8. The Many Legal Institutions that Support Contractual Commitments

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The problems of achieving third-party enforcement of agreements via an effective judicial system . . . are only imperfectly understood and are a major dilemma in the study of institutional evolution.

North (1990)

1. Introduction

The problem of enforcing agreements in exchange is at the heart of economic life and has been a central topic for economic theory in the past several decades. As economists have focused more closely on what goes on inside the 'black box' of the firm, especially under conditions of uncertainty and asymmetric information, the role of contractual commitment in economic organization has come to the fore. Much of the theory of incentives that has emerged since the 1970s depends crucially on assumptions about the enforceability of contractual mechanisms designed to align the interests of principal and agent and achieve efficient production and exchange (Laffont and Martimort 2002).

One of the fundamental contributions of transaction cost theory and institutional economics has been to focus attention on opening the 'black box' of contract enforcement, drawing attention to the institutions required to achieve effective and low-cost contract enforcement. Williamson (1985) emphasizes the obstacles to perfect complete contracting in his approach to analyzing the institutions of capitalism. North (1990) places specific emphasis on understanding the costs of third-party enforcement in his analysis of the dynamics of institutional change and the differential performance of economies across time and space. Our understanding of the critical interplay between institutions, the enforcement of contracts and economic development has been substantially advanced by the work of Greif (1989; 1993), Milgrom, North and Weingast (1990), Greif, Milgrom and Weingast (1994) and others on the role of coalitions, the private law merchant and the merchant guilds in securing the commitments necessary to facilitate long-distance trade and the commercial revolution in medieval Europe. Even in cyberspace, focus has shifted to the need to develop institutional mechanisms for secure commitment—notably for the problems of

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identification, security and verification in electronic transactions that in many ways recapitulate the problems of the legal vacuum facing traders in the 12th century (Hadfield 2004).

The idea that the effectiveness of contract law is critical to the growth of economic activity is widespread in the literature on development and transition economies. Study of the problems of economies making the transition from socialist to market organization has, somewhat belatedly, focused on the role of institutions necessary to support the enforcement of contracts (Greif and Kandel 1995, Hay and Shleifer 1998, Murrell 2001, Johnson, McMillan and Woodruff 2002). Numerous studies are beginning to emerge, attempting to document the strength of formal contract enforcement in different settings. (McMillan and Woodruff 2000; Hendley, Murrell and Ryterman 2001; Lee and Meagher 2001; Pei 2001; World Bank 2003; Johnson, McMillan and Woodruff 2002). Most of the measures of enforcement, however, are based on the confidence in courts or perceptions of court effectiveness reported in surveys of business managers; hard evidence on the relative effectiveness of contract enforcement is largely absent. Johnson, McMillan and Woodruff (2002), for example, asked respondent managers in five transition countries whether (yes or no) courts "can enforce an agreement with a customer or supplier" and whether courts had assisted (yes or no) in a recent payment dispute.

While providing important top-level data about the perceived effectiveness of (contract) law as an institution, this empirical work to date has yet to investigate, with limited exceptions, the institutional features that make contract law effective and low-cost as an enforcement mechanism in a given setting. It is now clearly understood that merely having contract laws on the books is not sufficient; the institution of contract law is much more complex than this. Djankov et al (2003) make an attempt to correlate procedural formalism with the length of time it takes in different countries to collect on a bounced check or evict a tenant for non-payment of rent; their measure of time, however, is a measure of the time estimated by lawyers that it would take to complete the procedural steps necessary to carry a case through to final adjudication and enforcement. They find that the more formal the legal system, the longer it takes to obtain formal enforcement of these simple contracts. Yet by focusing on the theoretical process, they have not captured data on contract enforcement in practice, most importantly, the extent to which formal contract law is in fact relied on in these instances as the exclusive enforcement mechanism.

Other efforts to assess the relative effectiveness of different legal families (German civil law, French civil law, Scandinavian civil law and English common law) in achieving legality (contract enforcement is a particularly important instance of legality) give us a clue that institutional features matter in practice but provide little guidance in identifying which features matter and how and in what combinations. La Porta et al (1998) found a significant relationship between legal family and legality; legality, however, is measured by law on the books and survey reports from business managers and private market risk assessments (largely for foreign investors) on the perceived overall