* at 23. It should be noted that over the last several decades, the New York Stock Exchange has experienced a gradual process of "professionalization," whereby its disciplinary proceedings for expulsion from membership were formalized to involve official hearings, rights of appeals, and other such measures. These formal proceedings have not changed despite the Exchange's recent public offering. Nevertheless, resorting to the traditional informal means of self-regulation remains a practice among traders—it is not uncommon for a trader on the Exchange's floor to stop doing business with, or refuse to offer the most favorable trading terms to, another trader who violates the traditional informal rules or norms of conduct for contract enforcement. E-mail from Doug Harris, Director of Policy, Research and Strategy, Market Policy and General Counsel's Office, Market Regulation Services Inc., Canada, to Jing Leng, Post-Doctoral Fellow, University of Hong Kong (Aug. 29, 2006, 07:03 EST) (on file with authors).

¹⁰¹ Avner Greif, *Institutions and the Path to the Modern Economy* 58–90 (2006).

property rights, thus contributing to the expansion of trade during this period.¹⁰²

Similarly, Kenneth Dam observes that boycotts and the threat of loss of reputation were early European substitutes for the rule of law during the evolution of long-distance trade in Europe in the Middle Ages.¹⁰³ He argues, however, that these informal solutions to the contract enforcement problem “illustrate why a Rule of law is essential to the efficient functioning of a modern economy,” which is fundamentally different from early trade in terms of the complexity of goods and services involved.¹⁰⁴

The histories of many developing countries contain additional examples of indigenous mercantile institutions of trust and commitment that facilitated long-distance trade and credit. These informal institutions were based on multilateral reputation mechanisms and informal codes of conduct and enforcement, such as those revolving around the mercantile families and groups in pre-colonial and colonial India, Chinese traders in Southeast Asia, and Arab “trading diasporas” in West Africa.¹⁰⁵

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

One issue that is not widely addressed in the literature on contract enforcement and development is the role of contract enforcement in contemporary international trade (the study by Daniel Berkowitz, Johannes Moenius, and Katharina Pistor,¹⁰⁶ discussed below, is a notable exception). In the arena of contemporary international trade, many informal contract enforcement mechanisms still prevail. A growing consensus in development studies is that long-term economic growth is significantly dependent on expanding international trade and attracting large-scale for-

¹⁰² Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 *J. Pol. Econ.* 745, 753–54 (1994).

¹⁰³ Kenneth W. Dam, *Institutions, History and Economic Development* (Univ. Chi. John M. Olin Law & Econ., Working Paper No. 271, 2d series, 2006), available at http://ssrn.com/abstract_id=875026.

¹⁰⁴ *Id.* at 3–7.

¹⁰⁵ Pranab Bardhan, *Institutions matter, but which ones?*, 13 *Econ. Transition* 499, 512–13 (2005).

¹⁰⁶ Daniel Berkowitz et al., *Legal Institutions and International Trade Flows*, 26 *Mich. J. Int'l L.* 163 (2004).

eign direct investment. Despite this recognition of the importance of international trade and foreign direct investment to development, however, so far NIE scholars have paid inadequate attention to investigating the impact on contract enforcement mechanisms brought by the expansion of international trade and growing trend of economic globalization.

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

International commercial arbitration has emerged over the past two decades as a common mechanism for settling trade and investment disputes among private parties in different countries. As compared to public courts, the advantages of international commercial arbitration in enforcing contracts include increased flexibility, technical expertise, privacy, and confidentiality, all of which are important in satisfying the needs of private parties for low-cost, expeditious, and effective resolution of contract disputes.¹⁰⁷ As a result, this mechanism for contract enforcement promotes international trade and investment, although it does not fully address some persistent forms of contractual uncertainty relating to the limits of the enforceability of international arbitration awards within national borders.

James Rauch observes that transnational social and business networks can reduce two typical “informal trade barriers”—weak enforcement of international contracts and inadequate information about international trading opportunities—and thus promote international trade.¹⁰⁸ Examples include the “outsourcing” of software development by Indian engineers in Silicon Valley to regions in India like Bangalore and Hyderabad, and the function of overseas Chinese business networks in building trust among traders where formal contract enforcement is weak or nonexistent. Means of deterring deviation include building “moral communities” and

¹⁰⁷ Walter Mattli, *Private Justice in a Global Economy: From Litigation to Arbitration*, 55 *Int'l Org.* 919, 944 (2001).

¹⁰⁸ James E. Rauch, *Business and Social Networks in International Trade*, 39 *J. Econ. Literature* 1177, 1200 (2001).

threatening collective punishment.¹⁰⁹ As noted by Rauch, one important aspect of the role of transnational business and social networks in international trade is their contribution to international technology transfer. Rauch explains that this contribution occurs because international technology transfer is not always an “arm’s-length” phenomenon: for firms in less developed countries, a major, and perhaps dominant, source of technology transfer and transfer of managerial know-how comes from instruction by buyers in developed countries.¹¹⁰ These buyer-seller relationships are usually long-term and thus fit the definition of business networks acting as repeated exchange mechanisms. The intermediaries between Taiwanese shoe manufacturers and Western fashion houses provide another example of private contract enforcement through transnational business networks in international trade. These intermediaries, usually serving as trading companies, perform dispute-resolution functions in addition to their primary matchmaking functions by utilizing their informational advantages relative to both parties.¹¹¹

Recent research by Dalia Marin and Monika Schnitzer also reveals that there is a significant resurgence of barter, or countertrade, in international trade.¹¹² Merging contract theory and international trade theory, the authors offer efficiency-based explanations for the resurgence of barter in international trade and transition economies. In their view, the increasing use of barter in both international trade and transition economies is an optimal institutional response to contract enforcement problems in both settings.¹¹³ Specifically, with regard to the problem of the declining creditworthiness of many developing countries since the 1980s, especially in the aftermath of regional financial crises, barter serves to mitigate uncertainty in enforcing trade agreements by providing a form of deal-specific collateral; thus, barter provides a substitute for both enforcement by supranational authorities and reputation-

¹⁰⁹ Id. at 1180–81.

¹¹⁰ Id. at 1197–98.

¹¹¹ McMillan, *supra* note 99, at 46.

¹¹² Dalia Marin & Monika Schnitzer, *Contracts in Trade and Transition: The Resurgence of Barter* 1 (2002).

¹¹³ Id. at 7–8.

based self-enforcement.¹¹⁴ Barter therefore facilitates the transfer of technology and capital between developed and developing countries by encouraging trade when there is contractual uncertainty regarding buyers' payment liquidity and sellers' exploitation of hold-up positions.

While informal enforcement still tends to be the prevailing mechanism for many transactions in international trade, an important study by Berkowitz, Moenius, and Pistor suggests new trends in the relationship between legal institutions and international trade flows.¹¹⁵ The authors find that as economies move up the value chain to more complex exports, the quality of their domestic legal institutions is increasingly important for assuring contract enforcement. As corroborated empirically in their study, weak domestic legal institutions adversely affect the ability of indigenous firms to expand trade in more complex goods and services.¹¹⁶ Specifically, the authors emphasize that "exports, and particularly complex goods exports suffer more from bad legal institutions in the exporter's home jurisdiction, than imports."¹¹⁷

D. Developing and Transition Economies: Contracting Without the Shadow of Law, in the Shadow of a Predatory State, and Under Dysfunctional Public Order

While, for many commentators, contract enforcement problems and, more generally, a lack of functioning legal institutions have become important factors in explaining differences in the performance of various developing and transition economies,¹¹⁸ it has also been widely recognized that it takes time for these economies to develop such legal institutions. During this transition period, informal mechanisms may fill some gaps and permit some markets to function.

There is a growing body of literature on informal product and credit markets in developing and transition countries that shows the importance of reputation and family or ethnic networks as

¹¹⁴ Id. at 6–7.

¹¹⁵ Berkowitz et al., *supra* note 106, at 164.

¹¹⁶ Id. at 166–68.

¹¹⁷ Id. at 165.

¹¹⁸ See, e.g., Marin & Schnitzer, *supra* note 112, at 10.

screening devices in selecting reliable partners in the absence of formal contract enforcement institutions. For instance, as Cheryl Gray notes, “African businessmen of Asian descent interact primarily with others from the same ethnic background, and Russian managers deal primarily with commercial partners who are familiar from central planning days.”¹¹⁹

Some recent empirical studies on the relationship between modes of contract enforcement and firm financing patterns in developing countries suggest that where formal sources of finance are unavailable to, or very costly for, indigenous firms, informal contracting practices are a major channel for obtaining external, albeit informal, sources of finance. For example, in an empirical study of the impact of ethnicity on financing practices of Kenyan firms, Tyler Biggs, Mayank Raturi, and Pradeep Srivastava find that ethnicity does not affect access to formal sources of finance, but being a member of an ethnic group is significant in explaining access to informal sources of finance, such as supplier credit.¹²⁰ The authors explain this pattern by attributing the availability of informal sources of finance to information and contract enforcement mechanisms that work within ethnic groups but not across them. Informal finance through so-called “back-alley banking” or “curb markets” is also pervasive in some East Asian economies, such as China, Taiwan, and Korea, as a primary source of financing growth in their private sectors.¹²¹

In a case-study of foreign investors in Sri Lanka, Amanda Perry finds that, despite weak governance and rule of law ratings, a majority of foreign investors interviewed had made no investigation of these issues before deciding to invest, and *ex post* investment would not have changed their decision.¹²² For many investors (es-

¹¹⁹ Cheryl W. Gray, *Reforming Legal Systems in Developing and Transition Countries*, *Fin. & Dev.*, Sept. 1997, at 14, 14 (citations omitted).

¹²⁰ Tyler Biggs et al., *Ethnic networks and access to credit: evidence from the manufacturing sector in Kenya*, 49 *J. Econ. Behav. & Org.* 473, 485 (2002).

¹²¹ See, e.g., Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* ix, 223–30 (2002).

¹²² Amanda Perry, *Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence*, 49 *Int'l & Comp. L.Q.* 779, 786 (2000) [hereinafter Perry, *Effective Legal Systems*]; Amanda Perry, *An Ideal Legal System for Attracting Foreign Direct Investment? Some Theory and Reality*, 15 *Am. U. Int'l L. Rev.* 1627, 1642 (2000) [hereinafter Perry, *Ideal Legal System*].

pecially Asian investors), the permeability of the state to special influence may have been seen as an advantage.¹²³ Perry notes that the quality of legal institutions mattered more to large investors than to small investors, and less to investors serving export markets than to those serving the domestic market (contrary to the findings of Berkowitz, Moenius, and Pistor¹²⁴), although she does not differentiate among types of exports.¹²⁵ Some recent studies also find that bilateral investment treaties, under which the host country contracts out of its domestic legal system and into an agreed international legal regime, do not significantly increase foreign direct investment flows; this finding suggests that quality of legal institutions in the host countries may often not be of paramount concern to many foreign investors.¹²⁶

Satu Kähkönen, Young Lee, Patrick Meagher, and Haji Semboja provide other examples of informal contracting practices in Africa, practices that are imperfect substitutes for formal contract enforcement regimes.¹²⁷ Based on surveys and interviews of firms in Tanzania, the authors find that long-term patterns of mutual dependency in repeated interaction provide the primary guarantee of contractual discipline. They note:

¹²³ Perry, *Effective Legal Systems*, supra note 122, at 789–90; Perry, *Ideal Legal System*, supra note 122, at 1650–53.

