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# PRIVATE ORDER UNDER DYSFUNCTIONAL PUBLIC ORDER

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The freedom and extent of human commerce depend entirely on a fidelity with regard to promises.<sup>1</sup>

## INTRODUCTION

Businesspeople need contractual assurance. Most transactions are less straightforward than a cash sale of an easily identifiable item. Buyers need assurance of the quality of what they are purchasing, and sellers need assurance that bills will be paid. The legal system may not always be available to provide contractual assurance — and when the law is dysfunctional, private order might arise in its place.

Many developing and transition economies have dysfunctional legal systems, either because the laws do not exist or because the machinery for enforcing them is inadequate. In such countries, bilateral relationships, communal norms, trade associations, or market intermediaries may work in place of the legal system.<sup>2</sup> In this Article, we use data obtained from surveys of firms in five transition economies in Eastern Europe and the former Soviet Union as well as Vietnam to show that, at least in these economies, social networks and informal gossip substitute for the formal legal system, while business networks

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1. DAVID HUME, *A TREATISE ON HUMAN NATURE* 546 (Oxford University Press, 1978 & 1739).

2. Even in countries where the legal system works well, there is still often a need for private order, as we discuss later. For example, market players may prefer private-order mechanisms to the courts, either because certain kinds of agreement are not susceptible to court enforcement or because the transaction costs of using private order are smaller than those of using the courts.

and trade associations work in conjunction with it.<sup>3</sup> These transition countries provide an informative place to examine the interaction between the formal legal system and private-order mechanisms because both are in a state of flux. Although market-oriented laws have begun to replace the bureaucratic controls of the old planned economy, private firms' access to the courts varies, from almost no access in Vietnam to considerable access in Poland and Romania. Even within these countries, the transitional state of the legal system means that managers vary in their perceptions of the courts' usefulness, and ultimately it is their willingness or unwillingness to utilize the formal legal system that shapes the development of private order.<sup>4</sup> Because the data from these economies contain more variation than would be found in a steady-state economy, we can run meaningful regressions relating firms' behavior to their perceptions of the courts' workability.

Many types of private-order mechanisms arise in market economies. Sometimes parties directly involved in the transaction arrange the private order. For example, if a buyer is locked in with a particular seller, either because the seller is a monopolist or because the buyer would face high costs of locating an alternative seller, the seller can make the contract self-enforcing by cutting off further dealings. Self-enforcement in these lock-in situations sometimes takes more imaginative forms. A New York cable television company, Paragon Cable, has a novel strategy to get its customers to pay their overdue bills.<sup>5</sup> It does not unhook the cable. Instead, using what is supposedly a far more effective bill-collection measure, Paragon runs C-SPAN, with its political speeches, debates, and hearings, on all seventy-seven channels.

In close-knit communities, where people interact with each other frequently and information flows freely, people may adhere to social norms of cooperation because it is in their long-term interest to do so. For example, this type of relational contracting has arisen spontaneously within groups such as whalers and neighboring cattle farmers, as Robert Ellickson has shown.<sup>6</sup> In Asia, especially among the ethnic Chinese, contracting typically rests on personal relationships, or

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3. The surveys in Eastern Europe and the former Soviet Union were done in collaboration with Simon Johnson. They are described in more detail in Simon Johnson et al., *Entrepreneurs and the Ordering of Institutional Reform: Poland, Slovakia, Romania, Russia, and Ukraine Compared*, 8:1 ECON. TRANSITION 1 (2000) [hereinafter Johnson et al., *Entrepreneurs*].

4. We asked our survey respondents (managers of recently started firms) whether they believed they could use the courts to enforce contracts with customers or suppliers. In Vietnam, just 9% said they could. In Romania, 87% said the courts were usable, in Poland 73%, in Slovakia 68%, in Russia 56%, and in Ukraine 55%.

5. See *Telecommunications Policy Review* 8 October 1995, p. 9.

6. See ROBERT C. ELICKSON, *ORDER WITHOUT LAW* (1991).

*guanxi*.<sup>7</sup> In Japan, according to Ronald Dore, firms' opportunism is limited by "moralized trading relationships of mutual goodwill. The stability of the relationship is the key. Both sides recognize an obligation to try to maintain it."<sup>8</sup>

In the right circumstances, then, private order can be achieved *spontaneously*. In large, anonymous communities, however, where people can enter and leave and where alternative trading partners are readily accessible, spontaneous private order may not be feasible. Anonymity strips reputational constraints of their power; more is needed than social norms or self-enforcing dealings. Private order, if it is to operate at all, needs to be *organized*.

Market participants thus sometimes form themselves into groups such as trade associations to support contracting and create private order. Profit-seeking firms also sometimes provide private order: market intermediaries such as wholesalers and trading companies on occasion supply, among other services, contractual assurance for buyers and sellers. We argue below that private-order organizations of either kind have two roles in sustaining contracting: first, providing information about breaches, and second, organizing the responses to those breaches. Historical studies of notably diverse settings, from medieval Europe to present-day Mexico, demonstrate a consistency in this functioning of private-order organizations: a private organization (such as a market intermediary or a trade association) disseminates information about contractual breaches, and then coordinates the community's response to them. The usual sanction is to boycott the offender. These private-order organizations provide contract-enforcement mechanisms that lie between formal, state-supported order and informal, spontaneous order.

Private order unfortunately also has a down side. It sometimes harms efficiency by excluding new entrants from trading or by achieving price collusion. Private order also can cause or perpetuate racial or gender discrimination. Additionally, some private-order organizations' enforcement techniques overflow into criminal violence. Because of these disadvantages, private order can usefully supplement public law, but cannot replace it.

Our evidence comes from two sources. First, we review published descriptions of private-order practices in various countries. In reviewing this anecdotal evidence we aim to show how similar private-order mechanisms have arisen in quite diverse settings, from medieval Europe to present-day Mexico. Second, we analyze data from the surveys of entrepreneurs we conducted in countries in the process of transition to a market economy from central planning: Vietnam,

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7. See Yao Souchou, *The Fetish of Relationships: Chinese Business Transactions in Singapore*, SOJOURN 2, 1, 89-111 (1987).

8. RONALD DORE, TAKING JAPAN SERIOUSLY 173 (1987).

Russia, the Ukraine, Romania, Slovakia, and Poland. In using this statistical evidence, we aim to examine, in depth, how the legal system affects the operation of private-order mechanisms, both spontaneous and organized.

In Part I, we discuss why private order is needed and why it sometimes needs to be organized, and argue that private organizations serve two functions — to disseminate information about contractual breaches and to coordinate the responses of multiple parties. We then provide evidence in Part II to demonstrate when private order works spontaneously and when it does not. In Part III, we present evidence regarding the information provision and coordination roles of private-order organizations. In Part IV, we discuss evidence demonstrating how private-order mechanisms interact with the formal legal system. We conclude in Part V with a discussion of the downside of private order, and argue consequently that public order sometimes is preferable to private order.

## I. REPEATED GAMES AND THE LAW

In this Part, we describe the role and emergence of relational, informal contracting (private order) in relation to the relative adequacy of the existing legal system (public order). As a preliminary matter, we then describe the different types of private order (spontaneous and organized), the functioning of each, and, correlatively, when each type arises. In the subsequent parts, we explore more fully when and how these two types of private order function.

### A. *The Law versus Relational Contracting*

Many business dealings have the character of the prisoner's dilemma. A seller can cheat by supplying inferior merchandise, and a buyer can cheat by not paying its bills. The best outcome for both, of course, is that neither cheats. In an isolated transaction, however, both parties may have an incentive to cheat, leading to an outcome that benefits neither.

There are two ways to counter the self-defeating incentives of the prisoner's dilemma. One is the law. If the players can write binding contracts in advance promising not to cheat, with a sufficiently severe sanction for cheating, then it is rational not to cheat. The other countermeasure arises from repetition of the game, or relational contracting. Players may refrain from squeezing the last cent out of the current deal because they wish to do business in the future, either with this particular trading partner or with others who could learn of this behavior. Contracting thus becomes self-enforcing through the threat of retaliation and consequent loss of business. In other words, the shadow of the future can induce the trading partners to cooperate.

If the legal system functioned perfectly, contracts would never need to be self-enforcing. A frictionless legal system would always work at least as well as relational contracting. In practice, however, laws meant to provide contractual assurance sometimes do not exist, and even when they exist, their application and enforcement may not be cost-effective or even possible.

Some countries, especially developing and transition countries, have inadequate legal systems. Writing good laws does not automatically solve the problem, for it takes years to create the institutions of a functioning court system and to train judges and lawyers. Indeed, in some countries rampant corruption renders the courts entirely unreliable.

