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June 18, 2008

The Role of Informal Legal Institutions in Economic Development

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Abstract

The purveyance of the rule of law in developing countries has frequently been associated with positive economic development. Better clarity, scope, transparency and enforcement of the laws will promote confidence and trust in the formal legal system, the argument suggests. At its core, this argument misses a fundamental yet widely recognized tangent to the rule of law – the role of informal legal institutions. The perception of legal systems perpetrated by the state - formal legal systems - is negative in many developing countries. Corruption, high costs and lengthy time periods for issue resolution limit the ability and willingness of many citizens, especially the poor, to access justice via the state. Accordingly, informal mechanisms are frequently relied upon to litigate property disputes, enforce contracts, regulate labor relationships, and address a variety of other legal issues. While some of these informal legal decisions are recognized and given effect by formal legal systems, the overall environment of two legal systems – formal and informal – begs the question, is the potential economic development effect of rule of law programs muted by the existence of a two-track legal system that leads many citizens to seek remedies outside of formal law? This briefing paper lays the groundwork for this discussion by presenting background on the existence of informal legal systems, an explanation of their benefits and discussion of

their significant limitations, and an outline of the nature of the informal economy that is largely affected by informal legal mechanisms. The paper concludes by explaining the contribution that informal legal systems can make to economic development when they are linked to formal legal enforcement.

Extended Abstract

The promotion of the rule of law in developing countries has frequently been associated with positive economic development. Better clarity, scope, transparency and enforcement of the laws will promote confidence and trust in the formal legal system, the argument suggests. It has been suggested that establishing property rights, enforcing contracts, streamlining business registration, and providing legal security for transactions between individuals and small businesses, will promote economic growth by making people more secure in their investments and business dealings. It appears clear that such rights are valuable as an economic development tool and that investments should be made to secure such rights. According to some authors, formal property rights and contract enforcement may even be a prerequisite to economic growth. Others find it to be a necessary, but not a sufficient condition for economic growth. But it has been widely held that some promotion of rule of law principles is essential for economic development.

The idea that law can play an important role in economic development arises from the law and development movement of the 1960s and 1970s. The models of development at that time paid substantial attention to the role of the state and formal legal institutions. Reform programs focused on "more effective operation of state-owned enterprises and 'modern' approaches to regulation of the private sector."¹ The role of the state in facilitating economic development was significantly emphasized. Attempts were made to transplant Western legal institutions, reform legal education programs, and re-evaluate the general culture of law in developing countries. By the mid-1970s, it became clear that this approach was ineffective in promoting development. The distinct conditions in developing countries made the application of Western legal principles largely useless. Changes in the legal culture and education system were largely rejected, and the role of the state was found to be less significant than once thought. One of the principal reasons for this failure was the inaccessibility of the formal legal system by the majority of developing country citizens.

The movement that arose out of the seemingly defunct law and development school of thought focused on the promotion of the rule of law. This movement associated largely with the neo-institutional economics field, which was motivated by the work of Douglass North, and which asserted the importance of institutions in facilitating economic growth. For North, the focal point should be property rights, contract enforcement, and mechanisms that reduce transaction costs between parties. At the same time as this shift in development theory, international politics began shifting from state-led growth policies to free market ideologies. The rule of law movement, then, shaped its developmental priorities on the facilitation of markets, attempting to use

¹ David Trubek, *The "Rule of Law" in Development Assistance: Past, Present, and Future* in David Trubek and Alvaro Santos, *THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL* (2006) at 75.

private law to facilitate economic transactions that would be beneficial to broad economic growth. As David Trubek, one of the founders of the original law and development movement, suggests, "it was necessary to create all the institutions of a market economy in former command economies and remove restrictions on markets in *dirigiste* economies such as those in many Latin American countries."²

Since the establishment of a rule of law movement and the subsequent influx of funding for rule of law programs by institutions such as the World Bank, the focal areas of the movement have shifted. The new model of rule of law recognizes the failures associated with focusing on formalist reform, which emphasized a top-down approach that relies heavily on transplanting Western legal concepts onto developing countries. The World Bank recently concluded that, "attempts to transplant formalist rule of law to developing and /or democratizing countries could actually be counterproductive for economic, institutional, and political development, especially when informal mechanisms would be more effective and efficient."³ Thus, the new rule of law movement began to recognize the reduced role of the state in economic development reform programs where their populations have limited access to formal legal mechanisms.

The effective implementation of rule of law programs today, accordingly, may be largely dependent upon informal legal mechanisms. While it seems clear that these informal mechanisms are utilized by many parties in developing countries, one particular population group is almost wholly dependent upon them. The "informal economy," as it has come to be known, comprises a substantial, if not a majority of the population of many developing economies. It consists of individuals that transact business, including buying and selling property and services, entering into contracts, and operating storefronts; managing labor relationships; regulating real property; and otherwise operating without the protection of the law.

Access to justice, facilitation of business, and control over disputes are part and parcel of an effective legal system, yet a large segment of society cannot, or chooses not to, resort to these state-run institutions. This portion of the population is generally poorer, less secure, less educated, and otherwise excluded from the rest of the formal economy. They are the most vulnerable portion of the population to market shocks and the most exposed to potential injustice. Their inability to access formal legal institutions further weakens their already limited bargaining position in society.

Law, as an institution, limits transaction costs by reducing the risk for the parties to a transaction. Security in the outcome and potential remedy for breach of an agreement, for instance, makes individuals more willing to enter into agreements. In societies in which formal law does not provide this security to individuals or is ineffective

² David Trubek, *The "Rule of Law" in Development Assistance: Past, Present, and Future* in David Trubek and Alvaro Santos, *THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL* (2006) at 84.

³ World Bank, *Legal Institutions of a Global Economy*, <http://www1.worldbank.org/publicsector/legal/index.html>

in what it does provide, informal legal institutions step-in to mitigate the risk and maintain business as usual.

The perception of legal systems perpetrated by the state - formal legal systems - is negative in many developing countries. Corruption, high costs and lengthy time periods for issue resolution limit the ability and willingness of many citizens, especially the poor, to access justice via the state. Accordingly, informal mechanisms are relied upon to litigate property disputes, enforce contracts, regulate labor relationships, and address a variety of other legal issues. These informal mechanisms are part of what Douglass North refers to as the institutional matrix of a society. They function as incentives for and constraints on the behavior of individuals. Property rights, contract enforcement, and labor relationships, can be part of the formal or the informal portion of this institutional matrix.

While some informal legal decisions are recognized and given effect by formal legal systems, the overall environment of two legal systems – formal and informal – begs the question, is the potential economic development effect of rule of law programs muted by the prevalence of informal legal mechanisms in a large portion of developing country populations? Significant mention has been made in law and development and rule of law literature of the importance of informal legal mechanisms and institutions. What has not been thoroughly addressed is the role that they play in the informal economy, where they serve as the primary means of legal redress. This paper attempts to begin to fill that gap in the literature with a brief introduction to the importance of informal legal institutions in the informal economy.

Thus, this briefing paper lays the groundwork for this discussion by presenting background on the prevalence of informal legal systems, an explanation of their benefits and discussion of their significant limitations, and an outline of the nature of the informal economy that largely employs these mechanisms. The paper also highlights the shift in some development thinking to integrate informal institutions into modern rule of law programs. The paper concludes by explaining the potential contribution that informal legal institutions can make to economic development.