¹²⁴ Berkowitz et al., supra note 106, at 164–74.

¹²⁵ Perry, *Effective Legal Systems*, supra note 122, at 793, 795–96.

¹²⁶ See Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract Foreign Direct Investment?: Only a Bit . . . and They Could Bite* 9, 18–20 (The World Bank Dev. Research Group, Pol’y Research Working Paper No. 3121, 2003); see also Tom Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, 25 *Int’l Rev. L. & Econ.* 107, 115 (2005); Jennifer Tobin & Susan Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties 2* (Yale Law Sch. Ctr. for Law, Econ. & Pub. Policy, Research Paper No. 293, 2005), available at <http://ssrn.com/abstract=557121>. But see Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 *World Dev.* 1567, 1567 (2005) (suggesting that bilateral investment treaties do in fact increase the flow of foreign direct investment (“FDI”) into developing countries).

¹²⁷ Satu Kähkönen et al., *Contracting Practices in an African Economy: Industrial Firms and Suppliers in Tanzania* (Univ. Md. Ctr. for Institutional Reform and the Informal Sector, Working Paper No. 242, 2001), available at http://www.iris.umd.edu/Reader.aspx?TYPE=FORMAL_PUBLICATION&ID=286c60b0-5ad8-4e0f-b927-f8669c7baad9.

Transactions tend to be documented by simple purchase orders, and the use of legal counsel is rare. Firms' perceptions of the legal system are consistent with research showing a weakly established rule of law, wide judicial discretion, and outdated commercial laws. Not surprisingly, then, examples of fixed non-fungible investments and commercial credit for any appreciable length of time are rare.¹²⁸

As a result, firms in Tanzania "often forego valuable international business opportunities due to [the country's] weak legal environment and the consequent contracting difficulties."¹²⁹ The weak rule of law also has a significant impact on firms' choice of contractual dispute resolution mechanisms. "[F]irms in Tanzania tend to bargain or renegotiate the terms of the contract with [counterparties] rather than resort to legal means" because "[n]on-legal enforcement mechanisms are perceived to be more satisfactory and less disruptive of business relationships than legal ones."¹³⁰

Marcel Fafchamps presents additional evidence of economic activity occurring in a business environment that operates outside of a formal contractual framework.¹³¹ Fafchamps uses survey and anecdotal evidence from African firms to evaluate the degree to which formal rules are used to facilitate or regulate transactions. He finds that Ghanaian and Kenyan firms face regular delivery and payment delays, yet such delays do not prevent them from engaging in repeat transactions through establishing "long term, personalized relationships."¹³² Imperfect compliance with contractual obligations does not stem from a cultural predisposition against formality in contract, however. Rather, it is a result of the recognition by firms that perfect compliance is an ideal that is out of reach for them, their clients, and their suppliers: "Lack of contractual discipline is thus largely a corollary of the prevailing level of economic development. Contract enforcement considerations have profound effects on the way firms deal with each other and with final consumers."¹³³

¹²⁸ *Id.* at 1.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ Fafchamps, *supra* note 25.

¹³² *Id.* at 68.

¹³³ *Id.*

As Greif has observed, informal contract enforcement will most likely prevail when there is no state, “when economic agents expect the state to expropriate rather than protect their property, or when the state is unwilling or unable to secure property rights and enforce contracts.”¹³⁴ A typical example of the state acting as a predator (a “grabbing hand”) rather than a protector (a “helping hand”) can be found in the large “unofficial” economies of post-communist former Soviet states. These economies arise partly as a result of punitive or arbitrary taxation and weak protection of property rights—elements that drive firms to hide assets and profits by “going underground.”¹³⁵ Hernando de Soto also provides a revealing narrative of the informal sector in the Peruvian economy, where private production and transactions operate largely outside the formal legal system because of the severe impediments to, and costs imposed on, formal productive activities.¹³⁶

In this context, it is important to distinguish between private ordering that reflects voluntary “opting out” of the formal legal system (for example, the New York diamond industry), and private ordering that is “forced out” of the formal legal system (for example, the Peruvian private actors in the informal sector and the unofficial economy in transition economies in the former Soviet bloc). According to Robert Ellickson, parties often opt out of the formal legal contract regime when they want to avoid the high costs associated with using courts to resolve disputes, and also when the relationship between the parties is close enough, as between members of an intimately close-knit community, that resorting to a formal legal regime to write and enforce contracts may be perceived as “pollut[ing] the atmosphere of a close relationship by implying that the parties don’t trust each other enough to rely on informal exchange.”¹³⁷

A related question that arises in this context is whether formal contract law and enforcement “crowd-out” or “crowd-in” informal contracting arrangements. That is, are formal contracting and in-

¹³⁴ Greif, *supra* note 101, at 8.

¹³⁵ See Simon Johnson et al., *The Unofficial Economy in Transition*, 1997 *Brookings Papers on Econ. Activity* 159, 159–61 (1997).

¹³⁶ See Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* 4–6 (1990).

¹³⁷ Robert C. Ellickson, *Order Without Law* 247 (1991).

formal contracting substitutes for, or complements to, one another? For example, Uri Gneezy and Aldo Rustichini's widely noted paper on Israeli day care centers provides evidence of the "crowding-out" effect.¹³⁸ In the day care experiment, the authors found that the introduction of a modest fine for parents who were late in picking up children from six selected day care centers actually increased the incidence of this behavior. The authors thus demonstrated that imposing a fine crowded-out prior social norms that constrained parents to limit both the frequency and extent of late pick ups.¹³⁹

The same issue of "crowding out" prior social norms is also examined by Rachel Kranton and Anand Swamy in their analysis of transplantation of legality and formalism from Britain to colonial India.¹⁴⁰ The authors find that the introduction during the colonial period of civil courts to agricultural credit markets in the Bombay Deccan made it easier to enforce credit contracts. This ease of enforcement, in turn, led to increased competition among lenders as well as wider availability and lower cost of credit to Indian farmers.¹⁴¹ However, the presence of the civil courts also reduced lenders' incentives to subsidize farmers' investments in times of crisis, which left farmers more vulnerable.¹⁴² Thus, in this case, formal contract enforcement crowded out the insurance function that was performed previously by informal contracting and enforcement in a less competitive lending sector.¹⁴³

In the same vein, Robert Scott argues—based on experimental evidence—that formal contract enforcement often crowds out informal contractual relationships.¹⁴⁴ This is because formal contracting and enforcement tends to undermine notions of "reciprocal fairness" upon which informal relationships are predicated. This occurs in part because parties insisting on formal contracts and en-

¹³⁸ Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 *J. Legal Stud.* 1 (2000).

¹³⁹ *Id.* at 5–8.

¹⁴⁰ Rachel E. Kranton & Anand V. Swamy, *The hazards of piecemeal reform: british civil courts and the credit market in colonial India*, 58 *J. Dev. Econ.* 1 (1999).

¹⁴¹ *Id.* at 2.

¹⁴² *Id.* at 1–2.

¹⁴³ *Id.* at 3–4.

¹⁴⁴ Robert E. Scott, *The death of contract law*, 54 *U. Toronto L.J.* 369, 388–89 (2004).

forcement mechanisms may be interpreted as signaling that they are non-reciprocitarians.¹⁴⁵

This observation, however, is contradicted in part by experimental evidence presented by Sergio Lazzarini, Gary Miller, and Todd Zenger, who find that “by enforcing contractible exchange dimensions, contracts facilitate the self-enforcement of noncontractible dimensions.”¹⁴⁶ They also find that this “complementarity” effect is important particularly when repetition is unlikely and thus self-enforcement is difficult.¹⁴⁷ Therefore, the authors argue that—at least in non-repeat relationships—formal contract law and enforcement may have a crowding-in effect on informal enforcement mechanisms, such as norms of reciprocity.

Optional private ordering usually does not imply dysfunctional public order and, indeed, is often rendered workable by an effective, background formal legal system that enforces contracts when necessary. Indeed, in most developed countries, the vast majority of litigated civil cases, including contract disputes, result in settlement before adjudication in the shadow of the formal law.¹⁴⁸ In contrast, forced private ordering is frequently a result of the unavailability of an effective formal legal system, however, and therefore can be highly inefficient and carry detrimental effects for long-term institution building. These detrimental effects often occur in economies that are transitioning from central planning to market-based systems because these economies generally lack both functioning legal systems and a strong base of social trust to facilitate transactions.

Vietnam, for example, is currently in transition from a planned economy to a market economy. John McMillan and Christopher Woodruff found that until the late 1990s the country had virtually no commercial code or contract law to regulate transactions or set-

¹⁴⁵ *Id.* at 388.

¹⁴⁶ Sergio G. Lazzarini et al., *Order with Some Law: Complementarity versus Substitution of Formal and Informal Arrangements*, 20 *J.L. Econ. & Org.* 261, 261 (2004).

¹⁴⁷ *Id.* at 264.

¹⁴⁸ For example, the 1991 U.S. Courts Annual Report reveals that only four percent of civil cases ended in trials in the federal courts. See Marc Galanter & Mia L. Cahill, “Most Cases Settle”: Judicial Promotion and Regulation of Settlements, 46 *Stan. L. Rev.* 1339, 1342 (1994).

tle disputes between private agents.¹⁴⁹ Vietnam's unreformed financial sector did not serve small private businesses well; moreover, there were no formal sources of market information, such as trade associations or credit bureaus.¹⁵⁰ The country's private sector is now booming, however, and has been a driving force in Vietnam's economic growth in recent years.