Even in countries with sophisticated legal systems, the law may not work smoothly. For example, the transaction costs of appealing to the law sometimes exceed the transaction costs of using relational contracting. Market participants have some advantages over judges in deciding whether commitments have been fulfilled.<sup>9</sup> First, market participants possess greater expertise than courts in the monitoring of other participants' conduct. Second, their decisions and actions can be more nuanced than the binary decision that a court must make — that of liability or no liability.<sup>10</sup> Third, they can consider information that cannot be introduced in court, such as impressionistic evidence about business trends or judgments about the quality of items sold. They can base their decisions on a firm's behavior over time, on probabilistic patterns that would not be admissible evidence in court.

In countries with functioning legal systems, then, relational contracting can supplement the law by mitigating the transaction costs of investigation and enforcement. In countries with dysfunctional legal systems, on the other hand, relational contracting may replace the law altogether. We shall investigate both situations.<sup>11</sup>

### B. *Spontaneous versus Organized Contracting*

The size of a community and the adequacy of existing market institutions influences whether spontaneous order can arise, or whether

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9. See David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 415-17 (1990). There are, of course, good reasons why certain kinds of evidence are inadmissible. A cost of achieving the economic efficiencies that, on average, such probabilistic evidence produces is that sometimes in specific instances the outcome is unjust. The law is designed to avoid specific injustices more than to produce outcomes that on average promote efficiency.

10. For example, a finding of liability in one lawsuit may not have the same far-reaching effects of a boycott by other market players, or of consequently restrained or narrowly tailored dealings with a party found guilty of breach.

11. See *infra* Part IV.

spontaneous order is rendered ineffective and the order must therefore be organized.

### 1. *Spontaneous Contracting*

If a buyer and seller expect to deal with each other repeatedly, each might refrain from cheating the other in order to maintain the relationship. Whether the prospect of future business suffices to overcome the immediate incentive to cheat depends on the value attached to any future returns. For cooperation to be consistent with self-interest, the interactions must be sufficiently frequent and future returns must not be discounted too heavily.

Spontaneous cooperation between two trading partners also requires them to be locked in with each other. If the buyer can easily find another seller to deal with, the seller's threat to cut off future business carries little weight.<sup>12</sup> On the other hand, if firms are locked in with their current trading partners, perhaps because they trade a unique product or because of the difficulty of locating alternative trading partners, the firms will make efforts to sustain their existing relationships. This implies, incidentally, that spontaneous cooperation is easier to achieve when market institutions are inadequate. Lock-in prevails in underdeveloped economies with poor market information or high transport costs. As the economy develops and market frictions fall, the cost of breaking a relationship will also fall and firms will become less willing to cooperate with each other. Thus, more sophisticated economies can rely less on this type of spontaneous, lock-in relational contracting.

### 2. *Organized Relational Contracting*

If no lock-in exists and the two parties deal with each other only infrequently, then cooperation will not further their interests. The shadow of the future can still come into play in such a situation, however, if the retaliation for a breach comes not only from the affected party but also from other firms — that is, if community sanctions apply.<sup>13</sup> A firm will more likely pay its bills if it knows that its other trading partners, current or potential, would otherwise refuse to do business with it.

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12. See Rachel Kranton, *Reciprocal Exchange: A Self-Sustaining System*, 89 AM. ECON. REV. 830 (1996) for a model of the effects of lock-in on cooperation.

13. See Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993) [hereinafter Greif, *Contract Enforceability*]; Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912 (1994); Michihiro Kandori, *Social Norms and Community Enforcement*, 59 REV. ECON. STUD. 63 (1992).

Although community sanctions sometimes can be invoked spontaneously, they often need to be managed.<sup>14</sup> For example, even in markets with adequate information flow, the sheer size of the market may mean that some players may not even learn about third-party contractual breaches, and therefore not know when to enact sanctions. Or, even where informational problems do not exist, the application of differential sanctions by uncoordinated market players may provide outs for the breacher. In these situations, community sanctions do not work without formal organization. This organization might be an independent third party, such as a wholesaler or some other kind of market intermediary, or it might be the firms themselves in combination, like a trade association. These organizations serve to provide both information about breaches and coordination of the community response.

*a. Providing Information.* As a first matter, then, the enactment of community sanctions requires the provision of information because firms must know when a breach has occurred and who caused it. Private organizations can serve as convenient and effective repositories of this information. In addition, by providing formal channels of communication, an organization can reduce the likelihood of mistakes in the transmission of this information. As anyone who has played the children's "telephone game" can attest, stories change when they are orally transmitted through a chain of people.<sup>15</sup> As a result, reliable information transmission depends on having only a few links between the original source of the information and each recipient. This would require every member of the group to communicate frequently with every other member. This type of spontaneous communication may be unlikely or even impossible in a large group, and organizations therefore provide the most reliable means of information transmission.<sup>16</sup> These organizations may take the form of trade associations formed by the actual market players, or of market intermediaries, such as wholesalers.

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14. We posit here that organized private order arises when market characteristics foreclose effective functioning (or even development) of spontaneous order. Of course, there are situations where organized private order exists but may be dysfunctional, see *infra* Section II.A, and market players therefore revert to (or maintain) spontaneous order as the primary mechanism for enforcing contracts. This phenomenon is unsurprising when one considers the existence of private order in the face of an existing but dysfunctional formal legal system.

15. In the telephone game, a long sentence is whispered from one person to another in a group. The second person repeats the sentence to a third, the third to a fourth, and so on, until everyone has heard the sentence. The last member then repeats what he or she heard, usually uttering a sentence entirely unrelated to the original. On the idea that a formal organizational structure reduces the likelihood of mistakes, see Joel Sobel, *How to Count to One Thousand*, 102 *ECON. J.* 1 (1992).

16. This problem with the transmission of information provides another explanation for the inability of relational contracting to be effective in larger groups.

A trade association can effectively serve as a repository of information. A buyer, say, considering dealing with a new seller can go to the information repository and check whether the seller has a history of renegeing on deals. In addition, a trustworthy party may be needed to investigate any reports of cheating and assess which party to the transaction actually cheated. A trade association (or other type of information provider) can perform this task, and can also check the veracity of the offended firm's claim that it has been cheated (for example, claims of unpaid debts or delivery of low-quality goods). Otherwise, sellers could use the threat of reporting to hold up innocent buyers, or vice versa.<sup>17</sup>

In the examples provided below,<sup>18</sup> we will show that trade associations must inspect their own members as well as those on the other side of the transaction. If they imperfectly police their own members, then those members may use the threat of multilateral sanctions in bargaining with their customers, thus undermining their own incentives. The key lies in verification of the claims of cheating. Having verified, the organization might just publicize the cheating, or it might take a more active role in generating punishment by community sanctions or some other route.

A wholesaler or market intermediary that deals with several customers can also have an effect similar to that of an information repository. If a seller produces a low-quality item, it risks losing not just the customer who bought the good, but also other customers, if the wholesaler that handled the purchase ceases dealing with the seller. In addition, if the wholesaler stocks multiple product lines, it has an incentive to drop a renegeing seller; otherwise its own reputation will suffer, with consequent loss of sales in its other product lines.<sup>19</sup>

Moreover, the benefit of intermediaries as information-providers goes beyond the implementation of community sanctions. By inspecting the quality of a product and certifying it, intermediaries resolve problems generated by asymmetric information about trading partners' capabilities. The fact that intermediaries are prominent in the marketplace and themselves have a reputation to maintain gives them an incentive to carry out this certification honestly. Trading through intermediaries generates a better match of buyers to sellers than does unintermediated trade.<sup>20</sup> If the intermediary is a monop-

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17. See Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225, 2267-69 (1999); Paul R. Milgrom et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 ECON. & POL. 21 (1990) reprinted in REPUTATION 243 (Daniel B. Klein ed., 1994).

18. See *infra* notes 74 to 80 and accompanying text.

19. See Gary Biglaiser & James Friedman, *Middlemen as Guarantors of Quality*, 12 INT'L J. INDUS. ORG. 509 (1994).

20. See Gary Biglaiser & James W. Friedman, *Adverse Selection with Competitive Inspection*, 8 J. ECON. & MGMT. STRATEGY 1 (Spring 1999).

list, this information provision and certification role may be attenuated; the monopolist might choose to reveal only partial information. If sufficient competition exists among intermediaries, on the other hand, complete information might be revealed.<sup>21</sup>

*b. Coordination of Community Response.* As well as information, coordination is sometimes needed in enacting community sanctions. Information and coordination are separable in principle though not in practice: without information, coordination obviously cannot occur. For private order to work, the issue is whether it suffices for market participants to be informed of a breach, or whether, in addition, effective sanctioning requires some coordination of their responses.