Introduction and Issue Identification

Substantial mention has been made in the development community of the importance of establishing and strengthening property rights, enforcing contracts, streamlining business registration, and providing legal security for transactions between individuals and small businesses. These reform efforts have commonly been associated with the rule of law movement. It appears clear that such reforms are valuable as an economic development tool and that investments should be made to procure them.⁴ In fact,

⁴ Although note that the use of law as a development tool has been criticized as having a weak link to economic development. See Kevin Davis and Michael Trebilcock, *The Relationship Between Law and Development: Optimists Versus Skeptics*, Am. J. Comp. L. (forthcoming 2008).

according to some authors, formal property rights and contract enforcement may even be a prerequisite to economic growth.⁵

What is not as clear, in economic circles at least, is the underlying enforceability of such rights and the law upon which they are based. Property rights, contract enforcement, and business regulation, are all legal concepts that require positive and effective law at their foundation. Without the legal enforceability of such rights, there is no practical value in having title to property or a formal contract. As Hernando de Soto pointed out with respect to property – land is useless without an accompanying title showing ownership. Rights and the enforceability of those rights set the foundation for effective exchange, investment incentive, and economic stability. Accordingly, to make the concepts of property, contract, and business rights useful, a body of law must underlie their implementation.

Economists have long-asserted the central role of the state and the individual economic transactions taking place within the state for economic growth. Yet despite the efforts made by many developing states to expand the role of the state and facilitate market transactions, the stark economic growth distinction between developed and developing countries is growing. The role played by institutions, while considered by early economists, has recently been suggested as the missing element in market-based economic growth theory. Institutions have been defined as “the rules of the game in a society or...the humanly devised constraints that shape human interaction.”⁶ These constraints have the potential to reduce transaction costs by facilitating trust and security. With strong institutions, individuals are more likely to take risks, trade freely, and invest in their assets. The resulting contribution to the economy can be beneficial to domestic economic growth.

Law serves as an effective institution by this definition, providing a set of humanly devised incentives and constraints that shape transactions. Law provides a set of rules designed to protect individuals, facilitate transactions between parties, and promote economic development by reducing transaction costs between individuals and firms. Accordingly, law has been promulgated as a means to repair the institutional gap in developing countries and place them squarely on the road to economic growth.

When we begin to examine how legal reform can be provided to all people in a developing country, we run up against a significant issue that is often sidestepped – informality. The majority of people that would be affected by land titling programs, enhanced judicial access, or even the ability to draft formally enforceable contracts, operate outside the formal system of law and thus are found in what the International Labour Organisation (ILO) and many others have called the informal economy. As such, these individuals have little if any access to formal legal institutions, nor any evidence to support claims to property rights or legal persona to defend against contract breach. The scope of this segment of the economy is growing in size and importance to economic development. According to the ILO:

⁵ See, e.g., Hernando De Soto, *THE MYSTERY OF CAPITAL* at 159.

⁶ Douglass C. North, *Economic Performance Through Time: The Limits to Knowledge*, Nobel Prize Lecture (Dec. 9, 1993) at 3.

Concerns with the global job crisis, with the decline in the employment content of growth and the low quality of jobs created, on the one hand, and with changing patterns of work under the new production strategies in the global economy, on the other, are giving new momentum to the informal economy debate in policy discussions, in developing and industrialized countries.⁷

Regardless of this lack of formal access, however, individuals in the informal economy have been able to operate outside the formal legal system, outside the formal economy, and seemingly without a need for formal judicial enforcement or recognition of rights, for many years. What some in the development community have begun to recognize is that these individuals are in fact operating under a very similar set of institutional protections, what we will refer to here as informal legal institutions.

Some economists have contended that the institutions of most relevance to development are economic institutions, which they contend are conducive to protecting property rights and allocating resources. "Societies with economic institutions that facilitate and encourage factor accumulation, innovation and the efficient allocation of resources will prosper."⁸ While economic institutions are indeed central to development, the fact that a substantial portion of the economy operates outside of formal legal and economic constraints makes the role of factor accumulation and innovation subservient to legal protection. The institutions that facilitate and protect property, capital, and labor, are legal institutions, and the driving force behind innovation is intellectual property protection, which is also grounded in legal institutions. Accordingly, the role of legal institutions, formal and informal, may in fact be the primary driver of development within a neo-institutional framework.

This paper, then, will examine what informal legal institutions are, whether or not they are effective for individuals in developing countries as a development tool, and the potential lessons that we can learn from their broad use and applicability.

Informal Rights

Defining the Informal Economy

In order to begin the examination of informal legal systems, we must briefly define the nature of the informal economy. Informality arises in economic and legal discussions in two principal cases – informal labor and informal property. Each will be discussed below.

⁷ International Labour Office, Committee on Employment and Social Policy Report (March 2007) at 2.

⁸ Daron Acemoglu, Simon Johnson, and James Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, Philippe Aghion and Steve Durlauf, HANDBOOK OF ECONOMIC GROWTH at 1-2.

While not the first to identify informality in general,⁹ informal property as a concept in economic development was highlighted by Hernando de Soto in his seminal work on the informal economy, *The Other Path*. Therein, de Soto suggested that the lack of individual property titles and formal state registration processes in many developing countries was causing a significant drain on economic progress. His argument was that the legal and administrative difficulties in registering property (and businesses) left many individuals without an ability to secure credit by using their property as collateral, causing that otherwise valuable property to be useless as an economic asset. Without title to the property, the owner was unable to effectively hold out the property against claims by others, had little incentive to improve upon their property as there was no assurance that they would be able to continue their occupation thereof, and were less likely to invest in their property for personal use or to convert it into some entrepreneurial use, such as a small home business or storefront, since they had little security in their ownership. According to de Soto, the lack of property titles drained the economy of valuable economic resources, creating a pool of what he called “dead capital.”¹⁰ His hope was that developing countries would consider property titling programs, which would require some type of land redistribution, in order to maximize the value of all property in the state.

Informal labor, on the other hand, was also highlighted by de Soto, but with very different causes and consequences.¹¹ The informal labor market consists of workers that do not maintain a continuous formal job but that are in fact engaging in productive work. In some discussions, they are called “underemployed”,¹² in others, “working poor,”¹³ and still others, “informal laborers.”¹⁴ They are not often regulated by the state and generally operate outside of formal legal constraints such as taxation and labor laws, and also without access to health and unemployment insurance. They are generally paid significantly less than formal workers, bear few of the benefits of formal work, and have no opportunity for job training or education that might help them to improve their position or transition to other work.¹⁵

One of the most prominent authors in the field of informal labor markets, Martha Chen, explored this sector extensively and recently identified the dynamic nature of the informal economy. She wrote that “the new definition of the ‘informal economy’

⁹ The informal sector was first publicized in an International Labour Organisation Report on Kenya. See ILO, *Employment, Incomes and Equality: A Strategy For Increasing Productive Employment in Kenya* (1972) at 503.

¹⁰ Hernando de Soto, *THE MYSTERY OF CAPITAL* at 6 (2000).

¹¹ Hernando de Soto, *THE MYSTERY OF CAPITAL* at 71 (speaking about the entrepreneurial opportunities of informal workers and that they are largely prohibited by overregulation).

¹² See, e.g., Franck Wiebe, *Income Insecurity and Underemployment in Indonesia's Informal Sector*, World Bank Policy Research Working Paper 1639 (1996).

¹³ See, e.g., Martha Chen, et al, *PROGRESS OF THE WORLD'S WOMEN 2005: WOMEN, WORK AND POVERTY* (2005) at 12.

¹⁴ See, e.g., Colin C. Williams, *Beyond market-oriented readings of paid informal work: some lessons from Rural England*, *Am. J. Econ. & Soc.* (April 2006).