To investigate this paradox, McMillan and Woodruff conducted surveys of privately-owned manufacturing firms in Hanoi and Ho Chi Minh City during 1995–1997. They find that business in the private sector often was conducted through ad hoc strategies devised by entrepreneurs at the ground level. While more than ninety percent of the managers surveyed said the courts were of no use to them in resolving disputes, many entrepreneurs had adopted substitutes for contract law and formal enforcement mechanisms.¹⁵¹ The managers' strategies for contract enforcement included the

¹⁴⁹ John McMillan & Christopher Woodruff, *Dispute Prevention Without Courts in Vietnam*, 15 *J.L. Econ. & Org.* 637, 637–38 (1999) [hereinafter McMillan & Woodruff, *Dispute Prevention*]; see also John McMillan & Christopher Woodruff, *Interfirm Relationships and Informal Credit in Vietnam*, 114 *Q.J. Econ.* 1285, 1286 (1999) [hereinafter McMillan & Woodruff, *Interfirm Relationships*]. Although Vietnam did enact a Civil Code and a Commercial Code in the late 1990s, and subsequently made amendments to these enactments in 2005 to facilitate market activities and clarify property and contractual rights, these legislative reforms have yet to bring any significant impact on Vietnamese commercial life. According to a recent qualitative survey of sixty Vietnamese private companies operating in the construction, wood processing, copper wire trading, electric batteries sales, and computer sales and service industries, conducted during 2004–2006, informal contract enforcement and dispute resolution mechanisms based on family connections, friendship, and more recently, self-regulatory commercial networks, are still overwhelmingly used by private entrepreneurs. In contrast, formal state enforcement mechanisms, such as commercial litigation, are still a rare practice among private entrepreneurs, partly due to the extremely slow pace of court proceedings—as of January 2005, the average time required to enforce a contract through Vietnamese courts was 343 days, involving thirty-seven procedures, according to the World Bank. Not surprisingly, the vast majority of entrepreneurs surveyed preferred to rely on family and relational practices to enforce contracts and collect debts. Vietnamese private companies that are most likely to increase their use of the reforming rights-based and market-facilitating formal legal rules to address contract enforcement issues are those doing business with foreign partners, but they are still in small numbers. See John Gillespie, *Regulating Business Networks in Vietnam* 1 n.1, 4, 7–8 (Sep. 2006) (unpublished manuscript, on file with the Virginia Law Review Association); World Bank, *World Development Indicators 2006*, <http://devdata.worldbank.org/wdi2006/contents/Section5.htm>.

¹⁵⁰ McMillan & Woodruff, *Dispute Prevention*, supra note 149, at 639–41; McMillan & Woodruff, *Interfirm Relationships*, supra note 149, at 1286–88.

¹⁵¹ McMillan & Woodruff, *Dispute Prevention*, supra note 149, at 653.

following: relying on reputation and social networks to select partners; trying to avoid disputes by checking their customers' financial backgrounds and personalities with others who had done business with them; and meeting each other regularly in teahouses and bars to exchange information and discuss market opportunities.¹⁵² McMillan and Woodruff describe the practices of Vietnamese private businesses as contracting "without the shadow of the law and only partly in the shadow of the future" (the "future" being the likelihood of repeat dealings based on reputation).¹⁵³ Here, it is worth noting that many transacting strategies adopted by the Vietnamese entrepreneurs are not attempts to substitute informal for formal contract enforcement. Rather, these strategies represented creative substitutes of nearly simultaneous exchange for long-term, impersonal contracting. In other words, these private strategies seem to be an attempt to avoid, rather than resolve, the problem that formal contract enforcement is designed to address.

Private contract enforcement in the transition economies of the former Soviet Union also presents problems. According to John McMillan, in post-communist transition economies, "repeated games and privatized coercion" substitute for formal legal contract enforcement, because such economies lack a well-established, comprehensive system of commercial law, including contract law.¹⁵⁴ In Bulgaria, for example, private firms often lack trust in formal enforcement mechanisms. As a result, they hesitate to deal with strangers, and often require payment *ex ante* if they do.¹⁵⁵ In Ukraine, banks' loaning practices are based on a careful screening process for selecting trustworthy borrowers. This is done in an informal way, however; the bank owners usually choose borrowers with whom they have personal contacts. Moreover, to reduce risk of default, the maturity of loans is usually short-term; the threat of exclusion from future loans deters the borrowers from defaulting.¹⁵⁶ Indeed, as a general matter in transition economies, firms choose

¹⁵² See *id.* at 650–52.

¹⁵³ *Id.* at 652.

¹⁵⁴ John McMillan, *Markets in transition*, in 2 *Advances in economics and econometrics: theory and applications* 210, 226–27 (David M. Kreps & Kenneth F. Wallis eds., 1997).

¹⁵⁵ Gray, *supra* note 119, at 14.

¹⁵⁶ McMillan, *supra* note 154, at 227.

to do business mostly with customers and suppliers that have established track records of repayment and fulfillment of contractual obligations.

Thus an important question arises: what alternatives are available to transition economies that have neither effective formal contract law and enforcement institutions, at least during the period of transition, nor a solid base of social trust, or so-called "social capital," to substitute for law in facilitating business transactions? For countries with little history of functioning market institutions, like Russia, and where social trust and efficient commercial norms do not exist, how can private agents enforce their contracts? Some scholars have attempted responses, most of which emphasize the role of informal contract enforcement mechanisms based on private or "privatized" coercion, such as private security agencies and mafia.¹⁵⁷ The most salient common feature of such informal enforcement mechanisms is that they have emerged to address contract enforcement problems under a dysfunctional public order. In particular, the use of some private contract enforcement mechanisms is a forced response to the reality of contracting in the shadow of a predatory state.

Perhaps the most revealing example of this phenomenon is the large unofficial economy in Russia, which is estimated to account for over forty percent of the Russian economy.¹⁵⁸ The arbitrary administration of the country's tax code deters firms from operating within the law and forces them to go underground and resort to private means of contract enforcement. Because the majority of Russian businesses are likely in violation of various tax, customs, foreign exchange, or regulatory rules, they will not use the official legal system to resolve disputes for fear of exposure.¹⁵⁹ A predatory state can also have negative implications for the utilization (or more accurately, the under-utilization) of otherwise effective private contract enforcement institutions. For example, although Rus-

¹⁵⁷ See generally Varese, *supra* note 88. See also Avner Greif & Eugene Kandel, Contract Enforcement Institutions: Historical Perspective and Current Status in Russia, *in* *Economic Transition in Eastern Europe and Russia* 291, 315-17 (Edward P. Lazear ed., 1995); Jonathan R. Hay & Andrei Shleifer, Private Enforcement of Public Laws: A Theory of Legal Reform, 88 *Am. Econ. Rev.* 398, 399-401 (1998).

¹⁵⁸ Hay & Shleifer, *supra* note 157, at 399.

¹⁵⁹ *Id.* at 399; see also Bernard Black et al., Russian Privatization and Corporate Governance: What Went Wrong?, 52 *Stan. L. Rev.* 1731, 1752-56 (2000).

sia's commodity exchanges have established private arbitration commissions to enforce contracts, traders have not widely used this form of arbitration to resolve contract disputes because disclosing information to the arbitration commissions could expose their financial interests to the Russian state. This risk of contracting in the shadow of a predatory state has led traders to develop a preference for off-the-market contract enforcement through private enforcers. This approach undermines the effective use of the arbitration mechanism and defeats the purpose of realizing self-governance among the traders whom it was created to serve.¹⁶⁰

Finally, the resurgence of barter in transition economies, such as Russia, is also a response to contractual problems that arise under a dysfunctional public order.¹⁶¹ As discussed earlier, in transition economies, barter solves contract enforcement problems by providing deal-specific collateral for trade credits when firms face liquidity constraints. The advantage of paying with goods rather than money is that goods can be earmarked as property of the creditors.¹⁶² Barter has long-term costs for transition economies' growth prospects, however. It is likely to lead countries in transition to fall into an "institutional trap" that can hinder the establishment and development of a functioning banking system. This result is possible because once barter and personalized exchange get "locked-in," they persist despite being less efficient forms of exchange than more conventional approaches; that is, a type of "path dependency" occurs.¹⁶³ As a result, countries with a large and increasing exposure to barter trade will see the development of their financial sector lag.¹⁶⁴

From the various examples discussed above, we can see that in many developing and transition economies, informal contract enforcement mechanisms usually emerge in the absence of a functioning formal legal system and are often imperfect substitutes for formal state enforcement of contracts. In extreme cases, private or

¹⁶⁰ Timothy Frye, Contracting in the Shadow of the State: Private Arbitration Commissions in Russia, *in* *The Rule of Law and Economic Reform in Russia* 123, 123–24 (Jeffrey D. Sachs & Katharina Pistor eds., 1997).

¹⁶¹ See, e.g., David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism* xiii (1999).

¹⁶² Marin & Schnitzer, *supra* note 112, at 42–43.

¹⁶³ *Id.* at 179–80.

¹⁶⁴ *Id.* at 180.

privatized enforcement not only manifests dysfunctional public order in which the state is unable or unwilling to enforce contracts, but also creates considerable costs for countries' long-term institution-building, which is detrimental to their growth prospects.

E. The "China Enigma"

China's almost consistent nine-to-ten percent economic growth rate over approximately two decades has attracted close attention in development circles. The economic exceptionalism that renders the Chinese example so intriguing arises from the fundamental difference between its political, economic, and legal regimes and those of the world's developed economies. China has an undemocratic and non-transparent political system, which leads to relatively low rankings on most governance indicators, and yet the country's economic growth continues to outpace those of most developed and developing nations.

In China, the absence of a consistently enforced legal framework largely prevents the state from being the credible third-party enforcer of contracts that North suggests is necessary for economic development. Among various institutional weaknesses in the Chinese legal system, courts in China are generally known for a lack of both professional competence and independence from political interference.¹⁶⁵ The courts also suffer from local and departmental protectionism in adjudication and enforcement of judgments.¹⁶⁶ In addition, judicial corruption is regarded as a serious barrier to the realization of the rule of law in Chinese society.¹⁶⁷ Thus, within the context of this Essay, the question is how the China Enigma informs the debate over the role of contract law in promoting a nation's economic growth.

To situate the China Enigma in context, it is critical to note that dependency on formal institutions for achieving economic growth is considerably lower in "catch-up" countries—ones that are transitioning from a low-income equilibrium to a state of rapid growth—

¹⁶⁵ See, e.g., Randall Peerenboom, *China's Long March Toward Rule of Law* 280–82 (2002); Stanley Lubman, *Law of the jungle*, *China Econ. Rev.*, Sept. 2004, at 24, 24–25.

¹⁶⁶ Lubman, *supra* note 165, at 24–25.

¹⁶⁷ Peerenboom, *supra* note 165, at 295–98.

than in countries moving from a middle-income equilibrium to higher levels of income.¹⁶⁸ In other words, different modes of growth at different stages of development may require different policies and depend on different levels of institutional quality. In this sense, China is a catch-up economy that can benefit significantly from the increased productivity that would result from market-oriented reform, even though the country's institutional quality would not be satisfactory to a more developed economy at a higher plateau of the growth trajectory.

