SECTION THREE

Legal Institutions of a Market Economy

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8. The Many Legal Institutions that Support Contractual Commitments

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)

I. 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 (Murrell 2001, Greif and Kandel 1995, Hay and Shleifer 1998, 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; World Bank 2003; Johnson, McMillan and Woodruff 2002; Hendley, Murrell and Ryterman 2001; Lee and Meagher 2001; Pei 2001). 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 relative 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 generally (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

effectiveness of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" and the "law and order tradition" of a country.[1]

Berkowitz, Pistor and Richard (2003), emphasizing the legal realist observation that it is law in practice not law on the books that matters (Pound 1911), find (using La Porta et al's 49-country data set) that it is not so much legal family that affects legality but rather whether the local law was transplanted from elsewhere, and if transplanted, whether the law was either adapted to local conditions or introduced into a population already familiar with its basic legal principles. They theorize that in order for law to be effective, the local population has to have "an incentive to use the law and to demand institutions that work to enforce and develop the law" and local legal actors such as judges, lawyers and legislators "must be able to increase the quality of law in a way that is responsive to the demand for legality."

This insight points us to the *complexity* of the operation of law in practice, and the need for a much more detailed appreciation of the multiple legal institutions at work to make contract law effective. Without this greater detail and sophistication in our understanding of these multiple legal institutions, the literature's current effort to identify differences between the economic productivity of "common law" and "civil code" systems runs the risk of being both oversimplified and misleading. Even if it is correct to identify "common law legal systems" as productive of greater economic growth, we still do not know what it is about those systems that produces this growth and in particular how these systems achieve more effective and lower cost contract enforcement. Nor do we know very much about how, in practice, specific "common law" systems differ from specific "civil code" systems. As Messick (1999) has observed, most of our questions—both theoretical and empirical—about what constitutes effective legal design in a given setting remain unanswered. Without a far more detailed appreciation of the institutions that interact to produce "contract law" we cannot hope to be able to investigate the relative cost and efficacy of institutions in different environments and to develop effective policy prescriptions for improving economic development and growth through improved contract enforcement.

This chapter provides a starting point for this research agenda. It explores the multiple legal institutions that support contractual commitments by structuring an essential environment for basic contract law and by increasing the efficacy and decreasing the cost of formal enforcement of agreements. By way of background, Section II sets out the basic problem of contractual commitment and places formal contract law in context as one of a range of enforcement mechanisms available. Section III then provides the principal contribution of this chapter, surveying a range of legal institutions necessary to support even simple contract law. Here I examine the many institutional structures at work

[1] La Porta et al's measure of contract enforcement is specifically limited to the risk of repudiation by government of its contracts.

in the organization of courts, the judiciary, the legal profession, enforcement services, and the process of lawmaking and legal innovation.

II. The Problem of Contractual Commitment and the Selection of Efficient Enforcement Mechanisms

The problem of contractual commitment refers to the commitment necessary to support agreed-upon exchanges that take place over time. The problem is essentially this: if I act today—invest my resources or give up other opportunities—and you take the actions we agreed on in exchange for my efforts—paying me money or providing a return service—tomorrow, how can I be sure that you will in fact do as you promise and that I will not be left having spent resources I will never recoup? The solutions to this problem can all be understood in terms of how they affect the likelihood that the first-mover in exchange will not be disappointed or exploited by the second-mover. (Of course in any exchange both parties—all parties in a multilateral contract—may be first or second-movers or both.) The second-mover's failure to act as agreed can stem from a number of sources: there may be an obstacle to performance, there may be a lack of information about the conditions of performance having been met, there may be a dispute about what performance was in fact promised. These are not, however, problems of *commitment*. The problem of commitment refers to the incentives on the part of the second-mover: the failure to act stems from the divergence between the second-mover's *ex ante* incentives—the incentives that led to the agreement to act—and his *ex post* incentives—the incentives that determine his behavior after the agreement has been struck and the time for performance has arrived. (Note that a commitment problem in need of an enforcement solution only arises when a gap in incentives arises, that is, when the limits of baseline norms of trust and trustworthiness are reached.)

There are many potential enforcement mechanisms available to support agreements. The list includes: self-enforcement, reputation, organization, technology and contract law. These enforcement mechanisms in one form or another all have a common feature: they seek to bring *ex post* incentives in line with *ex ante* agreements, to produce the outcome that the second-mover promised. They differ only in how they manage this shift.

Self-enforcement mechanisms and *reputation mechanisms* change the incentives of the actors by changing the consequences of actions. Self-enforcement mechanisms include the posting of bonds or exchange of hostages and the termination of valuable trading relationships (particularly those in which quasi-rents are generated by investment in assets specific to a particular relationship). (Williamson 1983; Klein, Crawford and Alchian 1978; Klein and Leffler 1981; Telser 1981) Reputation mechanisms alter the likelihood of future transactions with potential trading partners if an agent defaults on an agreement. Greif, Milgrom and Weingast (1994) demonstrate the potentially complex structures

involved in reputation mechanisms at work in medieval Europe. Reputation mechanisms fundamentally rely on institutions that capture and disseminate information about an agent's performance to a set of potential trading partners (such as coalition members) and include such diverse structures as trademark law, trade associations and third-party certification.

Organizational mechanisms change the actors involved in a decision and hence the incentives that are operative *ex post*. The most dramatic organizational mechanism, of course, is horizontal or vertical integration: transforming a transaction across organizational boundaries to one within organizational boundaries. (Williamson 1975) Other organizational mechanisms include delegating control over corporate oversight—such as auditing of financial reports or electronic commerce security systems (Hadfield, 2004)—to third parties and information channeling to alter the information available to an agent who may be tempted to renege on performance.

Technological mechanisms change the costs of actions and the capacity of an agent to act in various ways. Internet transactions, for example, are increasingly dependent on technological solutions such as encryption to assist e-commerce providers in committing to security procedures to protect private information and the integrity of a transaction. Technology provides a mechanism for customers to verify the use of encryption (by, for example, clicking on a website 'seal' that connects the user to a third-party verification server), making it very costly for a provider to renege on the promise to use encryption. (Hadfield 2004)

In its most rudimentary form, *contract law* achieves enforcement by establishing a set of rules administered by a third-party, generally the state, which determines when an agreement or promise is enforceable, establish the grounds on which a breach of the agreement will be found and set out the consequences for breach. Contract law backs up agreements with the third party's power to extract penalties or issue injunctions in the event a party to a contract fails to act as promised.

What enforcement mechanisms share in common is their impact on a first-mover's rational beliefs, at the time the bargain is struck, about the likelihood of performance: in the presence of the mechanism the first-mover attaches a higher probability to the occurrence of the event in which he or she receives the value of the promised performance. Formal contract law, in theory, achieves this transformation in beliefs two ways. First, it alters the payoff associated with reneging on a promise and thus alters the incentives of the second-mover. Second, it provides some guarantee of compensation or court-ordered performance in the event the second-mover fails to fully respond to the risk of legal consequences.