¹⁵ Martha Chen, *The Business Environment and the Informal Economy: Creating Conditions for Poverty Reduction*, Draft Paper for Committee of Donor Agencies for Small Enterprise Development, 11-19 (2005).

focuses on the nature of employment in addition to the characteristics of enterprises. It also includes informal employment both within and outside agriculture.”¹⁶ Chen went on to identify the reasons why development theories should be more focused on informal employment: “(t)he recent re-convergence of interest in the informal economy stems from the recognition that the informal economy is growing; is a permanent, not a short-term, phenomenon; and is a feature of modern capitalist development, not just traditional economies, associated with both growth and global integration.”¹⁷ It should also be noted that the informal economy, while significantly larger in developing countries than in developed countries, is not absent from the industrialized world. Saskia Sassen, among other prominent authors, has highlighted the existence and growth of the developed country informal sector, often found in immigrant communities that brought their home country practices to the developed world.¹⁸ The focal point of this paper, however, will be on the informal economy in developing countries.

The informal economy is growing.¹⁹ A recent Swedish International Development Agency (SIDA) report found that where economic growth is not accompanied by improvements in employment and better distribution of gains, there will be a rise in informal work, primarily through self-employed entrepreneurs. “In all developing countries, self-employment comprises a greater share of informal employment than wage employment.”²⁰ The report goes on to conclude that more innovative and supportive policies must be developed to focus directly on informal work and workers. These self-employed entrepreneurs could productively contribute to the economy if they were able to hold out their businesses as formal enterprises and count on the protection of the state against competing claims to the ownership of their store, corner of the sidewalk, or goods offered for sale.

Informal property and informal labor comprise the informal economy. Few studies examine the interaction between informal labor and property, and there is nothing that would indicate a necessary linkage between living in untitled property and working outside the formal economy. However, lack of access to benefits, stable income, and the ability to use their employment as a security interest limit the ability of an informal worker to obtain formal property. Both informal labor and informal property can have negative effects on the growth of the overall economy of a developing country.²¹

How is the Informal Economy Connected to the Rule of Law?

One of the principal concerns in development circles with regard to the growth of the informal economy is the increase in the number of people that are unable to rely on the state for protection from trade shocks, labor crises, health emergencies, and other

¹⁶ Martha Chen, “Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment”, DESA Working Paper 46 (2007) at 1.

¹⁷ Chen, DESA Working Paper 46 at 2.

¹⁸ See, e.g., Saskia Sassen, “New York City’s Informal Economy”, 4 ISSR Working Papers 9 (1988).

¹⁹ See, e.g., Chen, DESA Working Paper 46 at 2.

²⁰ SIDA, The Informal Economy Fact Finding Study (2004) at 3.

²¹ World Bank, Informality: Exit and Exclusion at 1-2 (2007); Inter-American Development Bank, *Outsiders: The Changing Patterns of Exclusion in Latin America and the Caribbean* at 7 (2008).

significant concerns that would generally give rise to some type of state protection. According to the World Bank, “(t)he presence of a large fraction of the workforce in Latin America that does not count on formal mechanisms to hedge or mitigate these shocks is, hence, of intrinsic concern.”²² The state serves to provide its citizens with public goods, such as roads and defense, prevent social bads, such as health crises and pollution, and provide for economic protections through regulation, property rights, and the rule of law.²³ Lack of access to these public benefits can leave large swaths of people in dangerously insecure economic territory.

While there is some evidence of voluntary participation in the informal economy, the decision to find work or property in the informal economy is often the result of an inability to secure work or property in the formal economy. High unemployment rates in the formal sector combined with flexible labor practices of formal enterprises lead many workers to seek alternative income opportunities and many employers to recruit such workers.

When citizens are forced or choose to enter the informal economy to find work or property, they leave behind many of the protections of the state. A job that a worker takes in the informal economy is not generally regulated or protected by the state. Accordingly, it does not provide benefits such as health insurance, unemployment insurance, right of redress for labor law violations, or benefits such as sick leave and skills training. In the case of self-employment, for instance, which makes up the majority of informal workers, a sick worker can mean the end of their business endeavor.

Many of the least appealing jobs, such as street vending and domestic service, are often filled by those with few alternative employment prospects. Perhaps more significantly, the informal economy is primarily occupied by the poorest citizens.²⁴ Because informal work is unstable and unregulated, low wages and lack of benefits maintain the limited individual economic growth opportunities already endured by these workers. And because informal property rights are limited, access to credit that might be used to improve an individual’s economic situation is equally limited. Add to this the failure of formal legal systems to protect the rights and enforce the duties of these individuals and the result is what has been dubbed “social exclusion.” According to the Inter-American Development Bank, “(s)ocial exclusion is an inefficient and dysfunctional dynamic social, political, and economic process whereby individuals and groups are denied access to opportunities and quality services to live productive lives outside poverty.”²⁵

Rule of law programs have attempted to remedy some problems with respect to judicial access, property rights, and contract enforcement. These programs developed out of the crumbling law and development movement of the 1960s, and came on the

²² World Bank, *Informality: Exit and Exclusion* at 22 (2007).

²³ World Bank, *Informality: Exit and Exclusion* at 22-23.

²⁴ Chen, *The Business Environment...* at 19-26.

²⁵ Inter-American Development Bank Report, *Outsiders: The Changing Patterns of Exclusion in Latin America and the Caribbean* at 3 (2008).

scene in Latin America in the 1980s.²⁶ The movement gained momentum quickly, despite the uncertain linkages between law and economic growth.²⁷ Authors such as Thomas Carothers, David Trubek, Alvaro Santos, and Kenneth Dam, recently provided substantive analyses and critiques of this linkage, identifying past approaches to using law to promote economic development and all generally concluding that it is a positive and necessary, if uncertain, force in economic development. A review of these works by Kevin Davis and Michael Trebilcock concluded the following:

While there appears to be an increasingly firm empirically grounded consensus that institutions are an important determinant of economic development...there is much less consensus on which legal institutions are important, given the existence of informal substitutes, what an optimal set of legal institutions might look like for any given developing country, or for those developing countries lacking optimal legal institutions (however defined) what form a feasible and effective reform process might take...²⁸

One of the perceived barriers to the implementation of effective rule of law programs is the existence of an underground economy that circumvents the law in their transactions. This informal economy comprises a substantial, if not a majority proportion of many developing country populations. It consists of individuals that transact business, including buying and selling property and services, entering into contracts, and operating storefronts; manage labor relationships; regulate real property; and otherwise operate without the protection of the law. Access to justice, facilitation of business, and control over disputes, are part and parcel of an effective legal system, yet a large segment of society cannot, or choose not to, resort to state-run institutions. While early rule of law programs, dubbed the formalist movement, pushed for better legal education programs, courts, and other state-based institutions, individuals living and working outside of formal constraints were all but ignored in their legal needs. "(T)he formal legal system – the main focus of legal liberalism – was not accessible to the majority of the populace in most developing countries."²⁹

As a result, social networks, community legal institutions, and other informal legal organizations arose to provide protection where the state was absent, inefficient, costly or unreliable. Social norms and culture served as bases for actions, and community members served as judges and juries. Property rights were protected, contracts were enforced, and in some instances, business transactions were regulated, by informal legal institutions. The social norms and culture underlying these institutions could be characterized, in the neoinstitutional context, as part of the "rules of the game," equivalent to formal law.³⁰

²⁶ Thomas Carothers, *The Rule of Law Revival*, in *Promoting the Rule of Law Abroad: In Search of Knowledge* at 3-4 (2004).

²⁷ See, e.g., Kevin Davis and Michael Trebilcock, *The Relationship Between Law and Development: Optimists Versus Skeptics*, *Am. J. Comp. Law* (forthcoming 2008).