There are a number of competing explanations for China's economic success in an environment of weak rule of law. Of relevance to this Essay are two widely accepted, and in our view compelling, arguments. The first is the "credible commitments" argument,¹⁶⁹ which is closely associated with the "performance legitimacy" of the Chinese Communist government. The second is the "informal/de facto property rights" argument, which is tightly linked to China's "market-preserving federalism."¹⁷⁰ Both of these arguments address the role of contract enforcement institutions in China's growth.

¹⁶⁸ Rodrik, *supra* note 28, at 1, 17.

¹⁶⁹ The term "credible commitments" has been used by NIE scholars to identify mechanisms of governance associated with private ordering. These mechanisms can inspire confidence in both contracting and investment respects through actions of a farsighted state aimed at "communicating credible commitments" to private economic agents. See Williamson, *supra* note 12, at 335–36.

¹⁷⁰ The phrase "informal/de facto property rights" generally refers to the actual entitlements enjoyed by Chinese managers in local collectively owned enterprises over their enterprises' assets, including management, usufruct, and disposition, which are not legally recognized. See *id.* at 333–35; see also Donald C. Clarke, *Economic Development and the Rights Hypothesis: The China Problem*, 51 *Am. J. Comp. L.* 89, 104–05 (2003). The phrase "market-preserving federalism" (as opposed to "market-distorting federalism") was coined by some political scientists and economists to describe a particular type of government structure adopted by China that is considered conducive to market expansion and efficiency-enhancing enterprise reform. For a general discussion of the characteristics and economic functions of China's "market-preserving federalism," see Rui J.P. de Figueiredo, Jr. & Barry R. Weingast, *Pathologies of Federalism, Russian Style: Political Institutions and Economic Transition*, 29–31 (Apr. 2002) (unpublished manuscript), http://faculty.haas.berkeley.edu/rui/mpf_russia.pdf (comparing the respective roles of Russia's "market-distorting federalism" and China's "market-preserving federalism" in their economy).

According to the “credible commitments” argument, the “performance legitimacy” (rather than “procedural legitimacy”¹⁷¹) on which the Chinese Communist regime is based requires the government to sustain employment expansion and raise the living standards of the Chinese population by delivering positive economic outcomes driven by high growth rates. One reading of the “credible commitments” argument is that there is an implicit social contract between the Communist Party and the Chinese population that the latter will not press vigorously for more democratic forms of government if the government delivers high levels of economic growth and prosperity. To deliver on this social contract, the Communist Party needs high levels of domestic and foreign investment to help build the legitimacy of its regime on economic performance. Thus, the Party must acquire and maintain a strong reputation for respecting contracts into which domestic and foreign investors enter with the government or its agencies by: first, not fecklessly repudiating contractual commitments; and, second, sanctioning government agencies or officials who do not respect these contracts. Thus, the Communist Party (often through local governments, as explained below), rather than the courts, provides the principal assurance to domestic and foreign investors that their investments will not be subject to political encroachment or expropriation *ex post* (once costs are incurred). More generally, political stability and a strong political commitment to economic development may provide a supportive environment for economic development even in the absence of credible legal institutions.

The “informal/de facto property rights” argument attributes China’s growth to managerial incentives in non state-owned enterprises, particularly township and village enterprises (“TVEs”) controlled by local governments, to engage in profit-oriented production and transactions.¹⁷² These managerial incentives were driven by relatively high levels of predictability that the state would not arbitrarily confiscate property and expropriate returns on invest-

¹⁷¹ For a discussion of the legitimacy crisis in post-communist authoritarian regimes, see Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* 46–58 (1991).

¹⁷² Clarke, *supra* note 170, at 104–09.

ment through predatory taxation, even though there were no legally recognized private property rights.¹⁷³

As to the rationale for local governments not to engage in arbitrary confiscation and expropriation, some have suggested that China's fiscal federalism and regional competition in product markets have led local governments to act in a "market-preserving" manner that is conducive to market expansion and efficiency-enhancing enterprise reform.¹⁷⁴ Under China's fiscal federalism, local governments face budget constraints and require stable revenues from local enterprises to finance local affairs; thus, the governments have strong incentives to secure property rights in local enterprises in order to promote their performance and increase their competitiveness in cross-regional markets. Local government officials also have incentives not to infringe arbitrarily upon property rights because of the cadre evaluation system used by the Communist Party; this system sets criteria for the performance—and hence the remuneration and promotion prospects—of local party cadres and government officials. Under the system, the most heavily weighted performance criteria emphasize promoting economic growth, collecting tax revenues, and generating employment opportunities, which cannot be easily achieved without according local businesses a considerable degree of security in property rights.¹⁷⁵

In sum, the "de facto property rights" argument implies that contract enforcement institutions were not as critical as property rights protection in supporting China's growth, at least at early stages of the transition; this is true insofar as the property rights protection provided much needed predictability to create private incentives to engage in efficiency-enhancing activities. This argu-

¹⁷³ *Id.* at 107.

¹⁷⁴ See Yingyi Qian, *How Reform Worked in China, in In Search of Prosperity: Analytical Narratives on Economic Growth*, *supra* note 28, at 297, 314–18 (discussing the role of fiscal federalism in economic growth); see also Shaomin Li & Shuhe Li, *The Road to Capitalism: Competition and Institutional Change in China*, 28 *J. Comp. Econ.* 269, 283–84 (2000) (arguing that competition among local economies in China promotes efficiency-enhancing enterprise reform).

¹⁷⁵ Donald Clarke et al., *The Role of Law in China's Economic Development* 26–27 (George Wash. Univ. Law Sch. Pub. Law & Legal Theory, Working Paper No. 187, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=878672.

ment thus discounts the primacy that North accords to third-party contract enforcement.

The “de facto property rights” inducement for economic performance has a significant limitation, however. Oliver Williamson predicted that, under China’s relation-based governance of contract enforcement and property rights protection, necessary investment in leading-edge technologies would be reduced or stymied, because in such an institutional environment there is a significant risk that large sunk costs in highly specific investments will not be recovered.¹⁷⁶ This prediction seems to be vindicated partly by recent reports that the technology content of Chinese exports is contributed largely by foreign-funded enterprises, while indigenous firms suffer from lagging technological innovation due to severe underinvestment in research and development initiatives.¹⁷⁷

We note here also the rise in corporatism and clientelism as a means of introducing market-type mechanisms into economic interactions absent an actual market.¹⁷⁸ Corporatism is an institutionalized relationship between government, trade, and industry that incorporates economic activity into the governance structure. Victor Nee and Sijin Su argue that the economic activity arising from the interaction between entrepreneurs and local government officials is made possible by the role of social institutions.¹⁷⁹ In the case of China, institutional arrangements that support private property claims and promote repeated social exchange create the trust and cooperation that individuals require to participate in economic transactions. John McMillan and Barry Naughton make a similar observation that “[c]ontracts in China are less legal than relational. Businesspeople in China keep their promises (most of the time) not because they are required to by the law, but because . . . renegeing on a ‘contract’ is likely to destroy the businessperson’s ability to do business in the future.”¹⁸⁰ A recent study by Donald Clarke, Pe-

¹⁷⁶ Williamson, *supra* note 12, at 334–35.

¹⁷⁷ George J. Gilboy, *The Myth Behind China’s Miracle*, *Foreign Aff.*, July–Aug. 2004, at 33, 34.

¹⁷⁸ Victor Nee & Sijin Su, *Institutions, Social Ties, and Commitment in China’s Corporatist Transformation*, *in Reforming Asian Socialism: The Growth of Market Institutions* 111, 132–33 (John McMillan & Barry Naughton eds., 1996).

¹⁷⁹ *Id.*

¹⁸⁰ John McMillan & Barry Naughton, *Elements of Economic Transition*, *in Reforming Asian Socialism*, *supra* note 178, at 3, 8.

ter Murrell, and Susan Whiting on the role of law in China's economic development finds that informal contract enforcement mechanisms, such as negotiation, mediation, and self-enforcement through reputation and long-term relationships, are used extensively by Chinese businesses.¹⁸¹

Recent research on contract enforcement during China's economic transition reveals more aspects of the interaction between local governments and private businesses. Most notably, Huang Shaoqin finds that local government officials have often acted as liaisons between private contracting parties in assuring contract enforcement, especially when one contracting party is from outside the local jurisdiction.¹⁸² Because local government officials have at their disposal both formal administrative powers (which usually dictate the allocation of local economic and social resources), and favorable access to local networks of *guanxi* (social connections), they have a huge advantage in linking the formal and informal elements of local business environment, both of which are required for effective enforcement of contracts.¹⁸³ According to Huang, Chinese private entrepreneurs have established an innovative method of enforcing contracts for impersonal transactions when they conduct business with partners from other localities: find in the host jurisdiction a local government official as their "agent for contract enforcement."¹⁸⁴ Sometimes this requires assistance from a third party who acts as the broker between the local official and the outside entrepreneur. In most cases, personal investment by the outside entrepreneur through contributions of in-kind consumption to local officials (instead of outright bribes) is a prerequisite to the establishment of a stable relationship.¹⁸⁵ As a result, the local government official, now acting as the "agent" on behalf of the outside contracting party, exercises influence or pressures on local contracting parties in their fulfillment of contractual commitments.¹⁸⁶ Huang concludes that, although this informal mechanism for con-

¹⁸¹ Clarke et al., *supra* note 175, at 38.

¹⁸² Huang Shaoqin, A Study of Contract Enforcement Mechanisms in China during Transition (*zhongguo zhuangui shiqi hetong zhixing jizhi yanjiu*), 3 *J. Legal & Econ. Studies* (Hong Fan Ping Lun) 184, 192 (2006).

¹⁸³ *Id.* at 188–89.

¹⁸⁴ *Id.* at 192.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

tract enforcement has been beneficial for promoting cross-region commerce and expanding local markets at early stages of China's transition,¹⁸⁷ in the long term, it will lead to the worsening of multiple deficiencies in China's social, political, economic, and legal institutions, eventually making the country fall into the trap of "crony capitalism."¹⁸⁸

Similarly, corporatism and clientelism in China can also create significant costs, which are often manifested in their localized or regionalized nature; this phenomenon is fundamentally harmful to the establishment of an integrated national market and the evolution of nationwide commercial norms. This is because, as Peerenboom notes, "[c]lientelist social networks are more likely to divide than to unite."¹⁸⁹ As a result, as far as contract disputes are concerned, local protectionism has been a serious impediment to effective enforcement of court judgments and arbitration awards by local courts (which are financed by local governments) when the winning party is from outside the local jurisdiction.¹⁹⁰ In recent years, foreign enterprises have also faced this difficulty.¹⁹¹ While local protectionism is one of the most cited reasons for difficulties in enforcing civil judgments in China, other factors also contribute to this problem, including widespread insolvency of debtor state-owned enterprises, courts' reluctance to use coercive measures in

¹⁸⁷ *Id.* at 198–204.