Enforcement mechanisms can vary in their effectiveness at transforming the rational beliefs of contracting parties about the likelihood of performance. Consider a simple agreement to accept deferred payment for goods. One enforcement mechanism could be completely effective, generating a belief in the seller that full future payment will occur with probability one. Another could

be incompletely effective, increasing the seller's expectation of payment from a baseline given generalized norms of trust and trustworthiness of, say, 20% to 50%. Moreover, the way in which expectations of payment are increased can vary: a mechanism could increase the probability of full recovery to .5 or it could increase the amount of certain recovery to one-half of the amount owed.

The use of an enforcement mechanism is generally costly. It may require time, information collection and/or dissemination, human capital investments, or the services of others. It may make errors. It may require technology. It may require distortions in incentives or reductions in the liquidity of assets. In order for an enforcement mechanism to be effective for a given agreement, these costs must not outweigh the gains achieved from increased contractual commitment in that agreement. Selecting an *efficient* enforcement mechanism, or combination of mechanisms, involves an assessment of the relative cost and efficacy of the alternatives available for a given contract in a given environment. As the minimum cost of enforcement across the range of available enforcement mechanisms increases, so too do the minimum gains that must be available from contractual commitment. Put differently, in an environment with only high-cost enforcement mechanisms, only high-value contracts and those that are supported effectively by baseline institutions such as trust or family relationships are likely to go forward.

The problem of contractual commitment from an economy-wide perspective is thus not a discrete question of whether contracts can or cannot be enforced. Rather it is a question of the *cost* of various enforcement mechanisms and the *efficacy* with which these mechanisms improve the confidence contracting parties have in the performance of their agreements. This is where attention to the institutional environment in which enforcement mechanisms operate becomes essential to understanding an economy's relative capacity to generate economic activity and growth. A self-enforcing mechanism such as a bond requires an institutional environment that recognizes and enforces the transfer of property rights; a lower cost mechanism is achieved if the institutional environment provides, for example, the organizational and legal elements necessary to establish escrow accounts or liens. Conversely, a higher cost mechanism is produced if, for example, legal rules override or penalize the use of the mechanism. (This is the concern, for example, of the literature criticizing US courts for applying antitrust law in ways that undercut the use of contracts to achieve efficient agency relationships. See, for example, Mathewson and Winter 1984, Masten and Snyder 1993.) A reputation mechanism such as a trademark requires an institutional environment that protects the integrity of the trademark as a reliable indicator of the origin (producer) of a product; this is the function of trademark law and the authority it gives a trademark owner to prevent others from copying the mark and thereby diluting the reputation incentive to provide high quality goods or services. If establishing or protecting trademarks is costly, the reputation mechanism is less effective in generating economic activity.

An understanding of the many institutions that support formal contract law is thus a prerequisite to the even more complex institutional analysis necessary

to appreciate the full range of enforcement mechanisms available to contracting parties, particularly those that merge features of different mechanisms (such as relational contracts which rely both on formal contract law and self-enforcement and reputation mechanisms), to assess the relative cost and efficacy of these mechanisms in different institutional settings, and to analyze the interactions between institutions that may either increase or decrease the cost and efficacy of particular enforcement mechanisms. Although I leave the analytical components of this research agenda to future work, in what follows I survey the wide range of institutions and considerations on which such analysis should focus.

III. The Role of Legal Institutions in Structuring an Effective Law of Contracts

Basic contract law seems simple enough: contracting parties designate a set of actions that each will perform (deliver goods, pay money, perform work, etc.) and the law establishes a right to marshal the coercive power of the state to extract penalties (damages, injunctions, fines, etc.) in the event the actions are not performed as promised. But in order for even this simple, although critical, enforcement mechanism to be effective and relatively low-cost, a wide array of legal institutions has to be in place. Contract law makes its own promises to contracting parties: it promises to be available to accurately interpret the agreement the contracting parties have made, to impartially judge the performances rendered, and to reliably implement the appropriate remedies. The fulfillment of these promises, and the cost of accessing them, depends on many other legal institutions and the coordination and interaction between them.

A. Courts and Judges

Contract law also requires the institutions of courts and judges; this much is plain. What is less obvious are the multiple court- and judge-related legal rules and institutions that are essential to the effective and low-cost operation of courts and the judiciary.

1. The Organization of Courts

Courts must be accessible at relatively low-cost in geographic and linguistic terms to contracting parties. They must also be accessible in legal terms, and this is a function of the legal rules governing personal jurisdiction (who may be required to appear in court and bound by its determinations), subject matter jurisdiction (what contract issues may the court adjudicate—contracts involving the government? Contracts involving foreign entities?) and standing (who has legally-recognized interests in a contract dispute for purposes of invoking the

work of the court—the parties to the contract? The competition authority of the government? Third-party beneficiaries of the contract?)

Delay in the resolution of contract disputes is an important impediment to the effectiveness of contract law—not only does the value of payment decrease with time but so too does the probability of recovery diminish as the potential for assets to be dissipated increases and circumstances change to make performance more difficult and/or less valuable. Thus courts must operate effectively as organizations if contract law is to operate effectively. Effective courts require personnel and resources to administer their procedures, and mechanisms by which they can establish effective and low-cost internal rules and procedures.

Most importantly, courts must be able to perform a critical role in the coordination of contract dispute processes. They require effective systems and rules for scheduling and giving notice of hearings, trials and other meetings requiring the coordination of court personnel, court space, parties, lawyers and witnesses. Achieving this coordination requires tools for enforcing a schedule (such as the power to sanction failures to appear with fines or legal consequences such as dismissal or the entry of a default judgment) and for assessing what are legitimate reasons for not appearing (such as inadequate notice or conflicts in obligations.) These coordination functions are distinctively different in Anglo-American systems, in which there is a culmination in a single event—namely a trial—and civil law systems, in which evidence and legal theories are developed and explored in a series of hearings that can address evidence in a piecemeal fashion and which are not governed by a strictly sequenced presentation of plaintiff's and then defendant's case. (Merryman 1985)

Coordination also requires effective information systems for tracking cases and reliably storing documents and evidence of the actions taken by the court (such as orders that have been issued) and the parties (such as compliance with filing deadlines and procedural obligations or the submission of motions or other requests for court action). Information systems are also important for implementing procedural and jurisdictional rules coordinating the relationship between courts over time and space: has the matter already been adjudicated in this court? Is it currently being adjudicated in a different court, whether in another region or at another level in the court system? And information systems must also be externally accessible at low cost by those who must use them to assess the validity of legal claims, to convey requests for court action, to monitor court action, and coordinate procedures.