²⁸ Davis and Trebilcock at 60.

²⁹ Davis and Trebilcock at 27.

³⁰ See, e.g., Kenneth Dam, *THE LAW-GROWTH NEXUS* at 66 (2006).

Informal Legal Systems

An informal legal system is a set of rules and guidelines by which individuals respect and enforce the rights and responsibilities of other individuals in situations that do not give rise to formal legal protection. These systems are found in what de Soto calls the extralegal sector, which he equates with the informal economy.³¹ De Soto argues that, “the extralegal world is typically viewed as a place where gangsters roam, sinister characters of interest only to the police, anthropologists and missionaries.”³² Yet, he continues, this is the world in which the majority of individuals operate, both socially and economically, and failure to address the pressing legal concerns of this population risks the stability of the economic system as a whole.

Informal law might be thought of as similar to traditional or mercantilist law, which developed early in human history and set the foundations for modern legal structures. Exchange was based on trust and reputation and disputes were settled within the confines of the community. As societies became more complex, more extensive legal structures evolved from these traditional mechanisms, including administrative law, codes and hierarchies of legal authority. “Formal codified law emerges when the social structure of a given society becomes so complex that regulatory mechanisms and methods of dispute settlement no longer can be dependent on informal customs and social, religious, or moral sanctions.”³³ Yet in many developing countries, factors such as the lack of central political control, unified communities, and weak economic development, have prevented them from fostering a formal legal system.³⁴

The Pursuit of Justice

In some developing countries, especially those that did not inherit or develop a strong rule of law system at their inception as nation-states, citizens resort to traditional legal structures to enforce their claims. This is especially true in states in which state courts and judges are seen as corrupt, inefficient, or otherwise costly.³⁵ Citizens may “exit” the formal legal marketplace when the institutions that would otherwise provide them remedies are seen as ineffective, inefficient and unfair.³⁶ This rationale has been characterized as a dysfunctional social contract between citizens and the state, whereby public services that the state is expected to provide in exchange for taxes and electoral power, are ineffective or non-existent.³⁷ A World Bank study found a correlation between the effectiveness of government services and the size of the

³¹ De Soto, *THE MYSTERY OF CAPITAL* at 122.

³² De Soto, *THE MYSTERY OF CAPITAL* at 30.

³³ Steven Vago, *LAW AND SOCIETY* (2006) at 39.

³⁴ See, e.g., Francis Fukuyama, “Social Capital and Civil Society”, IMF Conference on Second Generation Reforms (1999) (“The fact of the matter is that coordination based on informal norms remains an important part of modern economies, and arguably becomes more important as the nature of economic activity becomes more complex and technologically sophisticated.”)

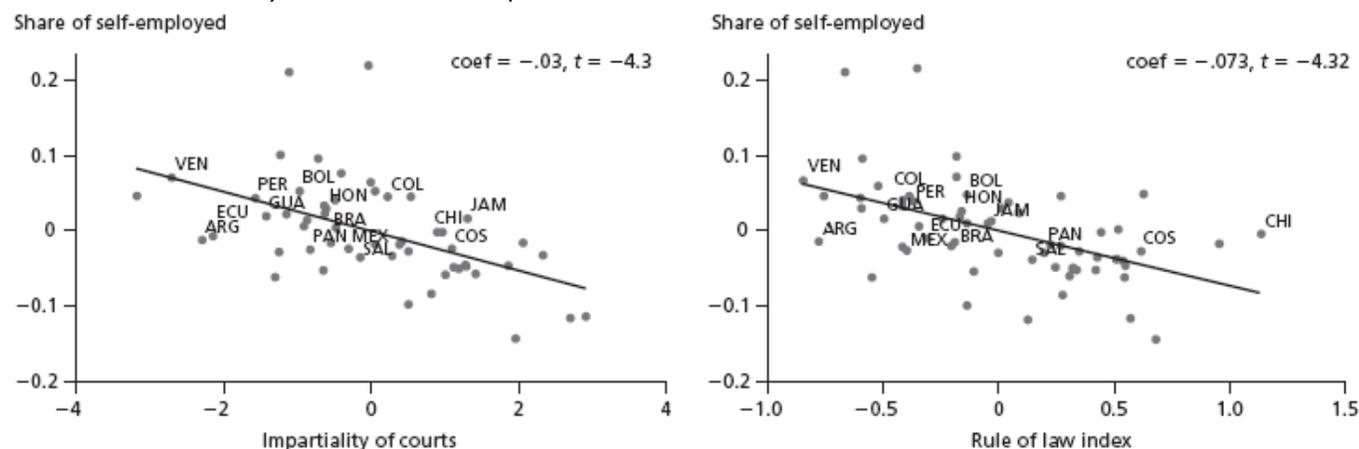
³⁵ See, e.g., Thomas Barfield, *Informal Dispute Resolution and the Formal Legal System in Contemporary Northern Afghanistan*, Draft USIP Report (April 21, 2006).

³⁶ World Bank, *Informality: Exit and Exclusion* at 215.

³⁷ World Bank, *Informality: Exit and Exclusion* at 216.

informal sector. Lack of trust in the government's ability to provide for their citizens appears to drive more people into informality.³⁸ Estimates from the World Development Indicators also identify a correlation between informality and weak rule of law in Latin America (table 1).

Table 1. Informality and State Competence Indicators³⁹



Informal legal mechanisms work to facilitate property, contract, and labor transactions in the absence of formal legal protections. If the costs of formal legal enforcement of property rights would be too high, the property is better off remaining in the extralegal sector than being subjected to judicial review of ownership. In the case of property, the extralegal sector fills the gap between formal rights recognition and simple possession, a grey area in many developing countries. For contracts, it serves to create binding obligations enforced via social trust networks when judicial remedies are unavailable. And in the case of labor, it creates employment relationships and informal obligations between employers and employees where formal contract enforcement is unavailable.

Protections Offered by Informal Legal Systems

Property Rights

When it is not possible to establish formal legal title to property, institutional mechanisms can step in to provide a basic level of recognition for that property. Communal property rights serve as the informal mechanism for providing limited security in informal property interests. Plots in many informal communities are carefully segregated and identified with one owner.⁴⁰ Within that community, that owner enjoys benefits that might be equivalent in some sense to formal title, including protection against competing claims, incentive to invest time and resources into maintenance and improvement of the property, and ability to identify the property as collateral for local credit.⁴¹ The enforcement problem arises when that property is challenged by the true

³⁸ World Bank, *Informality: Exit and Exclusion* at 220.

³⁹ World Bank, *Informality: Exit and Exclusion* at 221 (focusing study on Latin America and the Caribbean).

⁴⁰ Hernando de Soto, *DOG BARKS*

⁴¹ De Soto, *THE MYSTERY OF CAPITAL* at 183.

legal owner or by individuals outside of the community. Informal legal institutions can only protect property against claims by those that recognize the informal occupier as the rightful owner. Thus, while the informal system provides limited protection within the community, its geographic scope continues to restrict linkage with the broader economy, keeping any economically productive use of the property limited in scope to the community in which the occupying owner's rights are recognized.