¹⁸⁸ *Id.*

¹⁸⁹ Randall Peerenboom, *Social Networks, Rule of Law and Economic Growth in China: The Elusive Pursuit of the Right Combination of Public and Private Ordering*, 31 *Global Econ. Rev.* 1, 16 (2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=372740.

¹⁹⁰ The problem of difficulties in enforcing civil judgments in China has been extensively documented in both Chinese and English literature. See, e.g., Stanley B. Lubman, *Bird in a Cage: Legal Reform in China after Mao* 266–69 (1999); Donald C. Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments*, 10 *Colum. J. Asian L.* 1 (1996); Minxin Pei, *Does Legal Reform Protect Economic Transactions? Commercial Disputes in China*, in *Assessing the Value of Law in Transition Economies*, supra note 85, at 180, 190–94; Half of China's civil court rulings remain on paper, *People's Daily* (Beijing), Mar. 13, 2004, http://english.peopledaily.com.cn/200403/13/eng20040313_137390.shtml [hereinafter *People's Daily*].

¹⁹¹ See Lubman, supra note 165, at 24–25.

civil cases, the lack of finality of court proceedings, and inadequate administrative resources at courts' disposal.¹⁹²

According to estimates by the head of the judgment enforcement division of the nation's highest court, the average rate for enforcing civil and economic judgments in China is sixty percent at the basic-level court, fifty percent at the intermediate-level court, and forty percent at the provincial higher-level court,¹⁹³ meaning that roughly half of Chinese court rulings exist only on paper. Interestingly, while the Chinese legal community routinely identifies difficulties in enforcing judgments as a major obstacle to effective administration of justice in the country, some Western commentators wonder whether those reported enforcement rates are indeed "low" in a comparative sense.¹⁹⁴ For example, Donald Clarke cites the enforcement problem in the United States as a reference point to question the relative level of severity of the enforcement problem in China.¹⁹⁵ According to him, a 1993 study commissioned by the New Jersey Supreme Court "found that in eleven New Jersey counties surveyed for the year 1987, only 25 percent of writs of execution in civil cases (this category excludes small claims and landlord-tenant cases) were returned fully satisfied"; in small claims cases, the number was thirty-seven percent.¹⁹⁶ Because of the lack of comparable systemic data as well as diverse social realities between countries, however, the extent to which data on judgment enforcement in China and developed countries, such as the United States, are comparable is not clear.¹⁹⁷

Questions about whether judgment enforcement rates in China are "low" aside, we are inclined nevertheless to consider the enforcement issue a serious problem. We consider it to be so not only because the official statistics on enforcement rates may not reflect the real situation (given the possibility of under-reporting by local courts), but also because the kind of contract dispute that is most likely to involve significant amounts of unpaid debt—disputes in-

¹⁹² See Clarke, *supra* note 190, at 34–68; see also People's Daily, *supra* note 190 (describing the courts' inadequate overhead expenses).

¹⁹³ Clarke et al., *supra* note 175, at 42.

¹⁹⁴ *Id.*

¹⁹⁵ Clarke, *supra* note 190, at 33–34.

¹⁹⁶ *Id.* at 34.

¹⁹⁷ *Id.* at 33–34.

volving banks and state-owned enterprises—only yields an average enforcement rate of twelve percent according to *official* estimates.¹⁹⁸

China has experienced dramatic growth in civil litigation over the past decade, leading some commentators to claim that Chinese courts “appear to play an increasingly significant role” in dispute resolution during the reform period.¹⁹⁹ The effectiveness of courts and the level of satisfaction with formal contract enforcement institutions among both domestic and foreign investors suggest significant deficiencies, however.²⁰⁰ In contract disputes, litigants raise concerns about difficulties in enforcing judicial judgments and also about the observed fact that, when it is necessary for courts to adjudicate the substantive contractual rights and obligations, it is not uncommon for Chinese courts to invalidate private contracts, sometimes on formal grounds, thus frustrating the expectations of the parties.²⁰¹ Notably, in China, court-sponsored mediation is widely used to reach a settlement after commercial litigation com-

¹⁹⁸ People’s Daily, *supra* note 190.

¹⁹⁹ Clarke et al., *supra* note 175, at 40. There, the authors report that contract dispute litigation accounts for the lion’s share of all economic dispute cases accepted by the courts during the reform era, increasing at an average annual rate of 20.1 percent between 1983 and 2001. *Id.* Moreover, according to official statistics, over the past decade or so, the number of legal professionals, particularly lawyers, has also seen dramatic growth—the number of lawyers (including lawyers working full-time and part-time) increased from 83,619 at the end of 1994 to 142,543 at the end of 2003. See Law Y.B. China (Zhongguo Falü Nianjian) (1995–2004) (on file with the authors).

²⁰⁰ While the judiciary in China has often been subject to criticism for failing to enforce the law in an impartial and effective manner, its commercial arbitration system, which is generally regarded as part of the formal contract enforcement institution in China because arbitration awards need to be enforced through courts, also faces increasing dissatisfaction by foreign investors. See, e.g., Jerome A. Cohen, Time to Fix China’s Arbitration, 168 *Far E. Econ. Rev.*, Jan. 2005, at 31; Lubman, *supra* note 165, at 24–25.

²⁰¹ The existence of this tendency of Chinese courts to invalidate private contracts is suggested by Professor Fang Liufang, a respected expert on Chinese civil and commercial law at China University of Political Science and Law. Telephone Interview with Fang Liufang, Professor, China University of Political Science and Law (Feb. 9, 2006). This assessment is also confirmed by Dr. Xie Hongfei of the Chinese Academy of Social Sciences, based on information collected by Xie from some judges of the High Court of Beijing Municipality, Chaoyang District Court of Beijing Municipality, Intermediate Court of Liaocheng Municipality of Shandong Province, and High Court of Henan Province. E-mail from Xie Hongfei, Chinese Academy of Social Sciences, to Jing Leng, Post-Doctoral Fellow, University of Hong Kong (Feb. 16, 2006, 01:41 EST) (on file with the authors).

mences. Government officials often participate when unmet contractual obligations may result in lay-offs or non-payment of wages by an enterprise in financial distress. Mediation is also reportedly susceptible to the influence of *guanxi* in both personal and organizational relationships; this vulnerability undermines the autonomy of contracting parties.²⁰²

Despite the problems associated with both adjudication and enforcement processes, there has been a significant increase in the number of contract disputes filed with the courts in China, because a number of private economic activities, many of which have expanded after economic reforms began to accelerate in the 1990s, are mandated by the law to take the form of formal contracting.²⁰³ These activities include the establishment of trading companies and foreign-invested enterprises, insurance contracts, bank loan agreements, transactions in real estate, issuance of stocks, mergers and acquisitions of corporations, and business partnerships.²⁰⁴ The fact that these activities must employ formal contracting to a large extent explains the trend toward a more litigious society in China from the supply side. Not only do private parties go to court for contract enforcement more frequently, but state-owned commercial banks and state-owned enterprises, especially large enterprises, also constitute a significant fraction of litigants in contract disputes.²⁰⁵ This occurs for reasons similar to those that apply to large Russian firms: to signal that managers are not in a conspiracy with defaulting debtors to expropriate state funds or assets. This concern is especially pertinent in the context of problems caused by non-performing loans in the Chinese banking sector.

The social institutions that have developed in China may be conducive to increasing the level of economic activity, but it is important to note the actors involved. While the adoption and adaptation of market-derived structures into the Chinese economy have been conducive to foreign investment, the majority of the investment either comes from, or is facilitated by, investors from Hong

²⁰² See Clarke et al., *supra* note 175, at 41–42.

²⁰³ E-mail from Fang Liufang, Professor, China University of Political Science and Law, to Jing Leng, Post-Doctoral Fellow, University of Hong Kong (Feb. 14, 2006, 23:21 EST).

²⁰⁴ *Id.*

²⁰⁵ *Id.*

Kong, Taiwan, and overseas Chinese business networks. Indeed, some estimates suggest that the ethnically Chinese economies of Hong Kong, Taiwan, and Macao have contributed roughly sixty percent of total foreign direct investment in mainland China between 1978 and 1999.²⁰⁶ Graham Mayeda indicates that the degree “of investment by non-resident Chinese indicates that foreign investors in China can take advantage of the familiarity of ethnically Chinese business-people with the informal norms of Chinese business.”²⁰⁷ According to Noel Tracy and Constance Lever-Tracy, “Chinese business tends to be conducted through a series of personalized networks based on friendship and trust, which are given substance by long-term relationships and reputation for trustworthiness and reliability, rather than in the open marketplace or in an institutional framework.”²⁰⁸ When investing in mainland China, members of the Chinese diaspora usually first acquaint themselves with the local officials in the town or village in which they are considering investing. Existing connections within the diaspora—forged through common origins of linguistic and geographical identities—have also become a critical business advantage in fostering the expansion of connections. Linked connections, and the resulting networking effect, in turn buttress predictability and compliance in contract enforcement. Consequently, the enormous strength of the Chinese diaspora business network is the ability “to make horizontal linkages when the vertical hierarchical structures are not necessarily supportive of their business endeavors.”²⁰⁹

In summary, the relationship between law, including contract law, and economic development in China seems to suggest reverse causality. According to Clarke, Murrell, and Whiting:

Although the legal system has made great strides since the beginning of reforms and currently has a role of some significance

²⁰⁶ Yasheng Huang, *Selling China: Foreign Direct Investment during the Reform Era* 36 (2003).

²⁰⁷ Graham Mayeda, *Appreciate the Difference: The Role of Different Domestic Norms in Law and Development Reform—Lessons from China and Japan*, 51 *McGill L.J.* (forthcoming 2006) (manuscript at 33, on file with the Virginia Law Review Association).

²⁰⁸ See Noel Tracy & Constance Lever-Tracy, *A new alliance for profit: China's local industries and the Chinese diaspora*, in *Chinese Entrepreneurship and Asian Business Networks* 65, 71–72 (Thomas Menkhoff & Solvay Gerke eds., 2002).

²⁰⁹ *Id.* at 72.