The implementation of court procedures may also implicate a host of auxiliary service providers. Process servers are necessary to ensure that notification of parties and witnesses (through subpoenas for example) takes place as required by court rules. Notaries may be required to verify signatures on contract documents, reducing the cost of procedures of proof in the court; notaries may also play a role in the drafting of specialized contracts such as corporate by-laws. The power of the court to enforce its procedures (such as appearances by subpoenaed witnesses or the production of subpoenaed documents) also depends on the availability of enforcement services from institutions such as the police. Finally,

the power of a court's order—to pay damages or deliver goods for example—depends on the institutions available to identify, seize and/or liquidate assets. These are services that may be performed by police, court personnel or private bailiffs. The effectiveness, cost and integrity of these services depends then on the host of institutions that govern these service providers. Private bailiffs in some transition economies, for example, receive law degrees equivalent to those received by lawyers, are subject to the rules established by their professional organization and potentially subject to limits on their numbers and fees set by the government.

Finally, courts must, in fact, follow their rules and procedures in a reliable way. This requires court personnel and auxiliary service providers who possess the necessary human capital—knowledge of the rules and procedures, expertise in making judgments about scheduling and information systems, and so on—and who are motivated to act in accordance with the rules as opposed to shirking or accepting bribes. As I discuss in more detail in the context of judicial corruption below, protecting against the corruption of court personnel and auxiliary services is a function of multiple institutions including civil service compensation systems, monitoring mechanisms (including the court's own information systems for tracking the actions taken by the court), professional organizations (such as those regulating bailiffs in some transition economies) and penalties.

2. Judges

Just as the institution of a court is more than a building, so too is the institution of a 'judge' more than a person or public office. As the heavy emphasis on the problem of corruption in developing and transition market democracies attests (World Bank 2000), the institution of judging supports contractual commitments only when judges are expected to implement contract law accurately and reliably. This requires multiple legal institutions to support and complement the role of judge.

The fundamental requirement for effective judging in contract law is the accurate and faithful application of the legal rules parties relied on when making their contracts. There are many reasons why judges may fail to apply contract law: they may not know the law, they may lack the human capital necessary to apply the law, they may make mistakes, they make shirk their duties, or they may intentionally act at variance with the law because they will receive private benefits in the form of bribes or other benefits such as political influence, judicial advancement or the satisfaction of their own policy preferences. Many legal institutions play a role in reducing the risk of judicial failure to implement basic contract law.

The human capital of judges depends most obviously on the institutions of legal education and training. Who may become a judge? What are the educational requirements? What is in the curriculum? What resources and requirements are there for ongoing judicial education? What are the requirements for practical

experience or training? More subtly, however, judges' human capital depends on the organization of their work. Are courts and case assignments organized in a way such that judges develop specialized knowledge in particular areas of law or are able to transmit specialized knowledge within the court system? What resources—such as law clerks, databases, legislative updates, legal commentaries and libraries—are available to judges to learn legal rules and develop legal reasoning? Are the reasons for decisions reached by other courts and judges recorded and disseminated?

A judge's case-specific knowledge, of both law and facts, is also a function of the organization of legal work, much of which is fundamentally determined by legal rules of procedure and the institutions of legal practice. This is not merely a matter of information transmission but also of the incentives created by these rules and institutions for the discovery and development of information that can be used by the judge.

In Anglo-American legal practice judges are largely passive with respect to the production of case-specific information. Litigants are responsible for obtaining evidence, interviewing witnesses, researching the law and developing legal reasoning about the application of the law to the evidence and then conveying this to the judge. The incentives for litigants to make these investments in developing the judge's human capital are based on the legal rules governing judicial practice and the exercise of judicial power. Judges are generally prohibited, for example, from having *ex parte* independent contacts with witnesses or reviewing documents that are not obtained from the parties according to the rules of evidence. They may dismiss a lawsuit or enter a valid default judgment against a party if the party has failed to present the evidence necessary to support the application of a legal rule.

In civil law systems, in contrast, judges play a more active role in obtaining evidence and, less often, legal principles. (Merryman 1985) Although litigants may provide documents in their possession and suggest potential witnesses, German judges, for example, take on significant responsibility for obtaining additional documents and testimony, shaping the development of evidence, questioning witnesses and determining the order in which issues will be investigated. (Langbein 1985) The development of case-specific human capital is therefore more heavily dependent on judicial and bureaucratic incentives and resources.

Notice that these differences in the regime governing the production of evidence and legal rules and reasoning have important implications not only for the incentive for the development of the judge's human capital, but also for the allocation of costs between litigants and public legal institutions: litigants may bear these costs in adversarial systems more extensively than litigants in civil law systems. Unfortunately, data on the costs of litigation are very difficult to come by and comparative assessments difficult to undertake. These institutional features however are quite likely to affect the private cost of, and hence the private reliance upon, contract law.

Judicial human capital and the institutions that determine the development of judicial human capital have an impact on the incidence of judicial error. Judicial error is also affected by the legal rules and mechanisms available for auditing or correcting judicial error. Appeal mechanisms are more or less effective, and more or less costly, depending on whether appeals are available as of right or only with permission of the appellate court and the extent to which appellate courts defer to the fact-finding or legal conclusions of trial courts. Moreover, appeal mechanisms depend fundamentally on the assumption of the cost of an appeal by the parties in litigation; this has important implications for the selection of cases in which judicial error may be discovered. Other review mechanisms—such as bureaucratic supervision and auditing—alter the selection of cases for higher review, while also shifting the cost from private litigants to the public civil service.

In developing and transition economies there has been substantial attention paid to the problem of "error" caused by corruption in judging, that is, the risk that judges will decide and manage cases not on the basis of legal rules and evidence but on the basis of personal rewards in the form of bribes. (Bardhan 1997, World Bank 2000) Although selection mechanisms for judges are obviously important, corruption is a complex institutional phenomenon, not merely a failure of personal ethics. Compensation systems for judges play a role in determining judicial incentives to accept bribes: judges whose incomes have in the past depended on supplementing official salaries with payments collected directly from litigants and lawyers—whether legal or illegal—may be embedded in economic and social circumstances (where they live, the obligations they have taken on, the standard of living or social status they enjoy) that make for powerful incentives to continue accepting payments.

The incidence of judicial bribery also depends on the institutions that generate the incentives for litigants to offer bribes. Among these are some of the legal institutions we have already discussed, namely the rules and procedures in courts that may result in substantial delays in obtaining court action or significant failures in scheduling, case tracking or information management. Similar failures in other institutions that generate important pieces of evidence in contract disputes—such as title registries or banks—may also contribute to judicial bribery as judges are offered payments to overcome these obstacles. If required documents are unavailable or costly to obtain, litigants will have an incentive to offer bribes to induce judges to accept faulty documents or proceed with inadequate evidence. This is an incentive that can face litigants who seek justified outcomes as well as those who seek unjustified outcomes. The frequency with which bribes are offered, the belief that any outcome—right or wrong—cannot be obtained without them, and the difficulty of distinguishing between those who offer payments to bring outcomes closer to the one contract law would achieve under full information and those who offer payments to distort outcomes—all of these factors contribute to the incidence of judicial bribery and the loss of integrity in contract law.