Contract Rights

Informal legal mechanisms also serve to protect individuals to a formally unenforceable contract. Again, it is the enforcement of contracts and the resolution of contract breaches that require some form of legal intervention - a basic offer, acceptance and performance without resulting disputes hardly needs formal protection as the parties perform their duties without objection. In the situation in which a dispute arises when the parties are legitimately entering a contract and the subject matter of the contract is legitimate, a court may serve as an effective resolution mechanism.⁴² However, cost prohibitions, lack of access to representation, and inability to attach assets for enforcement of judgments, can limit the value and thus the utilization of this resource.⁴³ Thus, social stigma becomes the enforcement mechanism of choice in many informal communities. A vendor that is a member of a community is unlikely to risk his reputation by failing to perform his obligations under a contract. The result would be a loss of respect and a subsequent lack of business.⁴⁴ Of course, this stigmatization would have little effect if the contract is with a non-member of the community or if the breaching vendor chooses to leave the community. But in the instance of a vendor interested in maintaining his reputation, the risk of lost business provides an adequate informal mechanism to restrict his actions.

Labor Rights

Finally, in the informal labor market, informal legal mechanisms serve to provide labor regulation to a minimal degree; however, most of the issues that arise in this context can also be covered by the contract discussion above. Many service providers, such as the transportation or microfinance industries, form cooperatives to maintain consistent provision of services and to limit overlap of the provision of services.⁴⁵ These cooperatives, like informal communities, have the ability to ostracize members or take their routes away should they violate generally accepted codes of conduct. What informal legal systems are unable to do is to provide a system for the provision of fair wages, working conditions, benefits, or training. The expansive amount of labor available in developing countries provides a seemingly ceaseless supply of cheap

⁴² But note that even legitimate contracts may fail for lack of evidence. See De Soto, *The Other Path* at 163.

⁴³ De Soto, *THE MYSTERY OF CAPITAL* at 55-56 (discussing the risk of forfeiture and other property seizure upon an enforceable judgment in Western legal systems).

⁴⁴ See, e.g., Francis Fukuyama, *TRUST* (1995).

⁴⁵ Allan Rosenbaum, *Cooperative Delivery of Public Services: Reflections on the Dynamics of Public Sector – Private Sector – Civil Society Collaboration on Governmental Service Delivery*, The Fourth Global Forum on Reinventing Government: Capacity Development Workshops conference paper, at 5-7 (2002) (noting the rapid increase in cooperatives between the state and the private sector).

labor, meaning that any attempt to negotiate fair wages and benefits on their behalf with willing employers would be overcome by the availability of other sources of (non-union) labor. Accordingly, informal legal institutions outside of contract enforcement are less effective for labor contracts with the formal marketplace.⁴⁶

What informal legal systems do not provide

The informal economy as a whole is largely and directly affected by legal and regulatory systems that fail to provide several things:

1. Adequate and affordable access to formal legal dispute resolution mechanisms with the enforcement authority of the state;
2. Accessible and efficient property registration processes;
3. Appropriate levels of regulation of the labor market; and,
4. Recognition of informal property titles and contracts for financial and legal transactions with public and private entities.

Each of these concepts will be discussed briefly below.

Adequate and affordable access to formal legal dispute resolution systems with the enforcement authority of the state

When a contract is drafted by an attorney in the United States, the mindset of the parties is likely to be positive and looking toward the benefits of the transaction that each hopes to conclude in their interest. The mindset of the attorney, however, is on what will happen when something goes awry after the contract has been signed. Preparing for disputes is part of the contract drafting process, and identifying mechanisms to resolve those disputes in advance is part and parcel of a good contract. The result could be the inclusion of a binding arbitration clause, forcing the parties to arbitrate all disputes rather than submitting to the jurisdiction of a court, a liquidated damages provision, setting a specific amount to be paid in the instance of certain types of default, or perhaps a choice of forum clause, establishing a particular state, usually favorable to one of the parties in interest, where all legal claims will be heard. Each of these mechanisms serves to protect the parties in the instance of a dispute.

In many developing countries, such dispute resolution mechanisms are not as easily identifiable or accessible. Parties to a contract drafted outside the formal legal system particularly face substantial hurdles in enforcing their contract in the instance of a dispute. Without formal recognition of contracts drafted between parties for goods or services in the informal sector – such as a contract for the provision of labor at less than minimum wage, or the unlicensed sale of commodities on the street – a court is unlikely to enforce the terms against either party. Contracts that are drafted between informal laborers and formal or semi-formal enterprises have the additional problem of adhesion contracting as the parties are of unequal bargaining power and the informal party may have little ability to negotiate or challenge the provisions of the contract.⁴⁷

⁴⁶ Chen, DESA Working Paper 46 at 8 (suggesting that while labor relationships do exist between informal workers and the formal economy, they are often unregulated).

⁴⁷ Frank Garcia, *Is Free Trade "Free?" Is It Even Trade? Oppression and Consent in Hemispheric Trade Agreements*, 5 Seattle J. for Soc. Justice 505 (2007).

Additionally, the informal laborer is less likely to have access to legal representation or finances to invest in the resolution of disputes with a party that is more formally established and that has easier access to such services.⁴⁸

In place of formal dispute settlement mechanisms, many informal economy contracting parties rely on social norms to enforce the provisions of the contract. The loss of trust in a party that breaches a contract can significantly affect that party's future business opportunities and may negatively impact their family's reputation in the community. This may serve as adequate incentive to prevent the breaching party from avoiding the contract obligation. Failure to carry-out obligations under an informal contract can result in losses to one party, lack of trust in the breaching party and perhaps their family, and potentially, violence.

In other cases, parties require access to mechanisms beyond social stigmatization. The community often has an informal dispute settlement mechanism in place that the parties can access when they cannot afford formal dispute resolution. Examples of such mechanisms from Kenya, Afghanistan and Colombia, are below.

Case Studies on Dispute Resolution in Informal Legal Systems

Kenya

Research on informal dispute resolution systems in Kenya led two authors to conclude that even informal dispute settlement processes have their price.⁴⁹ In Kenya, two distinct legal processes are available to disputing parties. The first channel is via the provincial administration, which was established during colonial rule, and which allows for local resolution of disputes. This mechanism is less costly than state courts and utilizes parties from within the community to serve as decision makers to effectively settle conflicts. The formal mechanism constitutes the second channel, which directs parties to state-sponsored tribunals (e.g., land tribunals for property disputes) that consist of representatives from each of the local districts. The latter process is supported by the state and creates binding and enforceable outcomes. Because the state has sought to discourage the use of informal dispute resolution mechanisms, decisions of the provincial administration are non-binding and are not enforceable in court.

Interestingly, the authors of the article conclude that even though the informal process through the provincial administration is more affordable and accessible to those individuals operating outside the formal economy, it is also increasingly perceived as unjust and illegitimate due to perceived abuses of process.⁵⁰ This is one of the reasons that the informal process was stripped of power to enforce decisions by the state. The authors conclude that, while much literature supports the use of informal dispute settlement mechanisms, they may in fact be more costly in terms of rent-seeking

⁴⁸ For instance, the Uniform Commercial Code in the United States refuses to enforce any contract that is entered into unconscionably, that is, unfairly. U.C.C. § 2-302.

⁴⁹ Elin Henrysson and Sandra F. Joireman, "On the Edge of the Law: The Cost of Informal Property Rights Adjudication in Kisii, Kenya", SSRN 1003427.