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in the economy, it is impossible to make the case that formal legal institutions have contributed in an important way to China's remarkable economic success. If anything, *economic success has fostered the development of law, rather than the reverse.*²¹⁰

Clarke and his colleagues argue that while it is quite plausible that the “‘political, social, and economic equilibrium’ . . . in China over the last two decades upheld contract and property rights to some reasonable degree . . . the legal system was not by any means the central element supporting that equilibrium”²¹¹ The authors conclude that the “rights hypothesis” advanced by Weber and North that views formal institutions of property rights protection and contract enforcement as a prerequisite for development “clearly fails in the case of China.”²¹²

F. The “East Asian Miracle”

According to Frank Upham, “the experience of Asian economies demonstrates that the strict judicial enforcement of property and contract rights is not necessary to economic growth”²¹³ Specifically, the well-known “East Asian Miracle” achieved not only by China, but also by Japan, Korea, Taiwan, Malaysia, and other well-performing countries in the region, has presented a critical challenge to rule of law orthodoxy.

Upham's analysis of Japanese economic development offers evidence that formal contract enforcement is not a prerequisite to a nation's economic development.²¹⁴ He cites the fact that through the second half of the twentieth century, while Japan underwent dramatic economic development, it simultaneously experienced a shrinking of its legal system, measured in part by a decrease in the number of professionals that work in the system and a corresponding decrease in litigation rates.²¹⁵ Upham goes a step further with

²¹⁰ Clarke et al., *supra* note 175, at 51 (emphasis added).

²¹¹ *Id.* at 52.

²¹² *Id.*

²¹³ Frank K. Upham, *Speculations on Legal Informality: on Winn's “Relational Practices and the Marginalization of Law,”* 28 *Law & Soc'y Rev.* 233, 237 (1994).

²¹⁴ Frank Upham, *Mythmaking in the Rule of Law Orthodoxy* 21–31 (Democracy & Rule of Law Project at the Carnegie Endowment for Int'l Peace, Rule of Law Series, Working Paper No. 30, 2002).

²¹⁵ *Id.* at 23–24.

regard to the role he accords to formal legal institutions. He contends that in some developing nations, informal contract enforcement mechanisms are not mere complements to formal mechanisms; rather, introducing externally derived formal institutions may undermine the success of existing economic activity that is facilitated by informal social institutions and may disrupt or displace valuable indigenous institutions (the “crowding-out” hypothesis).²¹⁶

It is important to recognize, however, the idiosyncrasies of the Japanese context that limit its utility as a generalized model for development. First, the Japanese population is extremely culturally homogeneous. This homogeneity might allow Japanese cultural norms of social interaction—specifically, cultural norms of integrity and reciprocity—to inform business relations and thereby obviate a need for frequent formal contract enforcement. There are few developing countries today, however, that have similarly homogeneous populations. Indeed, for many developing countries, ethnic, religious, tribal, or cultural heterogeneity and fragmentation are the rule rather than the exception.²¹⁷ Thus, any argument suggesting that cultural norms of behavior could act as a substitute for formal laws enforcing a private ordering regime has limited practical scope. A second factor that limits the generalizations that can be made about the Japanese experience is its consistently limited reliance on foreign investment relative to most other nations. The current consensus in development circles regards foreign investment as an indispensable means of facilitating countries’ economic growth; it seems unlikely that many developing countries can afford to follow Japan’s example. Thus, the Japanese experience demonstrates that economic development *can* occur without state enforcement of contracts. But cultural and economic characteristics peculiar to Japan, and Japan’s unusual independence from foreign investment, suggest caution in using single successful cases as evidence to discount the North position.

²¹⁶ Id. at 32–33.

²¹⁷ See Robert Klitgaard, *Adjusting to Reality: Beyond “State versus Market”* in *Economic Development* 169–74 (1991); Pranab Bardhan, *Method in the Madness? A Political-Economy Analysis of the Ethnic Conflicts in Less Developed Countries*, 25 *World Dev.* 1381, 1381 (1997); William Easterly & Ross Levine, *Africa’s Growth Tragedy: Policies and Ethnic Divisions*, 112 *Q.J. Econ.* 1203, 1206–07 (1997).

Some critical observers also question the merits of the Japanese experience in solving disputes outside of a formal legal system. For example, by referring to the “dark side of private ordering,” Curtis Milhaupt and Mark West observe that members of organized crime in Japan are active in commercial areas such as “dispute mediation, real estate foreclosure, corporate monitoring, [and] lending.”²¹⁸ Regarding the relationship between this “dark side” of private ordering and the deficiencies in Japan’s public-order institutions for property rights and contract enforcement, they note: “in Japan, the activities of organized criminal firms closely track inefficiencies in formal legal structures, including both inefficient substantive laws and a state-induced shortage of legal professionals and other rights-enforcement agents.”²¹⁹ Therefore, the Japanese model of contract enforcement through private ordering cannot plausibly be optimal and without significant limitations, as Upham seems to imply.

We now examine how other economies in the “East Asian Miracle” achieved economic growth without an orthodox rule of law model (with the notable exceptions of Singapore and Hong Kong, which achieve strong rule of law ratings despite low democracy ratings). In particular, we explore how contract enforcement institutions have featured in the process of economic growth.

In 1996, the Asian Development Bank commissioned a comparative study on the relationship between law and economic development in Asia during a thirty-five-year period of dynamic economic growth from 1960 to 1995.²²⁰ One of the issues examined in this study was the role of dispute settlement institutions in resolving commercial disputes and facilitating contract enforcement between non-state parties. One major finding was that “[o]ver the long term, rates for litigation concerning civil and commercial disputes increased in all economies.”²²¹ The available empirical data on the sample economies show a positive and statistically significant correlation between per capita litigation rates (which indicate

²¹⁸ Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 *U. Chi. L. Rev.* 41, 44 (2000).

²¹⁹ *Id.* at 41.

²²⁰ Katharina Pistor & Philip A. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development 1960–1995* (1999).

²²¹ *Id.* at 215.

the frequency and extent of the use by private-sector agents of formal dispute settlement institutions, such as courts) and indicators for the division of labor (which can be viewed as a useful proxy for the level of economic development).²²²

The above finding seems to support the “Convergence Hypothesis” proposed by the authors, “which suggests that with economic development, legal institutions will perform increasingly similar functions throughout the world.”²²³ On its face, the North proposition appears to gain some support from this study, to the extent that the evidence indicates a positive link between formal contract dispute resolution and economic development in the sample East Asian economies. The Asian Development Bank study does not, however, control for other factors (such as human capital accumulation and good policies) that might have independently contributed to some Asian economies’ growth. Instead, the study treats the frequency and extent of the use of courts as an independent, exogenous variable in measuring its relationship with economic growth. It may well be the case that increased use of the courts in commercial dispute resolution is a result, not a cause, of economic development that has expanded markets and broadened the range of economic interactions. In short, reverse causality is possible.

The recent trend toward a more litigious society in China, noted above, is consistent with what has occurred in other Asian economies as they have reached higher stages of growth. Even in previously “non-litigious” Japan, recent data collected by Tom Ginsburg and Glenn Hoetker indicate a rapid increase in civil litigation and a resort to formal contract enforcement; this increase followed the relaxation in the 1990s of various institutional constraints on the use of the formal legal system, such as the relative paucity of lawyers and costly trial procedures.²²⁴ The authors note that, “[a]s legal reform was proceeding, Japanese began to litigate more frequently.”²²⁵ They also predict, interestingly, that the relationship between economic change and litigation will be “inverse,” in that sustained economic downturns, as recently experienced by Japan,

²²² *Id.*

²²³ *Id.*

²²⁴ Tom Ginsburg & Glenn Hoetker, *The Unreluctant Litigant? An Empirical Analysis of Japan’s Turn to Litigation*, 35 *J. Legal Stud.* 31, 36, 56 (2006).

²²⁵ *Id.* at 36.

are likely to lead to the breaking of at least some long-term commercial relationships, thus resulting in more litigation.²²⁶ This prediction also seems to suggest reverse causality, running from structural changes in the economy to wider use of formal contract enforcement mechanisms. While we do not believe that more litigation causes economic growth (nor does the Asian Development Bank study suggest this), we are inclined to draw a general observation from the empirical evidence, surveyed above, that formal contract enforcement becomes more widely used at higher levels of growth in most of the East Asian economies.

From a political economy perspective, the most frequently offered explanations for the so-called “East Asian Miracle” generally attribute economic growth in these economies to the role of their respective governments in coordinating development and maintaining political and macro-economic stability. These explanations vary, however, in their accounts of exactly what role the respective governments played, ranging from the “market-friendly” view to the “developmental-state” view.²²⁷ Of particular relevance to the discussion in this Essay is the theory of “relation-based governance” advanced by Shuhe Li in explaining the “East Asian Miracle” and the subsequent financial crisis from 1997 to 1998.²²⁸

According to Li, the relation-based governance model had been widely adopted by the East Asian economies over the three dec-

²²⁶ Id. at 42–43.

²²⁷ See, e.g., The World Bank, *The East Asian Miracle* 1–15 (1993). Both the “market-friendly” view and the “developmental-state” view regard markets as the initial basis for organization in the private sector and recognize that market failures are pervasive in catch-up economies. These approaches differ fundamentally, however, in their solutions to market failures or imperfections. The “market-friendly” view regards private-sector initiatives and institutions as the primary remedy and the role of government as only complementary and limited to providing a legal infrastructure for market transactions and public goods. In contrast, the “developmental-state” view looks to government intervention as the solution. A third view—the “market-enhancing” view—later emerged, reflecting an attempt to explore a middle ground that reconciles the “market-friendly” view with the “developmental-state” view, and arguing that the success of the East Asian economies was largely attributable to the role government policy played in facilitating or complementing private-sector coordination at an early stage of development. See Masahiko Aoki et al., *Beyond The East Asian Miracle: Introducing the Market-Enhancing View*, in *The Role of Government in East Asian Economic Development* 1, 1–2, 8–11 (Masahiko Aoki et al. eds., 1996).

²²⁸ John Shuhe Li, *Relation-based versus Rule-based Governance: an Explanation of the East Asian Miracle and Asian Crisis*, 11 *Rev. Int’l Econ.* 651 (2003).

ades prior to the crisis. The model was manifested in two salient phenomena: (1) “agreements [were] largely implicit, personal, and enforced outside of courtrooms”; and (2) “government, banks, and firms ha[d] close relations.”²²⁹ In coordinating economic activities, relation-based governance has both benefits (such as information and transaction costs advantages when the economy is characterized by long-term relationships and a small number of players)²³⁰ and costs (including non-transparency and “dampening private incentives to discover or experiment with superior coordination tactics”).²³¹ At early stages of economic catch-up, however, the benefits of relation-based governance tend to outweigh its costs.²³²

Under a relation-based governance model, the government plays an active role in organizing centralized finance through state-controlled banks and in encouraging and directing private and public investments to strategic firms and industries. Pranab Bardhan and Dani Rodrik both note that East Asian economies achieved economic coordination not through a formal contract law regime, but through government (often bureaucratic) intervention; this coordination was particularly prevalent in the organization of corporate finance, the formation of capital, and the “acquisition . . . of financial expertise in new industrial sectors in periods of large-scale reconstruction and acute scarcity of capital and skills”²³³

This government involvement proved conducive to economic growth in the East Asian countries because it provided appropriate positive and negative incentives to economic agents in raising long-term finance for industrial development.²³⁴ Although it was not carried out in the courts, the state nonetheless guaranteed financial sector contract enforcement in a predictable manner. This financial contracting—a critical component of development-enhancing economic activities for catch-up economies—was largely guided by a politically stable state strongly committed to economic development and able to process information and channel aggregate coor-

²²⁹ *Id.* at 652.