Corruption, whether in transition or advanced market economies, can also take the form of distortions in judicial decision-making caused by political influence and the pursuit of private policy preferences. The institutions of judicial selection and appointment (are judges elected? selected from those with expertise through a civil service process?) and removal (do judges have life tenure? can they be removed by the electorate? by administrators? politicians?) influences the likelihood that judges act on the basis of the legal rules contracting parties expect.

Finally, efforts to control judicial failures to apply contract law accurately and faithfully—whether due to bribery, political influence, the pursuit of private policy preferences, error or shirking—depend critically on institutions for detecting and sanctioning failures. Legal institutions determine whether legal decisions and reasons are written and to whom they are disseminated. Errors or corruption in written decisions made available only to the parties are less likely to be detected than are errors or corruption in decisions made available more generally. Are other judges aware of how individual judges are determining cases? Are lawyers and litigants in future cases? Are legislators and administrators? The general public? The publication of legal commentary by lawyers, law professors, and other legal experts—made available to judges and those who appoint judges—also serves the function of supporting the accuracy and fidelity of judging to the announced rules and principles of law.

B. Lawyers

Although lawyers are often derided as mere clogs on the operation of legal rules and courts, the institutions organizing the training, selection, governance, compensation and incentives of lawyers in fact are fundamental determinants of the cost and efficacy of contract law. With rare exception (Grajzl and Murrell 2003) the role of these institutions has generally been overlooked in, for example, legal reform efforts in transition economies, where attention has focused instead on the development of contract rules and independent courts. (Messick 1999) Lawyers, however, play a critical role in connecting litigants with law and courts and in the process of legal development. The institutions governing the production and allocation of legal services play a crucial role in determining the cost of accessing both contract law and the many other laws (evidence, procedure, judicial selection and conduct, etc.) on which contract law depends and on the substance of law as it develops through precedent, legislation, regulation and practice.

Legal services can be generally thought of as falling into two types: the provision of information and advice about law and legal institutions, and representation before legal bodies such as courts. The cost and quality of legal services—and hence the cost and value of relying on contract law as an enforcement mechanism—is fundamentally dependent on the legal institutions governing who may provide legal services and when legal services must be used in order to make use of law.

At one extreme, we can imagine legal services being treated no differently than any other service in a market economy: supplied by private actors (including the consumer of the service him or herself) at a price solely determined by market conditions. Under this pure market model there would be no restrictions on who could give legal advice, draft legal documents or appear in court to act on behalf of someone else. At the other extreme would be legal services provided exclusively as a public good: supplied by public actors selected by government officials and paid out of the public purse.

The pure public good model is generally rejected in a democratic regime on the basis of the argument that lawyers who are independent of the government must be available in order to enforce laws that restrict the power of government. The pure market model is rare but not unheard of: in England and Wales, for example, with few exceptions (immigration and asylum advice, conveyancing and probate matters), anyone may give legal advice. Even under a pure market model, however, legal institutions will influence the cost and quality of legal services. Most importantly, the complexity of legal rules and procedures—and hence the necessity of specialized investments in human capital—will affect both the underlying cost of the service and the competitiveness of the market for these services. (Hadfield 2000).

In most market democracies the organization of legal services is a mix of market and public good mechanisms and thus there are many legal institutions that influence the cost and quality of legal services.

1. Legal Education

In order for lawyers to play an effective role in reducing the cost and increasing the efficacy of contractual commitments it is in the first instance necessary for lawyers to know the relevant law. The extent of this need is a function of the complexity of law and hence the demand for expertise. Legal rules prohibiting those without a law degree from practicing law serve the goal of ensuring that suppliers of legal advice and representation know the law, but they also restrict the supply of legal services and create a role for degree-granting institutions and their governance structures in determining the conditions of supply. Shepherd and Shepherd (1999), for example, argue that the cost of legal services in the United States is significantly affected by the fact that in most states law schools must be accredited by the American Bar Association. They claim that the ABA exercises monopoly power in establishing accreditation requirements such as large library holdings and high remuneration for law professors that are driven not by pure competence considerations but also by rent-seeking. The institutions governing legal education influence curriculum as well, with implications for the cost of human capital and the value of legal services. In transition economies, for example, a law school curriculum that continues to emphasize abstract legal theory relevant to law under socialism and does not effectively teach commercial contract law produces lawyers who must either invest additional years in learning this area of law or who do not provide the services demanded by businesses

in an emerging market democracy. Whether or not the law school curriculum effectively trains lawyers to provide services for the new market environment depends on the institutions that govern, fund and create incentives for curriculum development.

2. *Professional Organizations*

In most advanced market democracies, legal services are organized as a self-governing profession meaning that the state delegates to one or more professional organizations the authority to regulate the conduct of its members. This institutional structure has enormous implications for the cost and quality of legal services relevant to the use of contract law. In this institutional environment, the profession establishes controls over who may practice law by establishing the standards and procedures governing admission to and continued authorization to practice by the profession.

The rationale for professional oversight is rooted in the perceived need to regulate the exercise of expertise on behalf of clients who are, by definition, poorly placed to monitor the competence and loyalty of their lawyer agents. Low quality legal services reduce the value of contract law; so too do legal services that lack fidelity to the client's expectation that contract law (whether in drafting and negotiation or in enforcement and defense) will be implemented on the basis of the relevant facts and principles. Lawyers may corrupt the value of contract law by acting against their client's interest in exchange for a bribe or in collusion with other professionals; they may also corrupt the value of contract law in a longer-term sense when, acting consistently with the interests of their clients, they transmit bribes to court personnel or judges. Corruption of lawyers is only recently coming into view as an important factor in the corruption of the legal system as a whole in developing and transition economies.

Professional control over the supply of lawyers (through both initial admission to practice and suspension of the right to practice in the event of failures of competence, honesty or loyalty) is thus potentially an important institutional instrument for increasing the value of legal services to contracting parties. Professional control, however, also gives rise to the risk of rent-seeking by the profession as a whole. (Shaked and Sutton 1981) Historically bar associations have, in the name of quality control, played a tremendous role in structuring the market for lawyers: restricting advertising, establishing minimum fees, requiring that legal services firms be organized as partnerships or sole proprietorships and not limited liability corporations, prohibiting the practice of law in conjunction with the practice of other professions such as accounting or business consulting, outlawing the selling of shares (and thus risk allocation and investment) in legal outcomes, preventing the use of contingency fees, and so on. The institution of the self-governing profession thus plays an essential role in structuring the determinants of the cost and quality of legal services and hence the cost and efficacy of control law as an enforcement mechanism.

The economics of how the structure of the market for lawyers influences the cost and quality of legal services are only beginning to be studied. Many of the effects of this institutional environment are subtle, going beyond the fairly well-understood mechanisms of monopolistic restrictions on supply or advertising for example. Hadfield (2000) identifies some of the features of the profession in Anglo-American systems that contribute to the imperfect competition and hence cost of legal services.