Coordination has two aspects. First, the repeated game has multiple equilibria; as in the standard prisoner's dilemma, many different outcomes are consistent with everyone behaving rationally. Cooperation supported by the threat of community sanctions is not the only possible outcome. Another equilibrium has everyone cheating. This rests on a self-confirming prophecy: each player expects everyone else to cheat, so each cheats, and everyone's expectations are fulfilled. An effective initiation of cooperation faces an obstacle: it does not pay to act in a trustworthy way unless you believe that everyone else will act in a trustworthy way. Escape from an untrusting equilibrium requires everyone to change his beliefs about others, and his own behavior, simultaneously. Such a coordinated change is unlikely to occur spontaneously if there is more than a handful of players; someone will have to organize it.

Moreover, because most economic interactions can be more complicated than the standard prisoner's dilemma, there is an aspect to this multiplicity of equilibria beyond the issue of achieving *cooperative* outcomes. Complicated economic interactions indeed have a range of *efficient* outcomes that can be achieved. So in addition to achieving cooperation, there must also be a resolution of the issue of how to share the gains from that cooperation. Squabbling over the division of the spoils frequently causes agreements to break down. By developing customary rules to govern exchanges, and perhaps even by offering formal arbitration procedures, an organization can help prevent these costly bargaining breakdowns.

The second aspect of coordination involves the resolution of the free-rider problem. After a seller has cheated a buyer, other potential buyers may have little incentive to join in the sanctioning of the cheater. It furthers each individual's interest to let bygones be bygones.<sup>22</sup> But if all do that, there is no sanction. A formal organization

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21. See Alessandro Lizzeri, *Information Revelation and Certification Intermediaries*, 30 RAND J. ECON. 214 (1999).

22. See Dilip Abreu, *On the Theory of Infinitely Repeated Games with Discounting*, 56 ECONOMETRICA 383 (1988).

may be needed to provide the discipline to prevent this free-riding over punishment.

How, then, do private-order organizations address these two problems? Organized private order means that any individual trader need not have frequent (or any) contact with any other particular trader in order for reliable information to be transmitted between the two. Hence, more open groups are workable. Furthermore, an organization increases the force of economic sanctions because it eliminates the need for future dealings to occur between any single pair of traders. To sustain cooperation it is only necessary that a firm foresee future dealings with *some* members of the group.

## II. WHEN SPONTANEOUS ORDER DOES, AND DOES NOT, WORK

Spontaneous cooperation may arise between two transactors or among many. In this Part, we review anecdotal and empirical evidence on bilateral relational contracting.

### A. *Bilateral Relational Contracting*

Long-term bilateral relations are pervasive in less-developed countries. In Moroccan bazaars, for example, the lack of an organized market for information means that the “search for information one lacks and the protection of information one has is the name of the game.”<sup>23</sup> The result is a “clientalization” of the market where, for the sake of assurance against being cheated, buyers habitually return to the sellers they know, even if other sellers offer lower prices. In rural Thailand, rice and rubber are marketed in different ways.<sup>24</sup> Rice is sold in impersonal auction markets, while rubber is traded via long-standing bilateral relationships between growers and buyers. The difference between these two formats lies in the ability of the buyer to assess the quality of the product. Whereas a buyer can immediately assess the quality of rice, the quality of rubber becomes apparent only several months later when it is processed. The buyer must trust the grower to have carefully removed impurities; this trust rests on the relationship.<sup>25</sup>

Vietnam’s transitional economy provides a stringent test of the workability of spontaneous private order because the legal system is inadequate (or at least is perceived as such by market players) and the economy is not yet far enough developed for private-order organiza-

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23. Clifford Geertz, *The Bazaar Economy: Information and Search in Peasant Marketing*, 90 AM. ECON. REV. 28, 28-30 (1978).

24. See Ammar Siamwalla, *Farmers and Middlemen: Aspects of Agricultural Marketing in Thailand*, 29 ECON. BULL. FOR ASIA & PAC. 38, 41-44 (1978).

25. See *id.* at 44.

tions to have been built. A survey of managers of small start-up firms in Vietnam we conducted in 1995 showed the inadequacy of formal contract-supporting institutions, both public and private.<sup>26</sup> The managers we interviewed said that they did not believe the courts could help them. "They normally just create more problems," said one.<sup>27</sup> "[I]n Vietnam no one believes we have a good legal system."<sup>28</sup> According to another, "[t]he court is weak and no entrepreneurs use it."<sup>29</sup> In responding to the inquiry on whether third parties exist that can enforce agreements with customers or suppliers, only 9% of those interviewed thought that a court or other government agency could help.<sup>30</sup> Third parties provide even less help for disputes over the quality of goods; only 2% of the managers said they would take such disputes to court or appeal to local authorities.<sup>31</sup> Moreover, trade associations do not seem to play a major contracting role. While 47% of the surveyed firms belong to a trade association, only 28% of these (or 13% of the total) say that the association provides "information about the trustworthiness of customers or suppliers," and only 13% (or 6% of the total) say that the association provides "contract and/or dispute resolution."<sup>32</sup> Most deals among Vietnam's firms, therefore, rest on unorganized bilateral relational contracting.

Because bilateral relationships require some degree of lock-in between the two parties,<sup>33</sup> our survey also asked a series of questions about the surveyed firms' first and newest customer relationship.<sup>34</sup> These data provide evidence regarding the relevance of customer lock-in for relational contracting. Using, as our measure of lock-in, the number of sellers of similar products located within one kilometer of the seller in question, we found that a seller's willingness to grant trade credit to a customer is significantly related to the buyer's degree of lock-in. A seller that has competitors nearby offers its customers about fifteen percentage points less trade credit than one with no nearby competitors.<sup>35</sup>

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26. See John McMillan & Christopher Woodruff, *Dispute Prevention Without Courts in Vietnam*, 15 J.L. ECON. & ORG. 637 (1999) [hereinafter McMillan & Woodruff, *Dispute Prevention*].

27. *Id.* at 640.

28. *Id.*

29. *Id.*

30. See *id.* at 641.

31. See *id.*

32. *Id.* at 649.

33. See *supra* text accompanying note 5.

34. See John McMillan & Christopher Woodruff, *Interfirm Relationships and Informal Credit in Vietnam*, 114 Q.J. ECON. 1285 (1999) [hereinafter McMillan & Woodruff, *Interfirm Relationships*].

35. See *id.* at 1299.

Given that they are locked together, people can learn to trust each other. Bilateral cooperation may evolve in relationships via a process in which the potential loss from having a trading partner defect is kept small in initial transactions and allowed to increase as the relationship progresses. Our Vietnamese managers described such a process. They said that they investigated potential trading partners before starting a trading relationship by talking with the customer's neighbors or other trading partners. But even with this pre-trading research, it is difficult for managers to identify trustworthy customers at the outset. Early in the relationship, the two sides of the trading relationship test each other. As trading continues, experience with the trading partner provides information. One manager explained that "[p]eople show their personality through their actions in difficult times," so after a few transactions this manager selected a few customers to concentrate on.<sup>36</sup> The data show that longer-lasting relationships involve significantly more trust. After two years of dealings, the amount of trade credit offered is on average fourteen percentage points higher than at the start of the relationship.<sup>37</sup>

Also, given that they are locked in, the firms may be able to design the terms of each transaction so as to reduce the reliance on the shadow of the future by reducing either party's immediate temptation to renege. Setting the timing of payments right might achieve this, for example. If a manufacturer must make some initial specific investment in order to meet a buyer's needs, the gains from defection can be balanced by having the buyer pay part or all of the bill in advance of delivery. There is evidence that the Vietnamese firms structure their transactions in this way.<sup>38</sup>

### B. *Multilateral Relational Contracting*

Bilateral relational contracting is not reliable if lock-in does not exist between the two trading partners. Relational contracting may still develop spontaneously, however, if community ties are strong enough.

Communities of traders may derive social norms that encourage cooperation between any two of their members. Interviewing ranchers in Shasta County, California, Robert Ellickson found that "most residents resolve trespass disputes not according to formal law, but rather, according to workday norms that are consistent with an overarching norm of cooperation among neighbors."<sup>39</sup> Among the rural

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36. McMillan & Woodruff, *Dispute Prevention*, *supra* note 26, at 652.