²³⁰ *Id.* at 658.

²³¹ Bardhan, *supra* note 105, at 516; see also Li, *supra* note 228, at 661.

²³² See Li, *supra* note 228, at 659–60.

²³³ Bardhan, *supra* note 105, at 517; see also Dani Rodrik, Getting interventions right: how South Korea and Taiwan grew rich, *Econ. Pol’y*, Apr. 1995, at 53, 78–79.

²³⁴ Bardhan, *supra* note 105, at 527.

dination in the financial market.²³⁵ This phenomenon again raises an important caveat regarding the relation-based governance model: the East Asian experience in organizing centralized finance is hardly transferable to most developing economies in Africa, Latin America, and the former Soviet Union, whose governments have not demonstrated comparable ability to act as catalysts and coordinators of financial markets.²³⁶

We do not take a strong position on whether a highly proactive developmental state was a precondition to the successful economic development of the East Asian economies (where this development has been at the center of a long-standing debate between proponents of the “market-friendly” view and proponents of the “developmental-state” view). We emphasize here the role of political stability, and, on a related note, macro-economic stability, in providing the assurances that both domestic and foreign investors need in order to make long-term investments. Long-term commitment to development goals by the political regimes or elites in these countries plays a significant role in providing these assurances.

Within the high-growth Asian economies, what are the implications of the Asian financial crisis of the late 1990s for relation-based governance, which is claimed to be a major explanation for the “East Asian Miracle”? In the 1990s, the Association of South-east Asian Nations (“ASEAN”) already represented one of the regions most dependent on foreign trade and foreign direct investment. Therefore, the Asian crisis “did not happen because the region lacked capital and export opportunities but because poor corporate governance and rampant corruption led to massive wastage of capital and inefficiencies in the corporate sector.”²³⁷ The underlying cause for these economic and institutional deficiencies, according to Li, is the inevitable “self-destructive” nature of relation-based governance. Eventually, these economies reached a turning point where rule-based governance became more cost-effective; this point occurred upon the transition from catch-up mercantile

²³⁵ Id. at 517–18; Rodrik, *supra* note 233, at 78–79.

²³⁶ See Bardhan, *supra* note 105, at 518.

²³⁷ Yasheng Huang & Bernard Yeung, ASEAN’s institutions are still in poor shape, *Fin. Times* (London), Sept. 2, 2004, at 17.

states to industrialized economies.²³⁸ The transformation of these economies from relation-based governance to rule-based governance, which stresses the role of formal law and contract enforcement institutions, began shortly before the Asian crisis. The institutional adjustments and vacuum left by the retreating relation-based governance—but not yet occupied by the emerging rule-based governance—created increased uncertainties and risks in these economies, especially at a time when financial liberalization accompanied this process.²³⁹ As a result, the Asian crisis erupted as a manifestation of the costs of the transition from relation-based governance to rule-based governance in a competitive global economy.

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

²³⁸ Li, *supra* note 228, at 659.

²³⁹ *Id.* at 665–66. Notably, it has been suggested that the remarkably quick turnaround of the Asian economies badly hit by the Asian financial crisis demonstrates the “strength” of informal institutions in their private sector, particularly the availability of informal finance provided by family and social networks. See Peerenboom, *supra* note 189, at 2.

CONCLUSIONS

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

To take first the case made by the contract formalists, it is clear that in both developed and developing countries, many contracts are self-enforcing. Often because of ethnic, religious, or cultural ties, informal transacting norms arise and are enforced through informal, extra-legal sanctions. Even in the absence of such contracting networks, long-term, incomplete contingent claims contracts are commonplace between arm's length business parties in both developed and developing economies. Where these contracts include substantial investments in relationship-specific assets, there are strong incentives to maintain the relationship. Of course, even long-term relational contracts eventually come to an end and, depending on the nature of dependencies or interdependencies that they create, these contracts are vulnerable to problems of hold up and opportunism ("end-game" problems). These problems can sometimes only be solved by complete vertical integration, although this may not otherwise be efficient.²⁴⁰

As noted earlier in this Essay, Williamson argues that both spot market and hierarchical (corporate integration) transactions require little support from the formal legal system; in contrast, middle range transactions (long-term contracting) are particularly vulnerable absent credible third-party enforcement mechanisms.²⁴¹ Williamson's claim implies a continuum of forms of economic co-

²⁴⁰ See, e.g., Robert Cooter & Thomas Ulen, *Law and Economics* 225–35 (4th ed. 2004); Lawrence M. Friedman, *Contract Law in America* 89 (1965); Paul Milgrom & John Roberts, *Economics, Organization and Management* 131–40 (1992); Goetz & Scott, *supra* note 94, at 1090–91; Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *J. Pol. Econ.* 615 (1981); Macaulay, *supra* note 92, at 58–59; Ian R. Macneil, *Contracts: Adjustment of Long Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 *Nw. U. L. Rev.* 854, 889–90 (1978); Ian R. Macneil, *The Many Futures of Contracts*, 47 *S. Cal. L. Rev.* 691, 758–59 (1974).

²⁴¹ Williamson, *supra* note 12, at 332.

ordination or cooperation in catch-up economies, with complete vertical integration at one end, spot markets at the other, and a large vacuum in the middle.

Even with respect to Williamson's two polar cases, however, it is not true that vertical integration can completely avoid the problems of a weak formal legal system. As a number of commentators have argued, and corroborated empirically, countries with poorer investor protection, measured by both the character of legal rules and the quality of legal enforcement, have smaller and narrower capital markets; this is particularly evident when minority shareholders are subject to serious agency costs (opportunism) by managers or controlling shareholders.²⁴² Moreover, employment contracts, including non-compete clauses and collective agreements, often require a formal enforcement mechanism. In any event, as Williamson himself acknowledges, vertical integration may be less efficient than other forms of economic coordination that an effective formal contract regime may facilitate.²⁴³ At the other pole, even spot transactions (for example, commodity contracts) may raise quality or product defect problems that require resort to the formal legal system, at least in the absence of industry or trade associations with their own codes of conduct, norms, and alternative dispute settlement mechanisms.²⁴⁴

Between these two poles, as we have seen, Williamson exaggerates the importance of formal contract enforcement by ignoring the role of relational contracting. He also ignores contract enforcement by private sector third parties such as credit companies, bourses, exchanges, arbitrators, and industry associations in both personal and impersonal relationships, and he minimizes the importance of formal contract enforcement at the poles.²⁴⁵

The contract informalists, in turn, risk overstating their case to the extent that they imply that most contracts are self-enforcing, rendering formal third-party enforcement unnecessary or unimpor-

²⁴² See, e.g., Beck & Levine, *supra* note 41, at 253–54; Black et al., *supra* note 159, at 1734–36; La Porta et al., *supra* note 39, at 1136–39; Simon Johnson & Andrei Shleifer, *Coase and Corporate Governance in Development 3* (2000) (unpublished workshop paper, on file with the Virginia Law Review Association), <http://www.worldbank.org/wdr/2001/wkshppapers/berlin/johnson.pdf>.

²⁴³ Williamson, *supra* note 12, at 235, 332.

²⁴⁴ See Bernstein, *Diamond Industry*, *supra* note 25, at 130–35.

²⁴⁵ See Williamson, *supra* note 12, at 332.

tant for economic development. As noted above, long-term relational contracts may raise end-game problems that require resort to the courts for resolution. Moreover, in many contracts for large investments in non-salvageable assets (sunk costs), such as infrastructure or complex technology, parties will still seek a fully specified, contingent claims contract. Often the investors will not share a common ethnic, cultural, or religious network with counterparties to these transactions, nor will investors wish to leave subsequent negotiation of contract details or enforcement to the vagaries of arbitrary domestic political, regulatory, or legal processes. Circumstances that arguably have facilitated Japan's economic success in the post-war years, and, more recently, China's, do not readily generalize to most other developing countries. As noted earlier, Japan is a remarkably culturally homogeneous society where reliance on informal social norms and sanctions may be particularly effective. In addition, Japan has been strikingly non-dependent on large-scale foreign direct investment for its economic success. While China has recently relied on large infusions of foreign direct investment, much of this investment has come from ethnic Chinese business networks outside of China. China's experience in attracting foreign investment cannot easily be reproduced in other developing economies that do not have a huge diaspora, members of which are not only capital-rich but also willing to invest in their home countries. As noted earlier, for developing countries, long-term economic growth is significantly dependent on expanding international trade and on attracting large-scale foreign direct investment from parties who do not share common ethnic, cultural, or social characteristics. Here, the absence of effective formal contract enforcement mechanisms is likely to entail a number of adverse implications.²⁴⁶

With regard to international trade, Rauch observes that, despite their advantages in overcoming information barriers and mitigating contractual uncertainty, domestic networks in international trade also incur costs.²⁴⁷ These networks can constitute "informal trade barriers," as their members may collude to increase market power

²⁴⁶ See Berkowitz et al., *supra* note 106, at 166–68.

²⁴⁷ Rauch, *supra* note 108, at 1183.

and restrict foreign competition.²⁴⁸ Dixit notes that “[r]elation-based governance works well in small groups that are connected by extended family relationships, neighborhood structures, and ethno-linguistic ties, because such links facilitate repeated interactions and good communication.”²⁴⁹ Yet, while relational contracting does facilitate economic gains within such groups, it has the potential to create significant adverse, external effects. McMillan and Woodruff acknowledge the economic weaknesses of exclusionary business networks, observing, for example, that private ordering “sometimes harms efficiency by excluding new entrants from trading or by achieving price collusion.”²⁵⁰ Gray notes a similar effect with ethnicity-based business networks, which can render it nearly impossible for an outsider to enter the circle on a business level.²⁵¹ This “shortage of new firms and new people” and “inability to enter into long-term contracts can inhibit the adoption and development of complex technologies.”²⁵² Thus, Greif recognizes that “reputation-based institutions that support personal exchange [may] have a low fixed cost but a high marginal cost of exchanging with unfamiliar individuals.”²⁵³

In a tightly knit community, Bardhan notes another obvious trade-off of private ordering: “transaction costs are low, but . . . production costs are high, because specialization and division of labour are severely limited by the extent of market defined by the personalized exchange process of the small community.”²⁵⁴ As a result, as Dixit suggests, in a relation-based contract enforcement system, “diversified conglomerates whose component parts have nothing in common except common ownership by a closely knit extended family or similar network” may eventually emerge.²⁵⁵ Aside from trade and production, relational contracting may also create high costs for corporate finance, because under such a system, capi-

²⁴⁸ *Id.* at 1178.