Numerous aspects of the organization of the legal profession have implications for the development of legal human capital and specialization. Professional organizations may promote the development and sharing of legal human capital through continuing legal education requirements, the organization of professional meetings and seminars, and the publication of legal reports, bulletins, newsletters and so on. But they also may inhibit investments in and diffusion of legal human capital through organizational restrictions on the practice of law.

There may be explicit prohibitions on specialization or mandatory representation requirements that penalize a lawyer who is unable to serve a general clientele. More subtly, requirements that lawyers practice in sole proprietorships or partnerships may restrict the size of a law firm. In Slovakia, for example, lawyers are not permitted to be employed by other lawyers; they must have direct client relationships. This limits the size of law firms and the scale of legal practice and thus limits the potential for the accumulation and sharing of human capital acquired through experience and the potential for the provision of lower-cost bundles of legal services, particularly to corporate clients with multi-dimensional legal needs. (Hadfield, in progress) Similarly the continued restriction on multi-disciplinary practices in the United States—preventing lawyers from combining with accountants or business consultants for example—prevents the offering of lower cost contract advice in settings in which contractual design involves not only the goal of securing commitment to the agreed upon exchange but also tax or business considerations affecting the value of the exchange.

These factors take on special significance in the context of contract enforcement. Contracts are essentially products designed by lawyers. As Gilson (1984) emphasizes, lawyers in advanced market economies are "transaction cost engineers": they assist in the development of transaction-cost reducing contractual provisions. They do this in conversation with contract law, establishing the legal meaning for the provisions they invent and their clients implement. Indeed, in common law systems contract law evolves significantly through the ongoing adjudication of contract innovations developed by lawyers. Larger law firms and more diverse law firms (potentially multi-disciplinary firms) are able to specialize more effectively and pool learning on a larger scale and across a broader range; they are also able to share this information at lower cost among members of the firm, minimizing the risks of free-riding by competitors or the need for more costly intellectual property protections for their innovations. The capacity to specialize, share knowledge and capture the returns to human capital investments is an especially important determinant of the extent to which

contractual commitment is an effective and low-cost enforcement device for complex transactions and environments.

3. Courts and Judicial Oversight of Lawyers

The potential for rent-seeking by a self-governing legal profession can be limited to some extent in an institutional environment that gives courts and judges a role in overseeing legal practice. In many U. S. jurisdictions (but not in many civil law countries), for example, the authority to admit or suspend a lawyer ultimately rests with the courts. Although judges are also members of the legal profession, they face incentives and constraints on the exercise of their authority over the profession that differ from those facing bar officials and thus may mitigate rent-seeking that increases the cost of legal services.

Perhaps more importantly, courts and judges may play an important role in determining the cost of legal services by establishing the incentives facing lawyers in the day-to-day practice of their profession. An essential determinant of the cost of legal services is the coordination of the activities of lawyers, witnesses, parties, court personnel and judges. Low-cost litigation requires, for example, documents to be exchanged when expected, evidence to be presented when the opportunity for response and cross-examination is also made available, and attendance at hearings by those required to resolve a matter. Courts that possess the authority to sanction lawyers for failure to comply with scheduling orders, appear at hearing or present the evidence necessary to decide a matter are able to control the time and hence expense of litigation more effectively than those that do not. Sanctions can include penalties expressly directed at the lawyer—such as fines or disbarment—and penalties that indirectly penalize the lawyer by imposing a loss on the lawyer's client—the authority to enter a default judgment or dismiss an action to the detriment of a party whose lawyer fails to attend a hearing or to present evidence—are powerful weapons for courts and powerful incentives for lawyers.

Courts may also play a direct role in establishing the legal fees earned by lawyers. Courts may be empowered to award legal fees to litigating parties as a routine matter, such as under the "British" rule awarding legal fees to a prevailing party, either based on an assessment of reasonable rates by the court or based on the actual expenditures. Even under the "American" rule, in which parties routinely bear their own legal fees whether they prevail in litigation or not, courts may be involved in assessing legal fees when litigation takes place under a statute or under a contract that provides for fee-shifting. Finally, courts' management and scheduling procedures can have important, and sometimes unexpected, indirect effects on legal fees. Kakalik et al (1996), for example, assessed the impact of case management efforts intended to reduce delay through more active judicial management. The study demonstrated that the court procedures led to substantial *increases* in expenditures on legal fees, a result that is likely explained by the fact that more active judicial management required litigants to interact with the court more often and created a wider set

of potential disputes between litigants as litigants can argue about the particular management decisions (setting discovery deadlines or requiring efforts to come up with an agreed set of facts, for example) judges make in an adversarial system.

4. Norms and Practices of Judicial Reasoning

Legal practice and the organization of legal services are also significantly affected by the norms and practices of legal and judicial reasoning. Much of what happens in a court depends not on formal legal rules about procedure but the practical way in which a judge manages a case. If a judge relies on adversarial presentation of evidence and legal argument, this requires and induces investments in legal human capital by lawyers, triggering the importance of organizational attributes such as law firm size and form as discussed above. If a judge is attentive to the decisions of other judges, this has significant implications for the cost of what lawyers do and the investments that they make in acquiring information from precedent. It also spurs the development of services to help reduce the cost of these investments, such as case reporters, journals and bulletins.

More subtle informal norms of legal reasoning also influence the cost of legal services. Legal reasoning rewards increasingly sophisticated argument about the contours of legal categories and concepts. A seller who argues, for example, that a contractual promise to accept a price P for goods was not intended to apply in the event that the market for these goods was subject to unexpected government rationing making the market price several times higher than P will have his argument assessed on the basis of an analysis of language and context and contract doctrine. He will not face an argument that he shouldn't be allowed to prevail on such an argument because doing so will lead to an overly complex inquiry not warranted by the marginal gain such inquiry will achieve in terms of efficient contracting: there is no legal norm counterbalancing the scholastic inquiry into the nature of contractual intent, for example, with judicial authority to take into account the impact of an argument on the complexity of law. Such legal reasoning norms value incremental increases in scholastic precision without attention to the marginal payoff in improved contract enforcement or efficiency. And because it is the decisions of courts in the Anglo-American system that generate the legal principles applied in future cases, this approach to legal decisionmaking generates legal complexity and ambiguity.[2] Increased complexity and ambiguity directly raise the human capital investments necessary to provide legal services. Indirectly, more complex law contributes to the imperfect nature of competition in the market for lawyers. (Hadfield 2000)

[2] In civil law systems norms of legal reasoning are also scholastic in the sense that cases are analyzed on the basis of meaning of language, particularly the language of legal codes. There is debate, however, about the extent to which legal decisionmaking in civil law systems is influenced by the decisions of judges (Schneider 2003) and thus whether a given instance in which a more refined understanding of a legal term is adopted has ramifications for the complexity of the legal environment facing future litigants.