37. See McMillan & Woodruff, *Interfirm Relationships*, *supra* note 34, at 1306.

38. See McMillan & Woodruff, *Dispute Prevention*, *supra* note 26, at 644-48.

39. ELLICKSON, *supra* note 6, at 48.

residents, interactions are frequent and residents expect them to continue indefinitely into the future. The conditions for cooperation in a repeated game are thus met. Similarly, merchants in Mexican California of the 1830s and 1840s, dealing with one another repetitively, enhanced the effect of reputation by communicating their experiences with one another.<sup>40</sup> Given the small size of the community and the frequency of interactions, gossip sufficed to keep traders honest. Among New York City garment-manufacturing firms, interfirm relationships promote cooperation, and thus reduce transactional uncertainty, facilitate the exchange of goods that are difficult to price, and enable the creation of agreements that are difficult to enforce contractually. These relationships often start from third-party referrals, and often are based on social relationships outside business.<sup>41</sup>

Our data on Vietnamese firms show that network links among firms engender cooperation.<sup>42</sup> We asked managers how they first learned about a customer before beginning to trade with it. If they responded that they found the customer through “other similar producers,” “other suppliers,” or business associations, we interpreted the two firms to be connected by a business network. One-quarter of the ongoing customer relationships in the sample were initiated through such business links. Connections significantly increased cooperation: a customer identified through a business network on average paid 10% to 20% more of its bills after delivery than did a customer identified by other means.<sup>43</sup> Similarly, in Africa, “firms that rely on information sharing to screen prospective credit recipients sell an additional 36% to 39% of their output on credit relative to others.”<sup>44</sup>

Social sanctions can add to, or replace, economic sanctions in helping to ensure cooperative behavior. Social norms and sanctions have particular force in ethnic networks — linked by ties of culture, language, or religion — because these networks possess the advantage of having a wider range of methods of influence at their disposal than do groups of merchants connected only by their commercial interests. For example, an ethnic network provided the backbone for the elev-

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40. See Karen Clay, *Trade without Law: Private-Order Institutions in Mexican California*, 13 J.L. ECON. & ORG. 202 (1997). Arguably the fact that trade was based on the missions facilitated this process by limiting the number of sites for trade.

41. See Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 AM. SOC. REV. 674 (1996).

42. See McMillan & Woodruff, *Interfirm Relationships*, *supra* note 34, at 1298.

43. See McMillan & Woodruff, *Interfirm Relationships*, *supra* note 34, at 1306.

44. Marcel Fafchamps, *Ethnicity and Credit in African Manufacturing*, 61 J. DEV. ECON. 205, 229 (2000).

enth-century Maghribi traders' coalition.<sup>45</sup> In Asia and Africa, firms use ethnic ties to support transactions.<sup>46</sup>

In the precommunist Vietnam of the 1960s, business among the merchants who were ethnic-Chinese (a well-defined category in Vietnam) "was based upon personal relationships and word-of-mouth agreements."<sup>47</sup> If a merchant was untrustworthy, "it would be impossible for him to do business. Once the fact that a merchant had failed to honour his word became known, other merchants would simply refuse to do business with him."<sup>48</sup> These relationships were specifically ethnic-Chinese, and the inability of the ethnic-Vietnamese merchants to establish trust among themselves was alleged to explain their "lack of success in competing with the Chinese."<sup>49</sup>

Among the present-day Vietnamese firms we surveyed, however, ethnic ties seemed less important. When asked how they first learned about a customer before beginning to trade with it, 17% identified family connections (a surprisingly small number given the conventional views about the dependence of Asian business on family), but there was no significant extra amount of trust (as measured by trade credit) in those trading relationships. Furthermore, 18% of the managers we interviewed said they could speak Chinese.<sup>50</sup> If the existence of a Chinese ethnic network depends on this language ability along with the use of family connections, we found no significant tendency for family-based contracting to be used in transactions with a higher-than-average risk of renegeing.<sup>51</sup>

Table 1 summarizes some studies of spontaneous cooperation. These groups have several characteristics in common. They lack the ability to implement formal sanctions, such as fines, although they may, and generally do, rely on social sanctions as an enforcement mechanism. These social sanctions usually operate through ostracizing or excluding members from the group. If this threat of exclusion is to shape behavior, there must be "social profits" from future interaction with the group, just as there must be economic profits for the threat of exclusion to have pecuniary penalties. This may be one reason that almost all of the groups on Table 1 are "closed" to the extent that membership is limited by ethnicity or geography.

45. See Greif, *Contract Enforceability*, *supra* note 13, at 535-41.

46. See generally JANET TAI LANDA, TRUST, ETHNICITY, AND IDENTITY (1994); Faichamps, *supra* note 44.

47. Clifton A. Barton, *Trust and Credit: Some Observations Regarding Business Strategies of Overseas Chinese Traders in South Vietnam*, in 1 THE CHINESE IN SOUTH VIETNAM 53, 49 (Lim & Gosling eds., 1983).

48. *Id.*

49. *Id.*

50. See McMillan & Woodruff, *Dispute Prevention*, *supra* note 26, at 651.

51. See *id.* at 650-51.

TABLE 1: SPONTANEOUS ORDERING

Group	Author	Reference Footnote	Open or closed	One sided or two?	Information or coordination?
Maghribi	Greif (1994)	13	Closed	One	Information
Vietnam manufacturers	McMillan/Woodruff (1999)				
Social networks		26	Closed	Two	Information
Business networks			Open	Two	Information
California merchants	Clay (1997)	41	Closed	Two	Information
Shasta ranchers	Ellickson (1991)	6	Closed	Two	Information
Singapore/Malaysia Ethnic networks	Landa (1994)	47	Closed	Two	Information

In sum, then, spontaneous relational contracting can work bilaterally if the two trading partners are locked in with each other. In the absence of lock-in, relational contracting requires the involvement, not just of the two parties to the transaction, but of a community of traders. Such community-based contracting can work spontaneously, based on social norms or on social or business networks, in close-knit communities with free flows of information. The market friction needed to support spontaneous relational contracting exists in transition economies such as Vietnam, which are characterized by thin markets and high transportation costs. As the private sector develops and infrastructure is improved, however, market friction decreases, making spontaneous order harder to sustain. As this occurs, more formal systems of private ordering are necessary to sustain cooperation between trading partners.

### III. ORGANIZING PRIVATE ORDER

In this Part, we review evidence from published anecdotes and from our own empirical studies that demonstrate how market players organize private order. As discussed above, private organizations serve two main functions in providing contract assurance: providing information about breaches, and coordinating responses (that is, sanctions) to those breaches.

#### A. *Information Provision*

In open communities of traders where entry and exit are frequent, reliable information exchange is critical. How can new traders become quickly informed about the reliability of trading partners? How can word about newcomers who cheat be spread quickly so that the

gains of cheating are minimized?<sup>52</sup> Numerous examples from diverse settings show how organized ordering increases the effectiveness of reputation in controlling behavior.

Wholesalers of fresh fish in the United States used to suffer from buyers' failure to pay their bills.<sup>53</sup> Relationships consequently developed, so much so that one observer identified long-lasting bilateral relationships as the defining characteristic of the industry: "[D]ealers, wholesale firms and retail firms maintain longstanding ties to ensure steady supplies and customers."<sup>54</sup> Nevertheless, despite the prevalence of long-term relationships, "sharp practices are rife," according to a 1984 study by James Acheson.

There are many stories in the industry about firms that have sent shipments of lobsters to distant parts of the country and then have had great difficulties collecting their money. Other firms have sold lobsters to out-of-state trucking firms for a good price only to find that the check was no good.<sup>55</sup>

The buyers could easily find other wholesalers to buy from, so they could get away without paying. Observing this, Neal Workman, an entrepreneur in Portland, Maine, formed a firm called GoFish to act as a debt-collection agency for the wholesalers. He soon realized that there was unused value in the information that he was gathering. "You can collect the bill once," he said. "You can sell the information about the guy that doesn't pay over and over and over."<sup>56</sup> GoFish began using the internet to provide fish wholesalers with credit information about deadbeat buyers. This changed the industry. According to fish dealers, buyers now must pay their bills if they want to continue to buy fish.

Two trade associations of footwear manufacturers in Mexico perform a similar role in regulating trade between manufacturers and retailers. The associations are located in the cities of Leon and Guadalajara, which together account for three-quarters of the coun-

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52. In an open network with no pre-screening, a trader will always be able to enter and cheat once. This could be prevented in two ways. First, there might be some profit from future trade within the network, giving an incentive for those who enter to remain after entering. Alternatively, it may be profitable for the network to use courts to sanction cheaters even when the cost of doing so exceeds the recovery. That is, business networks or trade associations may gain a reputation for punishing defectors as a means of preventing defections. This could explain why (as shown in Part IV *infra*) business networks complement, rather than replace, courts in Eastern Europe.

53. See James M. Acheson, *The Social Organization of the Maine Lobster Market*, in *MARKETS AND MARKETING* 105-51 (Stuart Plattner ed., 1990).

54. *Id.* at 128.

55. *Id.* at 117.

56. The GoFish story is on National Public Radio, Morning Edition, January 29, 1999, available at <<http://npr.org/news/business/1999/Jan/990129.fish.html>> (visited September 21, 2000).

try's manufacturing.<sup>57</sup> They offer two related services. First, each regional association maintains a database of information on the past behavior of retail clients of their members. Did the retailers pay their bills on time? Did they return an excessive amount of the merchandise, claiming it was defective? Did they cancel orders at the last minute, after goods had already been produced to fill them? A member receiving an order from a retailer with whom he has never worked can call the association and obtain a report on the retailer within 48 hours. Communication among manufacturers is made easier because they are geographically agglomerated. Second, both trade associations intervene to resolve disputes between manufacturers and retailers. Lawyers working for the associations travel regular routes throughout Mexico, visiting the retailers who owe money, and filing court cases if necessary.<sup>58</sup> Representatives of the association in Leon, however, claim that most disputes are resolved with a telephone call to the retailer. The association's power comes from its threat to put the retailer on a "clients in default" list that is sent to association members every two months. These collection services complement the information gathering, since manufacturers gain directly from reporting delinquent clients. Also, association lawyers traveling to collect accounts from one client will often gather information on other clients. This information is kept on file at the association and made available to members.