²⁴⁹ Dixit, *supra* note 28, at 66.

²⁵⁰ John McMillan & Christopher Woodruff, *Private Order Under Dysfunctional Public Order*, 98 *Mich. L. Rev.* 2421, 2423 (2000).

²⁵¹ Gray, *supra* note 119, at 14.

²⁵² *Id.*

²⁵³ Greif, *supra* note 101, at 311.

²⁵⁴ Bardhan, *supra* note 105, at 511–12.

²⁵⁵ Dixit, *supra* note 28, at 79.

tal markets tend to be compartmentalized among linked firms through potentially inefficient related borrowing and lending.²⁵⁶

Fafchamps notes that “[w]henver business communities are built along ethnic, religious, or gender lines, network effects result in apparent discrimination.”²⁵⁷ Not surprisingly, he finds that an ethnic bias in assigning trade credit has been “detrimental to entrepreneurs of African descent and favorable to entrepreneurs originating from outside Africa.”²⁵⁸ Thus, while ethnicity-based business networks may provide the predictability that helps facilitate certain economic transactions, such transactions may come at the cost of both discrimination against individuals outside that network and inefficiency from potentially mutually beneficial exchanges forgone. Indeed, in Greif’s example of the Maghribi traders, the coalition of traders that facilitated contract enforcement “was not dynamically efficient” because “[t]he same factors that ensured its self-enforceability prevented it from expanding in response to welfare-enhancing opportunities.”²⁵⁹

One strength of McMillan and Woodruff’s analytical framework is their distinction (which we have adopted) between formal contract law in dysfunctional and functional legal systems.²⁶⁰ They note, for instance, that in a functional legal system, relational contracting tends to complement the formal state-enforced contract framework, while in a dysfunctional legal system, relational contracting may be an imperfect substitute for a system of formal contract enforcement.²⁶¹

The mix of mechanisms that are likely to ensure both a fair and efficient domain of contracting in developing countries is a function of highly context-specific factors that defy easy generalizations. This caution has also been strongly voiced in recent development literature that stresses the need to adopt highly context-specific analysis in studying institutions.²⁶² Two considerations may be of particular relevance to this exercise.

²⁵⁶ *Id.* at 80.

²⁵⁷ Fafchamps, *supra* note 25, at 347.

²⁵⁸ *Id.* at 368.

²⁵⁹ Greif, *supra* note 101, at 88.

²⁶⁰ McMillan & Woodruff, *supra* note 250, at 2425.

²⁶¹ *Id.*

²⁶² See, e.g., William Easterly, *The White Man’s Burden: Why the West’s Efforts to Aid the Rest Have Done So Much Ill and So Little Good* 77, 100–01, 345–47 (2006);

First, as noted above, growth modes and income levels matter to the extent that catch-up economies starting from low-level economic equilibria have different demands for institutions from those of middle-income economies. As Rodrik argues, while “[t]he onset of economic growth does not require deep and extensive institutional reform[,] . . . [s]ustaining high growth in the face of adverse circumstances requires ever stronger institutions[,]” and “the institutional requirements of . . . growth in a middle-income country can be significantly more demanding.”²⁶³ Similarly, Daniel Klerman finds that historically, “economic growth often starts without strong courts, and efforts to improve the quality of the judiciary are often the consequence, not the cause, of economic development”; but, if economic growth starts without good judicial institutions, it may create a demand for quality courts at higher levels of development.²⁶⁴ Moreover, new evidence from patterns of international trade also generates support for this discriminating treatment of institutional dependency. The findings of Berkowitz, Moenius, and Pistor suggest how the nature of traded goods (of varying levels of complexity) can influence the relative importance of formal, as compared to informal, contracting.²⁶⁵ This conclusion corroborates the view that the requirements of formal institutional quality become more demanding as economies move up the development curve.

Second, prevailing societal structures for organizing individuals’ behaviors in the early stages of market development, such as the

Greif, *supra* note 101, at 350–52; Rohini Pande & Christopher Udry, *Institutions and Development: A View from Below 2–3* (Yale Univ. Econ. Growth Ctr., Discussion Paper No. 928, 2005), <http://www.econ.yale.edu/growthpdf/cdp928.pdf>; Francis Fukuyama, *Development and the Limits of Institutional Design*, Presentation at the Seventh Annual Global Development Conference of the Global Dev. Network 2 (Jan. 20, 2006), <http://www.gdnet.org/pdf2/gdnlibrary/annualconferences/seventhannualconference/Fukuyamaplenary1.pdf>.

²⁶³ Rodrik, *supra* note 28, at 1, 15–17; see also Kenneth W. Dam, *China As a Test Case: Is the Rule of Law Essential for Economic Growth?* 41 (Univ. Chi. John M. Olin Law & Econ., Working Paper No. 275, 2d series, 2006), http://www.law.uchicago.edu/Lawecon/WkngPprs_251-300/275-kd-china.pdf (stating that Rodrik’s argument is supported by the example of China).

²⁶⁴ Daniel Klerman, *Legal Infrastructure, Judicial Independence, and Economic Development* 1, 4 (Univ. S. Cal. Ctr. in Law Econ. & Org., Research Paper No. C06-1, 2006); see also Edward L. Glaeser et al., *Do Institutions Cause Growth?*, 9 *J. Econ. Growth* 271, 298 (2004).

²⁶⁵ See Berkowitz et al., *supra* note 106, at 169–72.

different modes of social interaction in communalist and individualist societies, also matter. Communalist societies tend to rely more on relation-based contract enforcement institutions that emphasize intra-group sanctions. Individualist societies, by contrast, tend to support more transactions across different groups with formal contract enforcement institutions.²⁶⁶

With regard to policy considerations, building contract enforcement institutions that support markets takes time.²⁶⁷ In this process of institutional evolution, alternative informal solutions, although transitional at particular stages of development, can serve value-adding and welfare-improving functions before formal institutional reform has taken hold and become effective. This is especially true for countries at early stages of industrialization, as the East Asian economies have demonstrated. As Dixit has observed, “it is not always necessary to create replicas of Western-style state legal institutions from scratch; it may be possible to work with such alternative institutions as are available, and build on them.”²⁶⁸ Thus, there is a legitimate justification for incorporating efficient indigenous institutions of contract enforcement into contemporary legal regimes, rendering formal and informal enforcement institutions complements rather than substitutes, and making the law more acceptable to the general population, thereby facilitating its implementation on the ground.²⁶⁹

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

²⁶⁶ See Avner Greif, Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange, *in* Handbook of New Institutional Economics, supra note 41, at 727, 762.

²⁶⁷ McMillan & Woodruff, Dispute Prevention, supra note 149, at 640.

²⁶⁸ Dixit, supra note 28, at 4.

²⁶⁹ In this context, it is worth noting that regarding legal transplant as an alternative path toward legal reform in developing countries, some authors propose that “adaptation” of the transplanted law to local conditions is important for achieving legality in the recipient countries—an assessment consistent with our argument here. See, e.g., Daniel Berkowitz et al., Economic development, legality, and the transplant effect, 47 *Eur. Econ. Rev.* 165, 192 (2003); Hadfield, supra note 53, at 197 (citing Daniel Berkowitz et al., The Transplant Effect, 51 *Am. J. Comp. L.* 163, 189–90 (2003)).

rimental effects on the various personal freedoms described by Amartya Sen in his book, *Development as Freedom*.²⁷⁰ Thus, for example, even if the lack of effective formal contract enforcement has not been a major impediment to economic development to date, as in China (although some commentators contend otherwise²⁷¹), weak rule of law surely carries other significant costs in a more complete conception of development. Moreover, to focus most rule of law reform efforts on property rights and contract enforcement (as Richard Posner advocates²⁷²) is to engage a very narrow political constituency as proponents of reform and to forego the support of the much larger potential political constituencies to whom formal property rights and formal contract enforcement are of little immediate salience (and in some cases a source of potential antipathy), but to whom protection against abuses of basic civil and political rights is of general concern. In these respects, private and public law should be seen as necessary functional and political complements.²⁷³

²⁷⁰ Sen, *supra* note 3, at 5.

²⁷¹ See, e.g., Yasheng Huang, Comment, China is not racing ahead, just catching up, *Fin. Times* (London), Jun. 8, 2004, at 19 (arguing that China has not fulfilled its “economic potential” due to poor policy choices and failure to implement market reforms); Martin Wolf, Why Is China Growing So Slowly?, *Foreign Pol’y*, Jan.–Feb. 2005, at 50, 51 (describing China’s economy as “highly inefficient” and naming numerous social and political obstacles to economic growth); Dam, China As a Test Case, *supra* note 263, at 40–42 (recounting “present difficulties and dilemmas in the financial sector” that “illustrate the complexities resulting from” poor policy choices). In China, manifestations of the consequences of inadequate formal contract enforcement institutions can be observed in a number of places, including the non-performing loans problem in a fragile banking sector, which threatens a systemic financial crisis (for this reason, the Chinese government has been pressing for profound banking reform over the past couple of years), the persistence of capital-starvation experienced by the private sector due to unavailability of bank loans through formal contracting, and wage arrears to rural migrant workers in foreign-invested firms due to weak legal protection of employees’ contractual rights. See Anastasia Liu, China’s migrant worker pool dries up, *China Daily*, Nov. 10, 2005, available at http://www.chinadaily.com.cn/english/doc/2005-11/10/content_493467.htm. All these negative consequences carry significant social costs and could entail potential risks to growth and social stability.

²⁷² See Richard A. Posner, Creating a Legal Framework for Economic Development, 13 *World Bank Res. Observer* 1, 1 (1998); see also North, *supra* note 5, at 51–53.

²⁷³ See Daniels & Trebilcock, *supra* note 24, at 118; Daniel A. Farber, Rights as Signals, 31 *J. Legal Stud.* 83, 84–85 (2002); Amartya Sen, What is the Role of Legal and Judicial Reform in the Development Process?, Address Before the World Bank Legal Conf. 1–2 (June 5, 2000), available at <http://www1.worldbank.org/publicsector/legal/legalandjudicail.pdf>.