Legal services are a credence good; complexity and ambiguity increase the information asymmetry between providers and consumers of legal services and thus inhibit the effectiveness of competition. Complexity of law also promotes specialization among lawyers, again reducing the effectiveness of competition. This effect can be particularly pronounced when ambiguity in law increases the role of judicial discretion and thus creates returns to highly localized experience with particular judges and courts—experience that is gained by only a limited number of practitioners.

5. Direct Government Regulation and Service Provision

Finally, the cost and quality of legal services may be influenced by the institutions of direct regulation and service provision by government. As mentioned previously, the pure public good model is generally rejected in market democracies in light of the perceived need for an independent legal profession capable of challenging government action. Still, particularly in the context of contract law where the goals are primarily focused on structuring an effective market system, there are numerous public institutions that may be involved directly or indirectly in the provision of legal services.

Legal services may be provided by government-employed lawyers; this is frequently the case for criminal defense work for example. Legal services in the context of contract law, however, may be more likely to be afforded by government funding of private lawyers through legal aid mechanisms providing assistance to lower income contracting parties, such as consumers, employees or small business operators. Legal services in support of contracting may also be provided directly by government agencies in the form of legal information and/or dispute resolution services: consumer complaint bureaus, labor tribunals, motor vehicle arbitration panels and so on. Government subsidies of legal education also have an impact on the supply of legal services to contracting parties.

Government institutions are also an important alternative source of regulation for private legal service providers, effectively taking back some or conceivably all of the powers traditionally delegated for independence reasons to a self-regulating profession. Government may directly license service providers, as the Office of the Immigration Services Commissioner in the U.K. does with respect to the provision of immigration and asylum legal services by non-lawyer practitioners. Government may regulate legal fees and insurance requirements for lawyers. Government laws and regulation may also establish the conditions for admission to practice and competition among lawyers, and the penalties and procedures for failures of competence or loyalty.

The absence of such policy levers in the government, particularly in transition governments attempting to solidify effective market economies and support the development of contracting relationships, is a serious concern. (Hadfield, in progress). The twin goals of democracy and a market economy can create tension over the allocation of power to regulate lawyers between government and the profession: democracy requires the independence of providers of legal

services necessary to ensure fidelity to constitutional and legislative constraints on government; a vibrant market economy requires government power to structure a competitive market for legal services necessary to reduce the cost and increase the efficacy of contract law. It is matter of institutional choice, however, whether to structure provision of legal services necessary to enforce democratic controls on government in the same way as legal services necessary to enforce contractual controls on private market actors are structured. The failure to distinguish between democratic concerns and economic concerns in designing the institutional environment for legal services is a fundamental problem for both advanced and developing market economies. (Hadfield 2000).

C. Legal Environment

Lawyers like to say that "the law is a seamless web." They mean by this that it is impossible to deal with one legal issue—such as the enforceability of a contract—without coming within the purview of a host of other legal rules: procedural rules, property laws, economic regulations, principles of legal rule development, and so on. In this section I first examine particular sets of collateral legal rules and doctrines that influence the efficacy and cost of particular instances of contract law, and then turn to the longer-term impact of legal rule development and evolution on contract law as a dynamic component of a changing economic environment.

1. Procedural Laws

Consider the basic problem of ensuring that contract law is applied on the basis of accurately determined facts: what was promised, what was performed, what loss was caused by a breach. Ensuring accuracy in factual determinations requires a host of procedural rules to be in place to answer questions such as the following: Who can determine facts: judges, juries, administrators, specially appointed referees, private evaluators? What evidence is admissible? What documents or testimony may be discovered before a hearing or trial by the parties and/or the adjudicator? Are parties obligated to produce documents or witnesses sought by the opposing side or the judge? What penalties are in place to enforce those obligations? What are the penalties for presenting false testimony or fraudulent documents in court? What third parties can be required to present documents and testimony in court? What penalties are available to prevent the abuse or strategic misuse of rights to discover documents and witnesses? What rules are in place to ensure that the process of fact discovery takes place in a reasonable amount of time and is coordinated at low-cost?

Contract law must also be reliably applied: as an institution, it must credibly commit to apply its announced rules and procedures. This commitment depends on legal rules regulating the exercise of judicial powers. In what cases *may* a court apply contract law? In what cases *must* it apply contract law—can parties avoid contract law by pleading their case under some other set of rules such as tort law?

When do particular courts (local courts, specialized courts, etc.) have jurisdiction to decide a particular contract dispute (such as one involving foreign parties)? Does the court have the authority to order particular remedies—to order parties (governments? foreign firms? state-owned enterprises?) to perform a contract? What if a judge simply ignores the law: what recourse of appeal or complaint is available? What if a judge follows the law: will he or she face repercussions such as removal, non-promotion or the dilution of his or her authority by the expansion of the number of judges? How likely is it that *these* legal rules—of appeal or complaint or judicial appointment, removal and promotion—will be implemented as announced?

Procedural and structural rules such as these governing evidence, discovery, jurisdiction and so on have an impact not only on the efficacy of contract law in theory but also, very importantly, in practice. These rules play a fundamental role in determining the transaction costs of using contract law as an enforcement mechanism. Extensive pre-trial discovery processes, while potentially promoting increased accuracy in fact-finding, may also give rise to costly strategic behavior and delays. A major legislative effort to promote the use of pretrial judicial management techniques to overcome delays and reduce costs in U.S. courts, for example, significantly *increased* litigation expenditures. (Kakalik 1996). Complexity of the structural rules governing legal decision-making—such as norms governing the production and use of precedent within the common law system or norms governing the interpretation of texts in code-based systems—may also raise the cost and reduce the effectiveness of using contract law if they reduce the predictability of legal outcomes and increase the need for specialized human capital (and thus the services of specialized professionals such as lawyers). (Hadfield 2001). The more expensive these processes are and the greater the delay and unpredictability in resolution they create, the less effective contract law is as an enforcement mechanism as the cost of enforcement exceeds the value of commitment gains in an increasing number of agreements.

2. Laws Governing the Contracting Environment

Basic contract law also relies on laws governing the environment in which contracting takes place, laws that regulate information and bargaining conditions. For example, the integrity of contractual exchange relies on fraud law to punish those who have positively misled their contracting partners into a contractual relationship and who are best (from an efficiency point of view) deterred by fines and the threat of criminal punishment. This is particularly the case when contract law is limited to the awarding of damages, a remedy that may be inadequate to deter deliberate fraud and that may be no deterrence at all against those who have no assets. Laws requiring truth in advertising and other consumer protection measures support the creation of contracts that reflect more closely the deals that those exchanging contractual commitments prefer under full information. (Hadfield, Howse and Trebilcock 1998).