In nineteenth-century Japan, contract-supporting information provision was one of the main functions of trade associations.<sup>59</sup> The names of firms that renege on agreements were posted on a blackboard for everyone to see, so cheating resulted in immediate loss of business. The courts were less effective then than they are now,<sup>60</sup> but organized information gathering is not limited to environments in which courts are ineffective, and Japanese trade associations still perform the same function. During the recession of the early 1990s, wholesalers of heat-insulation materials faced an increase in fraudu-

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57. See Christopher Woodruff, *Contract Enforcement and Trade Liberalization in Mexico's Footwear Industry*, 26 *WORLD DEV.* 979, 982 (1998). The associations were most effective when the market was closed to imports. For further discussion of this phenomenon, see *id.* at 984-86.

58. Using the courts in Mexico is possible, but problematic, according to manufacturers. First, the action must be filed in the city where the retailer does business. This makes delay tactics used by retailers' lawyers more costly. Second, judgments may be difficult to collect. One manufacturer recounted that he had been awarded the retailer's automobile by the court. However, since automobile titles were not registered electronically, there was no way to put a lien on the car. The retailer sold the car before he could take possession of it. The association representative reported that the most important role of the courts was to provide certification of the loss for tax purposes.

59. See ULRIKE SCHAEDE, *COOPERATIVE CAPITALISM: SELF-REGULATION, TRADE ASSOCIATIONS, AND THE ANTIMONOPOLY LAW IN JAPAN* at chs. 5 & 7 (2000).

60. See *id.* at ch. 7.

lent activity, with checks bouncing and customers disappearing after receiving merchandise. To protect its members, the wholesalers' trade association created a list of all its members' potential customers, indicating each one's creditworthiness. Dishonest companies were boycotted.

Credit bureaus similarly function as information repositories. For most consumers, the knowledge that failure to pay a bill would damage their credit rating is sufficient incentive to ensure they pay their bills.<sup>61</sup>

In the present-day Taiwanese footwear industry, trading companies act as a "hub of information regarding the managerial and financial condition" of manufacturers.<sup>62</sup> The trading companies gather similar information about the demands and reliability of buyers in the United States and in Europe. Employees of a trading company often stay in the factories to monitor quality while an order is being produced. If disputes later arise between seller and buyer, the trading company then has the information it needs to judge which party is at fault. Are the goods defective, or is the buyer claiming a quality defect to avoid paying for goods she has decided she doesn't want? The trading companies increase the effectiveness of reputation in two ways. First, since each trading company works with many manufacturers and many buyers, a manufacturer delivering merchandise late or of low quality will lose business with many clients all at once. Second, other players in the industry learn which party was at fault in the dispute (so long as the trading company can be trusted to be a fair judge). Wholesalers and similar intermediaries perform similar functions in other markets as well.<sup>63</sup>

## B. Coordination

The separation of the two roles of private-order organizations — information and coordination — is somewhat artificial. Since coordination requires information in the first place, organizations often do both. One can nonetheless independently assess whether the organization engages in coordination as well as information provision. In

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61. See generally Daniel B. Klein, *Promise Keeping in the Great Society: A Model of Credit Information Sharing*, 4 *ECON. & POL.* 117 (1992).

62. You-tien Hsing, *Trading Companies in Taiwan's Fashion Shoe Networks*, 48 *J. INT'L ECON.* 101, 106 (1998). Hubert Schmitz describes a similar role for wholesalers in Brazil's footwear industry. See Hubert Schmitz, *Small Shoemakers and Fordist Giants: Tales of a Supercluster*, 23 *WORLD DEV.* 9, 14 (1995).

63. Banks appear to operate in a similar manner in the market for Letters of Credit ("LOCs"). According to Ronald Mann, sellers rarely comply strictly with the terms of LOCs. The buyer's bank, however, will pressure the buyer to pay so long as the breach is not material. Thus, payment through LOCs rests on the reputation of the bank rather than on the formal legal system. See Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 *MICH. L. REV.* 2494, 2525 (2000).

Section III.A, we discussed organizations whose functions seem limited to information provision. We now discuss organizations that actively coordinate their members' responses to breaches of agreements.

Cooperation depends on history. If players have cheated each other in the past, they will tend to continue to cheat each other. Thus, cooperation requires coordinated action by all of the players to break out of a low-level equilibrium. The European car industry provides an example of a persistent inefficient equilibrium, and a coordinated attempt to break out of it. A report sponsored by the U.K. government noted: "The mistrust which is in evidence is the result of many years of broken promises, abuse of confidence, and general acrimony in the industry."<sup>64</sup> This was seen as raising the European industry's costs and harming its competitiveness against U.S. and Japanese imports. In 1994, the two European trade associations, representing the car makers and the components suppliers, launched an initiative "aimed at improving the often hostile relations between the two sides of the motor industry."<sup>65</sup> The guidelines sought more transparency in negotiations over prices, greater cooperation in design and technology, and quality improvement. While it was accepted that the guidelines "could not give a legal or contractual definition to the relationship between vehicle-makers and component suppliers," they were intended to provide a "framework for cooperation."<sup>66</sup>

Providing information about those who cheat may not suffice to deter cheating when punishment is costly — coordination may be required to prevent free riding.<sup>67</sup> For example, in interviews conducted as part of our study of manufacturers in Vietnam, managers expressed some hesitancy to use their full arsenal of sanctions, in part because doing so would give them a reputation among their other customers of being difficult to deal with. "[K]eeping a good reputation is the most important thing," noted one manager.<sup>68</sup> "[I]n Vietnam if you treat customers fairly when they have difficulties you will have that reputation. People will do business with you because they think you will not kill them when they have difficulties."<sup>69</sup> It is apparently not enough for the offended manager to determine whether the customer deliberately defected; it must also be clear to his other customers or potential customers that the customer cheated. Managers expressed a similar concern about hiring private agencies to collect unpaid bills. When a

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64. K. Done & G. Tett, *Peace Move in European Motor Industry*, FIN. TIMES, Apr. 13, 1994, at 2.

65. *Id.*

66. *Id.*

67. See *supra* Section I.B.2(a).

68. McMillan & Woodruff, *Dispute Prevention*, *supra* note 26, at 643.

69. *Id.*

wholesaler owed one of our interviewees 60 million dong (\$5,500), the interviewee considered hiring outside agents to collect his debt, but decided against it because it would have harmed his relationship with his other customers. He said, "in order to keep long-term relationships with other customers, the firm must be very careful in dealing with disputes."<sup>70</sup>

In the absence of an incentive to participate in sanctioning, free riding by traders weakens the *ex ante* incentive for cooperation. Private organizations can coordinate sanctioning by punishing those who fail to carry out required punishments. An early mechanism for doing this was the medieval law merchant.<sup>71</sup> Law merchants had the power to adjudicate disputes between trading partners, and set restitution to be paid by the party at fault. They kept records of defecting traders who had not made the payments set by the law merchant. This facilitated information transmission by providing a central location in which the past behavior of any potential trading partner could be checked. But this system is effective only if the traders stay informed by checking the status of each trading partner before trading with them and refusing to deal with those not in good standing. Otherwise, those who defect will not be fully sanctioned. Since checking on the status of each potential trading partner is a costly activity, traders had to be given an incentive not to free ride. Law merchants did this by establishing the rule that traders who failed to check on the status of a trading partner before transacting could not bring a case before the judge. This gave traders an incentive to stay informed, and ensured that the reputation of being a trader in good standing had more currency.

Japanese banks use a clearinghouse to deter default.<sup>72</sup> If a person or firm dishonors a note or check twice during a six-month period, all the financial institutions participating in the clearinghouse are required, by the rules of the clearinghouse, to suspend transactions with the defaulter for two years. Before the system was established in 1894, banks had a loose understanding that they would inform each other of defaults. The creation of the clearinghouse led to a substantial decline in default rates, showing that the spontaneous order that had prevailed evidently did not work as well as the organized private order of the

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70. *Id.* at 644.