⁵⁰ Henrysson and Joireman at 15.

opportunities of the decision-makers due to lack of a monitoring mechanism and the inability to enforce decisions in state courts.⁵¹

Afghanistan

A draft report on the dispute resolution system in Afghanistan points to a problem that appears to arise in the instance of post-conflict transitional states. The report discusses the substantial reliance upon informal dispute resolution mechanisms, called *shuras*, despite the existence and availability of formal courts.⁵² Individuals complained that the formal courts were corrupt, costly and inefficient, and judges were generally disliked. The informal system was found to be quicker and cheaper and thus more respected than formal mechanisms. The *shura* system involves the selection of representatives from the community, lending a degree of respect over the distant and temporary relations of local judges. Decisions of these *shuras* have the advantage of being registered with formal courts and, in many cases, given formal legal effect.⁵³ One judge noted that, "(i)n most cases, we encourage people to solve their disputes through local *shuras* and councils...at the end we stamp the arbitration paper as the representative of the court which gives it legal value."⁵⁴ This process takes a significant case burden off the courts and helps to facilitate the recognition of judgments. However, it should be noted that one of the reasons the informal and formal dispute resolution systems can function in tandem is that they both rely on sharia law as the basis for their decisions. Other developing countries in which customary rules relied upon in informal dispute resolution procedures differ from formal legal rules may have a more difficult time reconciling judgments.

Colombia

Similar to Kenya and Afghanistan, Colombian citizens have little faith in their formal judicial system. In a study of 4,500 rural households across three Andean districts in Colombia, Edgardo Buscaglia found that, like the rest of Latin America, Colombia has an ineffective legal system that is ill-prepared for the development of a strong private market economy.⁵⁵ In his study, he found that neighborhood councils, or *parroquias vecinales*, were used more than twice as often as formal court mechanisms, and that their decisions enjoyed a high-level of legitimacy due to the fact that they are constituted by prominent local residents. Like the *shura* decisions in Afghanistan, decisions of *parroquias vecinales* are generally given tacit approval by municipal authorities, allowing local government enforcement of their decisions.⁵⁶

Buscaglia's study sheds additional light on the subject of access to dispute resolution mechanisms by inquiring of residents what obstacles prevent them from seeking formal

⁵¹ Henrysson and Joireman at 23.

⁵² Thomas Barfield, *Informal Dispute Resolution and the Formal Legal System in Contemporary Northern Afghanistan*, U.S. Institute of Peace Rule of Law Program Draft Report (April 21, 2006).

⁵³ Note that business cases are not generally afforded such legal recognition by the formal court system.

⁵⁴ Barfield at 4.

⁵⁵ Edgardo Buscaglia, *Justice and the Poor: Formal Vs. Informal Dispute Resolution Mechanisms: A Governance-Based Approach*, World Bank (2001) at 5.

⁵⁶ Buscaglia at 9.

dispute resolution. The vast majority of residents complained of a lack of information about their rights and obligations under the law as preventing their access to formal justice. The three culprits in Afghanistan and Kenya followed in the Colombian survey responses – direct costs, delays and corrupt practices.⁵⁷ Interestingly, the Colombia study evaluates the net worth of residents before and after accessing formal legal channels for dispute resolution by measuring change in household income and assets. The study concludes that the poorest ranks of the population are negatively impacted economically when they try to resolve their disputes formally, which may be attributed to high court costs and delays in resolving pressing disputes. Buscaglia calls this a “regressive tax on those households within the bottom net worth range.”⁵⁸

The focus of acquiring access to dispute resolution mechanisms should be on both evaluating the effectiveness of informal mechanisms to determine their viability and whether their decisions can and should be enforced in formal courts, and also on providing more effective and affordable access to formal courts by reducing filing fees, providing a sufficient cadre of public defenders, and limiting damages against indigent parties. Access to formal dispute resolution mechanisms may be necessary in order to effectively enforce judgments and seek resolution of more serious legal complaints. However, use of informal dispute resolution channels appears to bypass legitimate concerns over costs, delay, and corruption, in formal dispute resolution systems, and reduces the caseload burden on formal courts.

Accessible and efficient property registration processes

In developed countries, we often take for granted the process of registering a business, transferring a title to property, or even renewing our driver’s license. These processes are the result of years of legislative and regulatory modifications that sought to streamline administrative processes and reduce bureaucracy. The fluidity to which many of us have become accustomed differs substantially from the cumbersome and often time-consuming administrative process in developing countries. De Soto conducted independent surveys of the registration and operation of a business in Peru in order to confirm his suspicions that the process in developing countries was too complicated and overregulated. The results were clear and provided strong evidence that overregulation was stalling the registration of businesses and, according to de Soto, discouraging some individuals from operating formally at all.⁵⁹

Recent World Bank reports continue to confirm de Soto’s conclusions about the regulatory processes in developing countries - the time that it takes to register a property in many developing countries is substantial in comparison to the process in developed countries. A sampling of countries ranked by ease of doing business and organized by property registration rank is listed in Table 2 below.

Table 2. Property Registration Number of Procedures and Rankings (World Bank Doing Business 2007).

⁵⁷ Buscaglia at 11.

⁵⁸ Buscaglia at 15-16.

⁵⁹ De Soto, *THE OTHER PATH* at 131-187 (discussing the costs of remaining or becoming a formal business).

<u>Economy</u>	<u>Ease of Doing Business Rank</u>	<u>Registering Property</u>
Singapore	1	13
Iceland	10	8
Belgium	19	161
Puerto Rico	28	117
Spain	38	42
Armenia	39	2
Botswana	51	36
Mongolia	52	18
Colombia	66	69
Jordan	80	109
Nicaragua	93	130
Russia	106	45
Bangladesh	107	171
Uganda	118	163
Tanzania	130	160
Sudan	143	32
Afghanistan	159	169
Sierra Leone	160	172
Eritrea	171	158
Venezuela	172	74
Congo, Dem. Rep.	178	141

To highlight the difference between the higher and lower rankings in terms of property registration, we can note that in Singapore, it takes roughly 9 days and 3 procedures at a cost of 2.8% of the property value to register property; in Colombia, it takes 23 days and 9 procedures at a cost of 2.5% of the property value; and in the Democratic Republic of Congo, it takes 57 days and 8 procedures at a cost of 9.7% of the property value.

Yet even if the registration of property is efficient and affordable, many individuals operating informally are occupying land that is not theirs (squatting) and thus will have to pursue legal action to quiet title, in order to determine the proper owner of the property. Some development economists have argued that the most effective way to achieve economic development in terms of property rights is to allow the most productive user of the property to acquire title.⁶⁰ Even if this procedure were applied, formal legal procedures would need to be established to ensure that the true owner of the property is duly notified and compensated, potentially by the state, and that conflicts over ownership between the owner, law enforcement and the occupier, do not impede redistribution efforts.

⁶⁰ Ronald Coase, *The Problem of Social Cost*, J. of L. and Econ. (1960) (arguing that the efficient allocation of property rights will have the most beneficial effect on reducing economic transaction costs).

Appropriate levels of regulation of the labor market

De Soto argued that the reason people function outside the formal legal system in a developing country is directly linked to the costs of operating formally. According to de Soto, ineffective administrative and legal mechanisms force people into extralegal relationships.⁶¹ Chen takes this analysis deeper by linking the nature of employment relationships to the state of the regulatory structure. She finds that informal work is either disguised deliberately in order to avoid recognition of a legal relationship; ambiguous, as in the case of a street vendor selling goods as an agent of a distributor; or not clearly defined, as would be the case in most sub-contractor relationships.⁶² None of these employment relationships provide labor law protections for the employee, yet firms relish the opportunity to utilize these informal workers because they come at a significantly lower cost and with less need for long-term employment contracts than do formal sector workers.⁶³ As employment opportunities decline in many developing countries, more workers find it necessary to find this survival work, despite the costs.

Chen agrees with de Soto that overregulation plays a major role in impeding employment in the formal economy.⁶⁴ But she also finds that the opposite can be true. Lack of regulation can be just as costly to economic development. As an example, she asserts that many cities do not have any laws regulating street vending, allowing law enforcement to deal with them as they see fit, which tends to exacerbate the problem rather than working with street vendors to ensure their safety and economic progress. Rampant corruption combined with low wages for law enforcement officers results in routine bribery and facilitation payments made by informal operators.