Legal rules governing the allocation of assets to satisfy contractual obligations (particularly debt obligations) also have an important impact on the efficacy of contract law. Bankruptcy law supports the credibility of commitments by providing a basis for committing to the order in which various creditors (including those who are entitled to collect payments or damages under contracts for goods and services) may lay claim to the assets of an insolvent contracting partner. The laws enabling and governing transactions secured by collateral, deposits, bonds and so on, provide mechanisms for increasing the effectiveness of a contractual promise by reducing the cost of enforcement and/or the risk of unsatisfactory court adjudication and orders. Hansmann and Kraakman (2000), for example, have illuminated the role of corporate law in allowing the owners of a firm to partition assets and make them available only to the firm as an entity (and not the owners themselves) for purposes of securing the contractual commitments of the firm.

The institutional nature of contract law also varies across different types of contract. In many cases particular types of contracts are regulated by statutes addressed to the particular contracting environment. Contract law in civil code systems, for example, tends to separately regulate particular types of contracts: sale contracts, credit contracts, transportation contracts, agency contracts and so on. Even in common law systems, however, with an overarching law of contract applicable in the abstract to any bargained-for exchange, there are numerous laws and regulations specific to particular types of contracts and particular contracting relationships, often with a view to consumer protection and balancing perceived inequalities in bargaining power that may disrupt the efficiency of a bargained-for exchange. Insurance contracts, for example, are often heavily regulated, both with respect to terms and allowed rates, to achieve goals of efficiency and fairness. Franchise contracts may be subject to state regulation, sometimes specifically at the level of industry as is the case in the U.S. with respect to automobile dealerships and gasoline service stations, in response to concerns of defects in the bargaining process or the judicial interpretation of these contracts (Hadfield 1990). Labor law such as the U.S. National Labor Relations Act regulates the process of collective bargaining and contract negotiation between unions and management. Other employment statutes may regulate contracts between non-unionized workers and their employers, guaranteeing minimum notice periods for dismissal for example. Consumer credit contracts are frequently subject to regulations governing required disclosures and terms; in some settings, consumer contracts are voidable to protect against overreaching sales efforts, such as in the door-to-door sales context. Competition laws more generally offer protection against abuse of market power through contracting, and specific contract doctrines such as doctrines of unconscionability (which render unenforceable contracts produced through excessive procedural or substantive inequality), duress and mistake seek to ensure that the contracts that courts do enforce are those that are, in fact, reached under conditions at least approximating efficient information and negotiation.

Laws such as these, which regulate the environment in which specific types of contracts are negotiated, may reduce the costs of contracting by reducing the need for more costly self-protective and enforcement measures, such as costly avoidance, costly negotiation, or costly legal interpretation. They may also increase the costs of contracting, and/or decrease the efficacy of contractual enforcement mechanisms, when they substitute other (public) goals—such as redistribution or political equality—for the private efficiency goals of private ordering. They thus constitute an important part of the richer institutional setting in which "simple" contracts are enforced.

More complex contracts are also dependent on the features of a richer institutional environment to achieve effective and low-cost enforcement. The corporation as a "nexus of contracts" is heavily dependent on the law of corporations supplying rules governing, for example, the duties of corporate officers, shareholder rights and the potential to achieve managerial change through takeovers. Contracts for cooperative business endeavors, such as partnerships, agency agreements and joint ventures, are frequently supported by detailed legal rules governing when these relationships are established, what rights and obligations they confer on the participants, what activities they may undertake, how profits will be shared, and how they may be dissolved. Although much of this law is supplied as default rules in Anglo-American systems—meaning contracting parties can substitute their own privately-tailored terms for the statutory terms—the development of specialized legal human capital, regularized interpretations, customized procedures and so on have an important impact on the cost and efficacy of contract law in these settings. In the absence of a developed law of partnership contracts, for example, it is perfectly possible for contracting parties to use basic contract law to create the features of a partnership such as fiduciary obligations, profit-sharing, an agency relationship, a definition of what activities belong to the partnership and so on. The cost of doing so is much reduced if by simply announcing that they are "partners" the parties are able to effectively obtain the same result through reliance on the default law of what the "partnership" contract entails. Moreover, the amount of information available to the parties to assess the likely consequences of various acts is much greater when they are working within an established legal category such as 'partnership' than when they rely on their one-shot effort to demonstrate the content of their contractual relationship to a court in the event of a future dispute.

Similarly, when parties face a setting in which a contract that fully specifies the obligations they wish to create in all contingencies (a complete contract) is not possible—such as when the features of a good or service are too complex to carefully delineate or when conditions are likely to change making it efficient to adapt performance over time or when the value of a contractual relationship depends on the delegation of roles and responsibilities in making future choices and it is difficult to judge ex post whether the choices made were efficient or self-serving—the cost and efficacy of contract enforcement depends on the availability of legal institutions capable of, and willing to, fills gaps and interpret the incomplete contracts the parties write. (Goetz & Scott 1981, Williamson

1985, Macneil 1985, Hadfield 1990). Whether and how this happens depends not so much on the contract law on the books as on the norms and practices of legal reasoning as applied to contract interpretation and enforcement.

The cost and efficacy of specific types of contracts is thus heavily dependent on the institutional environment and the resources it provides to contracting parties in designing a particular contractual relationship.

3. Rulemaking and Legal Evolution

The absence of institutional detail in our appreciation of what it takes to operate a low-cost and effective system of contract enforcement also reflects a deeper failure to recognize the importance of the institutions that support the essentially *organic* nature of contract law. In any modern economy, and especially in economies that are struggling to develop or transition to markets, the essence of the productivity of contractual relationships is their fluidity and their capacity to respond to and innovate in the presence of changing conditions, technologies and norms and political, social and legal constraints. Agreed-upon exchange generates economic wealth because it seeks out new opportunities and moves resources in response to changing prices and environments. Berkowitz et al (2003) present evidence that the adaptation of transplanted law to local conditions is an important determinant of the ultimate achievement of legality. Effective contract law must therefore be adaptive and changing. The dynamic nature of contract law, however, depends on many legal institutions.

The evolution of law is fundamentally dependent on the designation of which actors are able to adapt and change law and the sources of information available to those that possess the capacity to adapt law. Much of this is itself subtly determined by norms of judicial reasoning and practice, rather than formal rules. Pure common law systems—in which judges overtly possess the capacity to establish legal rules (albeit under the rubric of 'discovering' the law in custom or prior decisions)—create the potential for ground-level adaptation to changing conditions and this is frequently thought to be a strong virtue of common law. Empirical studies have attempted to bolster this conclusion with evidence that countries that have a common law rather than civil code tradition generate more efficient legal rules. (La Porta et al 1998).

Whether adaptation occurs and whether it is an efficient response to the changing needs of contracting parties, however, is a more complex institutional question than these studies let on. A common law/stare decisis system that is not combined with an adversarial process that places primary responsibility for the development of evidence and legal argument on profit-motivated lawyers could well be expected to be unresponsive to changing conditions. Judges who continue to look backwards for legal rules and who are not exposed to the stories of clients' needs and the changing problems of contracting are likely to produce a hidebound and conservative set of legal rules, impervious to the changes outside the courthouse and legal thought. Conversely, "code" systems may be more or less responsive to change depending on judicial practice.