71. See Milgrom et al., *supra* note 17.

72. See J. Mark Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. LEGAL STUD. 91, 110-11 (1991); Marc Ryser, *Sanctions without Law: The Japanese Financial Clearinghouse Guillotine and Its Impact on Default Rates*, in REPUTATION 225 (Daniel B. Klein ed., 1997). Ramseyer views the role of the clearinghouse as providing a commitment that the banks would actually carry out the prescribed punishments (that is, in our terms, its role is coordination). Ryser views it as a repository of data about defaulters (that is, its role is information). As we have noted, the two roles are not mutually exclusive.

clearinghouse. The creation of the clearinghouse coordinated a shift to a new equilibrium, involving increased cooperation among the banks. The clearinghouse also helps address the free-rider problem involved in punishment by making it harder for banks to continue dealing with defaulters. Further, it serves as a repository of information about defaulters.<sup>73</sup>

Industry trade associations may coordinate the actions of their own members as well. The Fur Dressers' and Fur Dyers' Association provides one example of this.<sup>74</sup> Operating in the United States in the early 1900s, the association consisted of thirty members who performed 70% of the cleaning and dyeing of fur pelts used in the manufacture of garments. Association members complained it was "general practice" for their clients (fur garment manufacturers) to claim that furs had been damaged in the dressing and dyeing process, and the damage claims were used to justify reductions in payments to dressers and dyers.<sup>75</sup> The small size of the transactions and the difficulty in describing the agreed-upon quality level made use of the courts impractical in resolving the disputes.

According to association bylaws, any manufacturer who did not pay the full amount demanded by a dresser and dyer after delivery of the merchandise was blacklisted directly by the harmed dresser/dyer. Association members agreed not to do business with a blacklisted client unless they were paid in advance for services.<sup>76</sup> Members of the trade association, who had to post bonds of \$500 upon joining, were fined for any transactions with manufacturers currently blacklisted. These fines helped overcome free-rider problems and strengthened the enforcement mechanism.<sup>77</sup>

The ability of an individual member to blacklist, however, admits the possibility of extortion: a dresser and dyer could force a garment

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73. In its early days, the New York Stock Exchange certified the creditworthiness of traders on the exchange and judged disputes involving members and suspended members found at fault, according to Stuart Banner. It also filled a gap in the formal laws. Traders frequently engaged in "time bargains," or futures contracts, even though, until 1858, contracts for the sale of stock that the seller did not own on the contract date were legally void in the state of New York, so these futures contracts were unenforceable in New York courts. The stock exchange took on the role of forcing traders to comply with their futures contracts, with the penalty for breach being suspension or expulsion of members. *See generally* Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. LEGAL STUD. 113 (1998).

74. The association's activities are discussed in *United States v. Fur Dressers' & Fur Dyers' Ass'n*, 5 F.2d 869 (1925). This, and other similar cases, are also discussed in GEORGE P. LAMB & SUMNER S. KITTELLE, *TRADE ASSOCIATION LAW AND PRACTICE* 96-105 (1956).

75. *See* LAMB & KITTELLE, *supra* note 74, at 100.

76. In this case, the manufacturer could make no ex post claim even if it were legitimate.

77. In a closed community, norms might be used to overcome problems with proper enforcement by members of the group. In Shasta County, Ellickson notes that "persons who respond [to transgressions] with excessive force" are themselves punished by the community. ELLICKSON, *supra* note 39, at 253.

manufacturer to pay in full even when there were legitimate reasons for a discount. Such an action, which would work to the detriment of the overall association, suggests the need for the association to monitor its own membership as well. The monitoring might even be conducted informally. For example, in Mexico, footwear manufacturers reportedly ignore complaints against retailers made by certain manufacturers because those manufacturers are themselves viewed as unreliable by the manufacturing community.<sup>78</sup>

Some trade associations use more formal methods of monitoring their own members. The Popular Priced Dress Manufacturers Association, for example, formed a subsidiary called the Dress Control Returns Bureau. The Bureau employed investigators to inspect all merchandise returned to manufacturers by retailers and certify that each return was made because of legitimate quality defects.<sup>79</sup> Retailers (clients) who returned merchandise for any reason other than legitimate quality defects, and who refused to pay for that merchandise, were blacklisted by the manufacturers' association. The members of the association themselves were "coerced and compelled . . . to abide by rules and regulations . . . under penalty of being required to pay . . . fines in a substantial amount of money."<sup>80</sup>

Arbitration may also provide a method of enforcing standards and coordinating equilibria. For example, the New York Diamond Dealer's Club "facilitates the transmission of information about dealers' reputations and, at least with respect to members, serves both a reputation-signaling and reputation-monitoring function."<sup>81</sup> A typical transaction in the diamond industry involves the transfer between traders of bags of diamonds worth millions of dollars, but without any written contract. Upon joining the association, members must sign an agreement that they will submit all disputes to arbitration. The "Floor Committee" (the arbitral body) can exact a fine up to \$1,000 and suspend a member's trading privileges for twenty days. Both the amount of the fine and the rationale for reaching the decision are kept secret,

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78. See Woodruff, *supra* note 57, at 986.

79. See Popular Priced Dress Mfg. Group, Inc., 47 F.T.C. 1608 (1951). The association "employed and now employ[s], investigators to investigate the return by retailers of all ladies' dresses to the manufacturers thereof and to ascertain whether or not said returns are in accordance with the rules and regulations promulgated by . . . [the] Popular Priced Dress Manufacturers Group, Inc. . . ." *Id.* at 1612.

80. *In re Nat'l Coat & Suit Recovery Bd.* 47 F.T.C. 1552 (1950). The Film Board of Trade carried out similar monitoring of their members. See *United States v. First Nat'l Pictures, Inc.*, 34 F.2d 815 (S.D.N.Y. 1929), *rev'd*, 282 U.S. 44 (1930). The monitoring of members in these cases may have extended beyond that needed for contract enforcement. Actions by these and other associations allowed under the National Industrial Recovery Act were later deemed to constitute restraint of trade.

81. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 121 (1992).

but unpaid fines are posted.<sup>82</sup> The arbitration board also has the power to suspend or expel a member from the association.<sup>83</sup>

In the grain industry, the arbitration board of the National Grain and Feed Association indeed provides more effective enforcement of contracts (than do courts) for a novel reason, argues Lisa Bernstein. While courts search for “immanent business norms” to guide dispute settlements, the trade association arbitrators strictly apply the terms of the contract. This allows trading partners to structure contracts on two levels, with a set of rules (“norms”) governing relationships in the cooperative phase, and a set of rules (contracts, or “end-game norms”) governing relationships in the defection phase. These two sets of rules allow trading partners to sustain cooperation under a broader set of circumstances. The failure of the courts to more strictly enforce the contracts, on the other hand, undermines cooperation. In this example, private ordering substitutes for the formal legal system not because it has a better understanding of industry practices, but because it has a better understanding of the theory of contract.

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Table 2 summarizes cases of organized private ordering from the literature. The organized institutions divide along several characteristics. Some institutions provide only information, while others sanction their own members for failure to sanction defectors. Those providing only information allow their members’ trading partners more latitude to maintain strong relationships with some members even while they cheat others. Those that sanction their own members provide a stronger incentive for cooperation.

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82. According to Bernstein, the secrecy of the arbitration rulings enables a trader to “minimize the reputation cost of his breach.” *Id.* at 126. Thus the fine imposed by the arbitrator is the sanction against defecting. Traders are not doubly punished by reputation sanctions as well.

83. *See generally id.* Numerous other trade associations provide arbitration services to their members. These associations generally have memberships comprised of traders on both sides of the transaction. Among these are the American Spice Trade Association and the National Grain and Feed Association. *See* HANDBOOK, BY-LAWS, AND CONTRACT RULES OF THE AMERICAN SPICE TRADE ASSOCIATION (1936). *See also* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1771 (1996).

TABLE 2: ORGANIZED INSTITUTIONS

Group	Author	Reference Footnote	Open or closed	One sided or two?	Information or coordination?
NGFA	Bernstein (1996)	84	Open	Two	Coordination
Diamonds	Bernstein (1992)	82	Closed	Two	Coordination
Mexican footwear	Woodruff (1998)	58	Open	One	Information
Taiwan footwear	Hsing (1998)	63	Open	Independent	Information
Japan mafia	Milhaupt/West (1999)	115	Closed	Independent	Coordination
Law merchant	Milgrom/North/Weingast (1990)	17	Open	Independent	Coordination
Merchant Guild	Greif/Milgrom/Weingast	115	Open	One	Coordination
NYSE	Banner (1998)	74	Open	Two	Coordination
Japanese banking clearinghouse	Ryser (1997)	73	Open	One	Coordination
US trade associations (not previously published)					
Fur dressers/dyers		75	Open	One	Coordination
Popular Priced Dress Association		80	Open	One	Coordination
GoFish		57	Open	One	Information

Note: Open means there are no significant restrictions to becoming a member of the institution; closed means there are significant restrictions.

A second way in which the organized institutions differ is that some are primarily interested in actions that are *verifiable*, while others are interested in actions that are *observable* to the parties involved in the transaction, but which are not verifiable by those outside the transaction. Credit bureaus and some trade associations, for example, are interested primarily in whether or not sellers actually deliver goods and buyers pay for them. Once the information is gathered, third parties can verify these actions by examining shipping receipts, canceled checks, and so on. Where courts function poorly, the trade associations reduce the cost of transmitting information about such behavior.