Following the logic of Chen, Victor E. Tokman explains the need for employers to have flexibility in their hiring and employment of laborers.⁶⁵ Tokman argues that employers are interested in bypassing labor regulations in order to maintain responsiveness to changes in labor costs and demand for their goods and services. Yet Tokman makes clear that we must recognize the distinction between the existence of regulatory frameworks on the books and the state's willingness or interest in enforcing those frameworks.⁶⁶

Accordingly, thorough examination of the regulatory environment in which informal labor markets operate is a crucial area to address. Flexibility is a key facet of effective labor market regulation because it can limit opportunities of employers to take advantage of unregulated labor, while at the same time freeing them to expand their

⁶¹ De Soto, *THE MYSTERY OF CAPITAL* at 156.

⁶² Chen, *DESA Working paper 46* at 8.

⁶³ Chen *DESA Working paper 46* at 9.

⁶⁴ Chen *DESA Working paper 46* at 9.

⁶⁵ Emilio Klein and Victor E. Tokman, "A Comparative View of Regulations and Informality", in Victor E. Tokman and Emilio Klein, *REGULATION AND THE INFORMAL ECONOMY* (1996).

⁶⁶ Klein and Tokman at 33.

cadre of workers formally without being forced into excessive employment relationships when their need is short-term.⁶⁷

Recognition of informal property titles and contracts for financial and legal transactions with public and private entities

De Soto opens his book, *The Other Path*, with a story about the transportation industry in Peru and how many rural areas that needed access to the city for work were unable to find adequate transportation due to their remote location and the limited availability of buses. A group of informal entrepreneurs recognized this problem and formed a cooperative to try to service the necessary routes with adequately-sized vehicles. As the popularity of such services grew and the city continued to be unresponsive to the needs of its rural citizens, the cooperative sought to purchase over 100 buses, but they lacked an effective mechanism to finance the purchase. They had no titles to their homes or to any of their personal possessions that could be used as collateral, no bank accounts, and no formal credit. In the end, a foreign financial institution, Deltec Banking Corporation, provided them with sufficient funding to purchase buses for the routes using the buses as collateral and listing the new owners' informal property titles as evidence of property ownership.⁶⁸

The fact that informal communities lack formal titles should not signify to the world that they are not the owners of their property. But the lack of formal title is evidence of substantial lending risks for banks and credit institutions as there is no way for them to ensure that their property could actually be signed over to the bank upon default and whether their contract would even be enforceable in court. In most developed countries, processes for title searching are commonplace and are used by all lending institutions considering the provision of collateral to guarantee a loan. Such searches are less common in developing countries and, even if they did exist, they would be unlikely to result in the recognition of the informal property holder's name in the record as they are only occupying the property.

However, the use of informal networks and organizations as a substitute for the state in conducting business transactions is growing. As informal organizations become accepted by a larger constituency, comprise a larger portion of the informal economy, and provide access to a greater amount of information, reliance upon such organizations to reduce the costs of conducting business is becoming commonplace. The World Bank has emphasized its focus on law as an institution conducive to economic change, rather than the state.⁶⁹ In order to conduct business outside the strictures of state institutions, where the bulk of those in greatest need of legal and

⁶⁷ See Chen, DESA Working Paper 46 at 9 (suggesting the firms prefer informal workers in order to avoid strenuous regulated labor contracts).

⁶⁸ De Soto, *THE OTHER PATH* at 118.

⁶⁹ World Bank, Law and Development Movement, available at <http://siteresources.worldbank.org/INTLAWJUSTINST/Resources/LawandDevelopmentMovement.pdf>

economic protection reside, informal institutions can serve as a valuable substitute for formal law.⁷⁰

What is largely absent from many formal legal systems in developing countries today is formal recognition of property titles and judgments set forth by informal legal organizations. The need for credit to invest in businesses and basic home improvements, education, and health care is clear. Accordingly, a system of informal title recognition should be developed in which the state or a third party can rely on informal title records and community affidavits to provide a guarantee that can be used to secure credit. These guarantees could be backed by the full faith of the government to repay the loan if necessary. They could provide much needed access to credit and they would convert an informal legal institution – reputation and trust – into a formal legal tool – collateral. The ability of a party to enforce judgments or seek remedies for breaches of contract regulated by informal legal organizations in the formal legal environment is a key element in the provision of security for investors. Recognition and enforcement of such judgments may build a bridge between informal businesspeople and their formal counterparts.

The Potential for Developmental Gains from Informal Legal Institutions

There is potential to rely on informal legal institutions as a form of precedent for formal legal mechanisms. In the case of property, this could mean that recognized property titles in informal communities would be able to serve as evidence and perhaps as a sufficient basis for providing formal legal protections against competing claims and for granting formal title. With respect to contracts, decisions of community councils and other informal enforcement bodies could serve as evidence of the existence of a valid and enforceable contract in the formal court system, allowing the court to effectively enforce judgments of those informal bodies. And in the case of the labor market, employment relationships that have existed informally may serve as a reasonable basis to extend formal labor rights to the employee upon the showing of certain factors, perhaps including a minimum length of employment, minimum working hours, and a willingness to continue such employment by both parties. By creating legislation that authorizes the use of informal property titles, contracts, and labor relationships, as precedent for formal legal enforcement, a bridge is built between the formal and informal economies, allowing for a limited degree of integration of the two markets and moving toward broader formalization.

Supplanting often ineffective and incomplete informal enforcement mechanisms with the force of formal law is likely to be beneficial to economic development and growth; however, ignoring the existing informal legal institutions could be a costly mistake as it sacrifices an existing body of law that relieves investigators and legal professionals of significant fact-finding missions to identify proper titles, contract relationships, and labor arrangements, for instance. Existing legal structures serve a valuable purpose not only to maintain order outside formal economic relations, but also as a bridge between

⁷⁰ Kerry Rittich, "The Future of Law and Development: Second-Generation Reforms and the Incorporation of the Social," in David Trubek and Alvaro Santos, *THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL* (2006) at 224.

informal and formal enforcement of the law. "No law is better than another, as long as it is able to regulate relations between people or communities, protect the weak and establish a degree of equity in the way the society functions."⁷¹

The World Bank recently moved away from a formalist conception of the rule of law and instead embraced the possibility of engaging the informal legal economy:

A new conventional wisdom about the rule of law and development seems to have taken root in development circles. It is asserted that formalist rule of law, which stresses institutionalized legal mechanisms and absolute autonomy from politics, is a necessity for economic development. But attempts to transplant formalist rule of law to developing and/or democratizing countries could actually be counterproductive for economic, institutional, and political development, especially when informal mechanisms would be more effective and efficient.⁷²

The Role of Institutions in Development

Douglass North argues that institutions are essential for economic development, including not only law and social norms, but also customs and unwritten codes of conduct.⁷³ North suggests that institutions are the "rules of the game" that allow transactions to take place and that these rules can be measured in terms of transaction costs and efficiency. In addition, North found that the two types of institutions – formal institutions, such as an existing legal system, and informal institutions, such as codes of conduct or cultural norms – work together in most societies to provide necessary incentives and limits on behavior.

Enforcement of law requires not only law enforcement personnel, but also a certain level of awareness of, respect for, and understanding of the law. If the law is ineffective or does not serve the needs of the people, it will be exceedingly difficult to enforce. "Substantive rules on the books do not capture the essence of a legal system."⁷⁴ Enforcement of laws may be even more important to economic development than the existence of substantive law itself.