Indeed, Merryman (1985) presents the view that the goal of the civil code of France in particular was precisely to break from the past and to locate the power to change the law not in a backward-looking judiciary but a forward-looking legislature.

Moreover, even in common law systems, there are vast quantities of code law; statutory legal reasoning is heavily influenced by common law legal reasoning in Anglo-American systems. There is as yet no account of why civil code systems, although lacking a historical body of judge-made law, cannot also behave in this way. Schneider (2001), for example, presents evidence that German judges rely extensively on precedent in deciding cases under the civil code; Merryman (1985) suggests that this is generally true in many civil law systems. Institutions such as the practice of publishing and disseminating legal decisions and the subtle norms of judicial behavior and preferences are likely to play a far more important role in the development of a vibrant adaptive contract law than whether or not the formal "source" of law is a civil code.

A comparative institutional analysis of the relative success of common law and civil law systems in generating effective and low cost contract law also has to take into account the impact of these institutions on the quality of information available as law is adapted over time. Precedent-based systems may fall into the problem of bias as they evolve solely on the basis of information culled from existing cases (which are in turn generated by the existing set of rules) rather than information culled (potentially) through the more systematic and representative methods of research available to a legislative process (Hadfield 1992). The bureaucratic and legislative processes involved in drafting legislation, however, may face other distortions in information and incentives arising from interest group politics or organizational failures within the civil service (Bailey and Rubin 1994; Schwartz and Scott 1995).

The evolution of law is also particularly dependent on the subtle interactions between norms of judicial reasoning and legal practice. Law in practice is what judges say it is; if judges resist or do not understand legal rules, then lawyers must respond to what judges perceive and implement rather than what the law says on the books. This can be a particularly important obstacle to the evolution of contract law in economies in transition from socialism to markets. (For examples in Russia, see Hendley (2001).)

Informal judicial norms of legal reasoning will also play an important role in the development of low cost and effective contract law in the face of changing circumstances by making judges more or less receptive to the use of incomplete and relational contracts. These contracts are important devices to provide commitment in settings in which it is difficult *ex ante* to specify precise legal obligations. Judges that are willing to employ relatively expansive approaches to contract interpretation may support contractual commitments in these settings (Goetz & Scott 1981; Hadfield 1990, Shavell 2003); errors in this process may, or may not, undercut contractual commitment (Hadfield 1994; Schwartz and Scott 2003). A judicial approach to interpreting vague and incomplete contracts that attempts to identify the obligation that the parties would have created had

they anticipated a particular contingency may promote more efficient contracting; an approach that penalizes parties for failing to divulge information about the contingency in initial contract negotiations may produce lower cost and effective contracting. (Ayres and Gertner 1989). The judicial approach to these contracts in turn affects the investment by lawyers and others in the development of contracting innovations.

D. Private Dispute Resolution Mechanisms

Contracting parties, in theory, can contract not only over the substance of their transaction but also over the enforcement mechanism they will use to resolve disputes in the event of a failure of commitment. In theory they can therefore avoid public courts, procedures and judges, even public contract rules—other than the rules enforcing their agreement about dispute resolution. Historically, private contract enforcement has been an important factor in the development of commercial contracting (Benson 1989, Greif 1993). Internationally, private arbitration plays an essential role in trade between countries. In the United States, commercial parties have long relied on arbitration and fought in the early part of the 19th century to have their arbitration agreements enforced in public courts (Stone 1999). Trade associations frequently rely on an agreement among members to bring all contract disputes to arbitration conducted under the 'laws' and procedures established by the trade association (Bernstein 1992).

Private dispute resolution holds out the potential to contracting parties of reducing the cost and increasing the efficacy of contractual commitments, by overcoming failures of the institutions that support public contract law regime: corruption; inadequate judicial investments in human capital (particularly with respect to the specific details of a trade or industry); slow, disorganized or overburdened courts; high cost pre-trial procedures or evidentiary standards; overly complex or ambiguous contract rules that require high-cost legal services; and so on.

Private dispute resolution of contract disputes, however, is itself dependent on the background institutions of public contract law. Private arbitration outcomes are valuable only if they are enforceable by the state in the same way that court orders are enforceable. Private arbitration arises through contract, and hence is effective only if the arbitration contract is itself enforced by the public courts. Indeed, arbitration agreements have to be enforced with specific performance in order to be effective, a remedy that may or may not be available under ordinary contract law. Moreover, public courts must cooperate with the private agreement to arbitrate by refusing to hear a dispute that the parties have agreed to submit to arbitration.

The importance of these background legal institutions necessary to support private contracting are evident in the history of the pressure in 1925 for passage of a federal statute in the United States, in the form of the Federal Arbitration Act, in order to overcome Anglo-American common law doctrines dating back to the 17th Century enshrining judicial hostility to the enforcement of agreements

to arbitrate (Stone 1999) Similar issues face courts today in deciding how to respond to the evolution of efforts to develop alternative methods of resolving contract disputes such as mediation agreements, agreements to negotiate in good faith, agreements to refer issues to third-party evaluators, and so on. In this setting we can see vividly the organic role of legal institutions in supporting not only enforcement of contractual agreements but also the evolution of contractual mechanisms to respond to changing conditions, including the conditions of the institutional environment itself.

IV. Conclusion

New institutional economists have understood for some time that there is a need to investigate the institutions that support contractual commitments if we are to understand the determinants of economic growth and prosperity. The complexity and multiplicity of the institutions that support contracting, however, are still underappreciated in the literature. The institutional needs of contracting range from the mundane—court scheduling and case tracking practices—to the sublime—judicial philosophy and the legitimate sources of lawmaking authority. We lack detailed accounts across the entire spectrum. Some (such as La Porta (1998)) have suggested that "common law" systems outperform "civil code" systems but these studies are based on highly simplified notions of the legal institutional differences between "common" and "civil" law; moreover, we do not know what particular features of "common law" institutions matter and whether they are in any way essential to "common law." We have some evidence that "formality" in contract law is associated with longer delays in enforcing some simple contracts but we do not know whether formality depresses contract enforcement in practice or whether formality survives because other institutional adaptations make it irrelevant, reducing the pressure on the law to evolve.

In this chapter I have documented a wide range of institutions that play a role in supporting basic contract law, potentially contributing to the cost and efficacy of this method of enforcing agreed-upon exchange. What we most need to know, however, is which of these institutions matter and how in a given environment. The challenging aspect of studying contractual commitment is the fluidity and adaptability of contracting relationships. Contracting parties have available to them a wide array of enforcement mechanisms and an even wider array of mixed mechanisms such as relational contracts that combine features of formal contracting with reputation and self-enforcement. The enforcement mechanisms vary in cost and effectiveness and what we ultimately require in order to explain and predict economic growth in general and contractual activity in particular are data on the cost and effectiveness of different mechanisms in different institutional environments. For this institutional economists need to explore in far greater detail than we have to date the wide variety of specific institutions that support contractual exchange.

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