The trading companies in Taiwan and the arbitration boards at trade associations provide examples of institutions involved in disputes that are observable but not verifiable. The Taiwanese trading companies, for instance, certify the quality of footwear delivered. Since the precise quality level agreed upon proves very difficult to write down, trading companies cannot provide information which allows third parties not involved in the transaction to verify which party is at fault in a dispute. To be effective, then, the trading companies must have some incentive to be impartial in their judgments — and their own reputation in the market provides this. Two-sided membership in trade association (that is, both buyers and sellers) may provide a similar incentive for fairness.

#### IV. INTERACTIONS BETWEEN PRIVATE AND PUBLIC ORDER

How does the presence of the legal system, or its absence, affect the operation of private-order mechanisms? In advanced economies with well-functioning legal systems, courts underpin existing private-order mechanisms. Bargaining occurs in the shadow of the law; the law shapes agreements even if they operate without appealing to it. Even when it does not work well, a formal legal system can sometimes help spontaneous private order work. The ability to damage a trader's reputation works as a sanction even if the court's coercive enforcement powers are weak.

In China in the early 1990s, for example, lawyers who specialized in debt collection maintained good relations with the local press and would then threaten debtors with publicity.<sup>84</sup> The unworkability of official enforcement mechanisms meant that even the courts sometimes did this. Courts in the province of Heilongjiang, for example, threatened newspaper exposure of debtors who failed to pay. This apparently worked in the big cities, and particularly with enterprises wishing to protect a reputation they had built through expending huge sums of advertising money.<sup>85</sup>

Private order can serve as either a complement to or a substitute for public order. Private order provides a complement (or a substitute) to the law if an improvement in the law generates an increase (or a decrease) in the marginal value of private order. An improvement in the law will increase the use of complementary private-order mechanisms; it will similarly decrease the use of substituting private-order mechanisms. Which type of private order exists in any given system is an empirical question.

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84. Private conversation with Donald C. Clarke, Professor of Law, University of Washington.

85. *Id.*

Countries making a transition from a centrally planned to a market economy provide an experimental forum to study how the various contract-assurance mechanisms interact. Certainly legal systems have been created there, and many companies indeed express faith in them, but trade associations, informal networks, wholesalers, and reputation also still have a profound effect on contracting. In this Part, we turn to evidence from a survey of manufacturing companies carried out in Poland, Slovakia, Romania, Russia, and the Ukraine.<sup>86</sup> We use these survey data to determine whether a manager's use of social networks, business networks, wholesalers, and/or reputation depends on his faith in the ability of courts to enforce contracts with trading partners.

### A. *The Data*

As determined by managers' perceptions, the courts in Eastern Europe and the former Soviet Union are more effective than those in Vietnam. The survey asked the managers about the ability of courts, other government agencies, or private parties to enforce contracts with customers and suppliers. Overall, just over two-thirds (68%) of those surveyed said courts could enforce contracts with customers. (Eighty-seven percent of the Romanian managers, 73% of the Polish managers, 68% of the Slovakian managers, 56% of the Russian managers, and 55% of the Ukrainian managers said the courts were effective.)<sup>87</sup> This reflects a much higher confidence in the court system in these countries than exists in Vietnam.<sup>88</sup>

Similarly, trade associations seem to underpin contracting in these countries more than they do in Vietnam. Although the survey gave us little direct indication of the role of organizations other than courts in contracting, overall two-fifths<sup>89</sup> of the managers said they belong to trade associations that provide important services: information about the location of new suppliers and/or customers; information about the trustworthiness of suppliers and/or customers; or arbitration services. In Vietnam, by comparison, 26% of the firms belong to trade associations that offer some sort of contracting support.<sup>90</sup> Wholesalers inter-

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86. This survey asks questions similar to those asked in the Vietnam survey discussed above. *See supra* Part II.

87. *See* Simon Johnson et al., *Courts and Relational Contracts* (Sept. 2000) (unpublished manuscript, on file with authors) [hereinafter Johnson et al., *Courts and Contracts*].

88. *See supra* text accompanying notes 26 to 29.

89. The actual numbers, by country, were 44% in Romania, 21% in Poland, 23% in Slovakia, 60% in Russia, and 64% in the Ukraine.

90. The membership percentage for Vietnam given here differs from that given in Section II.A because we have included "information about new customers and suppliers" as contracting support. Just over 12% of the Vietnamese firms belong to a trade association providing information about new trading partners without providing the other contracting services.

mediate more a higher percentage of sales (10%) in Vietnam than in Romania (7%), Russia (5%), or Ukraine (4%). They are much more likely to intermediate transactions in the most advanced or the Eastern European economies — Poland (26%) and Slovakia (19%). With the possible exception of Vietnam, this ranking coincides with these countries' relative degrees of institutional development.<sup>91</sup>

We find that both the courts and trade associations have a significant effect on business trust in Eastern Europe. A firm that finds courts effective is on average 9% more likely to grant its customers trade credit than one that says the courts are ineffective. A firm that belongs to a trade association providing contract-supporting services is 6% more likely to offer trade credit than one that does not.<sup>92</sup> These numbers demonstrate the relevant role that these institutions play in providing contractual assurance.

Spontaneous relational contracting also plays a significant role. From our data we can identify two types of relational contracting — the use of *social networks* and the use of *business networks*. The survey asked a series of questions about the firms' longest-running and newest customer relationships, and also identified how the manufacturer first made contact with the customers identified in the survey. In particular, we know whether the trading partners are managed by family members or by people who were friends of the manufacturer before their trading relationship began. In both these scenarios we identify the relationship as one that arose from a social network. About 17% of the customer relationships arose from social networks.<sup>93</sup> Almost half (45%) of the time, however, initial information about customers came from business networks — suppliers, other customers, or competitors of the manufacturer.<sup>94</sup> Both social and business networks increase information flow and make sanctions possible.

In addition to providing information about the ability to use formal institutions and to rely on networks for contractual assurance, the survey gives some indication about how well reputation functions. With respect to customers, manufacturers were asked: "If your company had a dispute with this customer, would other suppliers of this customer find out about it?" and "If this customer had a dispute with another firm, would your company find out about it?"<sup>95</sup>

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91. For evidence of these countries' relative institutional development by a variety of criteria, see Johnson et al., *Entrepreneurs*, *supra* note 3, at 4-13.

92. See Johnson et al., *Courts and Contracts*, *supra* note 87.

93. See *id.*

94. Regardless of the initial source of information, 14% of the customers are identified as wholesalers. See *id.*

95. Word gets around. In 28% of the relationships for which we have complete data (618 of 2184), the manager said a customer's other suppliers would hear about a dispute. In 39% (854 of 2184), managers said they would hear about any transgressions of their customers.

We find that these forms of relational contracting, like the courts and trade associations, also have a significant effect on business trust. Customer lock-in matters: having one fewer competitor located nearby raises the probability of offering credit by 3%. More trust exists in longer-lasting relationships: three years after the start of a relationship, the probability of credit increases by 18%. Customers identified through business networks are 13% more likely to receive credit, and those identified through social networks are 14% more likely to receive credit, than customers identified without the help of networks.<sup>96</sup>

### B. *The Interaction of Public and Private: Analyzing the Data*

We now use these data to ask how the courts, trade associations, informal networks, and reputation interact in supporting contracting. We do this with a series of regressions (reported in Table 3). We asked firms about both their oldest and newest customers, so the sample includes two observations per firm. The questions indicating membership in a trade association and belief in the effectiveness of courts relate to characteristics of the firm rather than of the individual relationships between the manufacturers and their customers. To correct for the biases in the standard errors created by the mismatched aggregation of data, we use a random-effects probit model. In addition to the variables of interest reported in Table 3, all the regressions include a set of variables which control for firm and manager characteristics, and a series of dummy variables for each of eight industries in each of the five countries. These variables are described in the notes to Table 3.

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96. Johnson et al., *Courts and Contracts*, *supra* note 87.

TABLE 3: INTERACTIONS OF USE OF NETWORKS

	----- Random Effects Probits -----					
	Customer identified by business network	Customer identified by social network	Customer is wholesaler	Manufacturer learns about customer's other disputes	Customer's other suppliers learn about disputes	Customer is located in a different city
Courts are effective	0.172 (2.57)	-0.157 (1.93)	-0.035 (0.42)	-0.27 (3.59)	-0.073 (0.91)	-0.101 (1.38)
Member of trade association	0.009 (0.14)	0.073 (0.92)	-0.188 (2.18)	0.227 (3.04)	-0.005 (0.07)	0.042 (0.58)
Customer identified through business network				0.318 (5.06)	0.124 (1.92)	-0.195 (2.99)
Customer identified through social network				0.295 (3.42)	-0.099 (1.08)	-0.436 (4.62)
Customer is wholesaler				-0.088 (1.02)	0.02 (0.23)	0.542 (6.25)
Number of observations	2381	2381	2381	2184	2184	2231

Note: Regressions also include three variables measuring characteristics of the firm's manager (age, years of schooling, and a variable indicating that the manager previously worked as a high-level manager in a state-owned enterprise), three variables measuring characteristics of the firm (log age of firm, log of the number of employees, and an indicator that the firm was started from scratch rather than spun off from a state-owned firm), and 39 industry/country dummy variables.