Kenneth Dam asserts that "rule-of-law institutions are not essential for economic activity (although they are relevant to economic growth)."⁷⁵ To ensure productive foreign trade, contract enforcement and property protection are essential. Transition to rule-

⁷¹ Abdou Diouf, Justice and Development, from World Bank Ideas for Development blog (Feb. 27, 2008).

⁷² World Bank, Law and Justice Institutions, Rule of Law and Development, available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20934363~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062,00.html>; see also, David M. Trubek and Alvaro Santos, *The New Law and Economic Development: A Critical Appraisal*, at 90-91 (2006).

⁷³ Kenneth W. Dam, *THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT* (2006) at 22.

⁷⁴ Dam at 22.

⁷⁵ Dam at 70.

of-law in most states has been an evolutionary process. “(N)o degree of improvement in substantive law – even world “best practice” substantive law – will bring the rule of law to a country that does not have effective enforcement.”⁷⁶ Without effective legal institutions, Kenneth Dam argues, such as the judiciary, changes in substantive law make little difference.⁷⁷

North argues that institutions “form the incentive structure of a society” and that these in turn are the foundation for economic performance. Institutions consist of formal and informal constraints and their enforcement characteristics. They determine the transaction costs, which constitute part of the costs of production. Only when there are no transaction costs are institutions unnecessary. Because economic markets are imperfect and include high transaction costs, institutions matter.

North finds that the rational-choice framework in economic theory only holds water in the context of individual decision-making in highly developed societies. It does not function in environments of uncertainty, especially within markets in transition. Growing interdependence among people spurs the need for more complex institutions to capture potential gains from trade. Yet it is important to note, as North does, that “economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement.”⁷⁸ Accordingly, endogenous growth of complex institutions may be the most effective contributor to overall economic growth.

These increasingly complex institutions that North refers to may in fact be reflected in the existence of informal legal systems. There is a growing recognition that civil society organizations and social networks may serve a valuable purpose in providing for the legal demands of citizens that otherwise do not have access to formal justice.⁷⁹ Formal legal institutions may not be necessary for a society to function properly in a global marketplace. “Rather than the antithesis of law, now informal norms may supplement or even supplant formal law in the facilitation of business transactions.”⁸⁰ This is a significant change in previous thinking about the rule of law and has given rise to a number of important ramifications. The role of law in development may be multi-faceted and complex, operating both at a formalistic level within state-based institutions that govern transactions similar to developed countries, as well as an informal level where informal institutions, social networks and civil society organizations develop or inherit rule-based structures that provide the equivalent of state-based protection, yet outside the state structure.

Informal institutions serve to fill the supply gap of formalist law, yet they also reflect a distinct approach to the provision of justice. They operate at the community level, giving them some sense of additional credibility, and serve equitable as well as judicial remedies. In the interest of community cohesion and development, these informal

⁷⁶ Dam at 93.

⁷⁷ Dam at 95.

⁷⁸ North, *Economic Performance Through Time*, at 366.

⁷⁹ See World Bank Rule of Law website, *supra*.

⁸⁰ Kerry Rittich, in Trubek and Santos at 224.

institutions are in a better position to use law as a redistributive tool, whereas formal institutions are bound to constrain their decisions to formal law.⁸¹

Some theorists, especially those interested in East Asian growth, have concluded that formal legal institutions have little role to play in development.⁸² Rather, they contend that informal social networks and systems of dispute resolution can have the most dramatic effect on economic growth. “(I)nformal mechanisms that recognize and protect private property rights and ensure performance of contracts are often effective substitutes (for formal law)”.⁸³ However, it has also been asserted that once a country reaches a certain stage of economic development, formal mechanisms play a more substantial role in continuing the developmental trajectory.⁸⁴

North believes that a key facet to good development policy is the development of flexible institutional structures that adapt to their particular environment.⁸⁵ Informal legal systems may well provide the flexibility needed to meet the demands of the informal legal marketplace. For North, the need for institutions arises due to high transaction costs.⁸⁶ Law, as an institution, reduces transaction costs by reducing the risk for the parties to a transaction. Security in the outcome and potential remedy for breach of an agreement, for instance, makes individuals more willing to enter into subsequent agreements. In societies in which formal law does not provide this security to individuals or is ineffective in what it does provide, informal legal institutions step-in to mitigate the risk and continue business as usual.

Accordingly, the value of informal legal institutions may be equally important in terms of economic development as is the establishment of formal institutions. Rule of law practitioners and institution-oriented economists would do a disservice to developing countries if they were to ignore the importance of these institutions to economic development.

Limits on the practicality of informal legal systems

Informal legal systems are not appropriate for all cases. While they are likely more effective at resolving most civil disputes involving land, family, contract and tort law, and may be effective in managing some criminal cases, they are unlikely to be effective in resolving cases involving deprivation of liberties, serious criminal cases requiring state punishment, and cases involving foreign law or parties.⁸⁷

“Property is not a primary quality of assets but the legal expression of an economically meaningful consensus about assets. Law is the instrument that fixes and realizes

⁸¹ See, e.g., Kerry Rittich at 225.

⁸² See, e.g., Katarina Pistor & Philip A. Wellons, *THE ROLE OF LAW IN ASIAN ECONOMIC DEVELOPMENT (1999)*.

⁸³ Davis and Trebilcock at 47.

⁸⁴ See, e.g., Kenneth Dam, *THE LAW-GROWTH NEXUS (2006)*.

⁸⁵ North *Economic Performance Through Time* at 367.

⁸⁶ North, *Economic Performance Through Time* at 360.

⁸⁷ See, e.g., Buscaglia at 20.

capital.”⁸⁸ Focusing on this legal identity behind the assets, contracts, and labor relationships, will help us to understand the legal intricacies of economic exchange. What this briefing paper has presented is a system of alternative law, a mechanism that exists in the formal and informal economy, and one that can be capitalized upon in order to extend the reach of the rule of law.

The principal issue raised in this essay is whether there exists, in addition to an informal economy, an informal legal system intended to fill the void left by the ineffective formal legal system in developing countries. And if such a system exists, should the system be exploited through a process of unifying formal legal institutions with informal legal operations, should informal decisions be given no formal weight, or should jurisprudence outside of formal state-sanctioned institutions serve as persuasive, or even mandatory authority.

Conclusion

Informal legal systems fill the void in property recognition, contract enforcement, and in some cases, labor rights, for those individuals unable or unwilling to avail themselves of formal legal enforcement. Recognition and utilization of this informal mechanism to help us determine the identity of property owners and the existence of informal contract and labor relationships can help legislators build effective formal legal institutions that encompass the full range of legal relationships in developing countries.

The majority of literature on rule of law and institutions suggests that the law has an important role to play in guiding economic development. However, as Kevin Davis and Michael Trebilcock conclude in their survey of the field, there is no certainty as to what that role is and which legal institutions in particular play the most important part in economic development.⁸⁹ This essay suggests that informal legal institutions play a key role in providing access to a substantial portion of the population that otherwise would have no formal legal options. Accordingly, while their impact on economic development directly is uncertain, their importance in informal communities is indisputable. Broader recognition of the role played by informal legal mechanisms and enforcement of informal legal body decisions has the potential to further reduce transaction costs between individuals, which may in turn facilitate the expansion of economic opportunities through investment, credit arrangements, and small business development. Thus, the formal recognition and enforcement of informal legal rights and decisions appears to have a positive role to play in economic growth and development.

⁸⁸ De Soto at 157.

⁸⁹ Davis and Trebilcock at 60.