Taking the manager's attitude toward the effectiveness of courts and membership in trade associations as given, we first ask how these affect the use of business networks, social networks, and wholesalers.<sup>97</sup> Managers who express confidence in the courts are more likely to use business networks and less likely to use social networks to identify customers. The first effect is significant at the 0.01 level, the second at the 0.10 level. Trade association members are less likely to have customers who are wholesalers. There is also a negative relationship between confidence in courts and the use of wholesalers, though this effect is

97. Whether the manufacturer is a member of a trade association might also be taken as an endogenous variable, dependent on the ability to use courts. Given that a trade association providing customer/supplier services exists in the manufacturer's industry, the manufacturer can choose whether to join or not. We find no significant relationship from belief in courts to membership in a trade association in the data ( $\beta = 0.019$ ,  $t = 0.60$ , result not shown on table). It is also possible that belief in the effectiveness of courts is itself affected by membership in trade associations, or the use of business or social networks. We are unable to identify appropriate instruments in the survey to address this possibility. But the regressions do include controls for variables that affect the ability to use courts, including the size and age of the firm, the age and education of the manager, and the industry and country in which the firm is located.

not statistically significant. These results suggest that firms use social networks and perhaps wholesalers as substitutes for courts, but use business networks in conjunction with courts.

The amount of information a manufacturer possesses about his customers depends on how much effort the manufacturer expends on information gathering and on the difficulty of gathering that information. Institutions like trade associations make information gathering less costly, leading to traders who are better informed about their trading partners' past behavior. We find that both trade associations and networks result in manufacturers' being better informed. Members of trade associations are more likely to say that they would learn about their customers' disputes with other manufacturers, although not that the customers' other suppliers would learn about disputes. Manufacturers are also more likely to be better informed when the customers came from business or social networks. Manufacturers who believe that courts are effective, however, are less likely to say that they would know if their customers had disputes with other trading partners.

Together, these results present a coherent picture. Trade associations and networks lower the cost of information gathering, resulting in better-informed manufacturers. Effective courts, on the other hand, lower the benefit of information gathering, resulting in less well-informed manufacturers. Social networks and reputation appear therefore to serve as substitutes for functioning legal systems, while business networks function better when courts are effective.

Whether the customers are located in the manufacturer's same city, in a different city in the same country, or in another country might affect contracting. Geographic distance adds to the complexity of relationships, making shipping, payment, quality inspection, and other issues more difficult. The last regression in Table 3 explores the use of public and private ordering to support trade over long distance. Both business and social networks are strongly and significantly associated with trading locally, suggesting that geographic proximity makes reputation easier to communicate.

We find no evidence that either courts or trade associations support long-distance trade. Those who believe courts are effective are more likely to trade locally, and those who are members of trade associations are more likely to sell to distant buyers, but neither effect is significant. Long-distance trade is instead supported by wholesalers. Customers located in distant cities are much more likely to be wholesalers than are local customers.<sup>98</sup> Our data likely underestimate the

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98. The regressions use data for only two of the manufacturer's customers. Other data from the survey support the role of wholesalers in long-distance trade as well. We find a very strong positive correlation between the percentage of the manufacturer's overall sales that are made to wholesalers and the percentage of overall sales that are made outside the manufacturer's city ( $\beta = 0.21, p < 0.0001$ ).

importance of wholesalers in supporting trade over distance, since wholesale customers located in the manufacturer's city likely sell some part of their purchases in distant cities. These sales would not show up as sales in distant cities in our data. Hence, while we find no correlation between courts and trade associations, on the one hand, and selling over long distances on the other, we do find evidence of a strong role of wholesalers in supporting trade over long distances. This is the case even though wholesalers have not yet become a significant force in the five surveyed countries. Overall only 12% of manufacturers' sales are made through wholesalers.

Finally, we consider what the data illustrate about when firms take their customers to court. The survey asked firms if a customer had ever failed to pay them or if a supplier had ever refused to accept the return of defective merchandise. The majority of firms (80%) reported having had at least one such dispute with a trading partner, most of which (86%) involved a dispute with a customer. We focus here on the manufacturer-customer disputes.<sup>99</sup> Courts were used in the resolution of 37% of these disputes.<sup>100</sup> In 86% of the cases where the court was used, the relationship with the customer ended; the relationship ended only 53% of the time when the court was not used. This difference may reflect the severity of the dispute. Manufacturers reported that the debt owed by the customer was collected in full in 28% of the cases in which the court was involved and in 40% of the cases when the court was not used. On the other hand, the debt was written off completely 26% of the time when courts were used and only 12% of the time when courts were not used. This suggests either that courts are so ineffective as to be detrimental to recovery, or that the court was more likely to be used for more difficult disputes.

Table 4 shows the results of probit regressions with actual use of the courts as the dependent variable. Here, we are most interested in knowing whether membership in a trade association, reliance on business and social networks, use of wholesalers, and belief in the reputation mechanism are correlated with the decision to use courts. The results indicate that firms that are members of trade associations use courts more often, but the effect is not statistically significant. We do find evidence (consistent with the Table 3 results) that courts and reputation substitute for one another. Court use is less likely among firms who say that other suppliers of the customer would hear about disputes. (It is not clear in which direction the causation runs here.)

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99. The survey instrument used in Russia and the Ukraine does not allow us to determine whether the reported dispute was with a customer or a supplier. We therefore exclude the data from these two countries from the sample used in the regressions reported in Table 4.

100. The survey did not ask for what purpose courts were used. Thus, we do not know if courts helped resolve disputes, or simply certified losses.

Neither networks nor wholesalers have significant associations with court use.<sup>101</sup>

The probit regressions in Table 4 include several other control variables. Not surprisingly, we find that court use is more likely among firms expressing a belief that courts are effective. The regressions also control for how long the two firms had traded before the dispute arose, where the trading partner is located (in the same city as the manufacturer or not), and whether the trading partner is a private firm or a state-owned enterprise, as well as a set of manager and firm controls described in the notes to Table 4. Among these additional variables (which are not shown in the table), only the size of the interviewed firm and the duration of the relationship before the dispute occurred are significant. Larger firms are more likely to have used courts. Disputes are also more likely to end in court when the two trading partners had dealt with each other for a longer period of time before the dispute occurred, perhaps reflecting an increase in the complexity of trading relationships over time. The first regression controls for whether or not the two firms are still trading partners; the second regression removes this control.

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101. The lack of a significant association between networks and the use of courts may reflect the indirectness of our measure. We do not know how the customer involved in the dispute was identified, or whether this customer is a wholesaler. We know only whether the surveyed manufacturer used social and business networks to identify his oldest and newest customer, and the percentage of his sales that is made to wholesalers. Thus, our measures provide a noisy indication of the interaction between use of courts on the one hand and networks and wholesalers on the other.

TABLE 4: PROBIT FOR USE OF COURT

Did manufacturer use courts in most recent dispute with customer?		
Member of trade association	0.063 (1.11)	0.048 (0.88)
Reliance on business networks	0.002 (0.05)	0.016 (0.47)
Reliance on social networks	-0.055 (1.06)	-0.065 (1.30)
Percent of sales through whole- salers	-0.0003 (0.33)	-0.0001 (0.10)
Manufacturer knows if customer has a dispute with another trading partner	0.023 (0.60)	0.021 (0.57)
Customer's other suppliers learn of disputes	-0.081 (2.04)	-0.064 (1.70)
Courts are effective	0.161 (2.69)	0.167 (2.84)
Relationship ended	0.421 (7.86)	
Number of observations	499	499
pseudo R-square	0.243	0.136

Notes: Data for Poland, Slovakia and Romania only. Regressions also include 3 manager and 3 firm characteristics variables (see the note to Table 3 for a description), and variables measuring the duration of the relationship before the dispute occurred, a dummy indicating the trading partner is located in the same city, or is an SOE, and 23 country/industry dummies. Reliance on social (business) networks is measured from 0 to 4 — the number of the 4 trading partners identified in the survey. The survey identifies the oldest and newest customer and the oldest and newest supplier. The three reputation measures are based on responses to questions related to the oldest and newest customer.

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In sum, we find evidence from our survey of small-firm managers in Poland, Slovakia, Romania, the Ukraine, and Russia that social networks and reputation act as substitutes for effective courts. Manufacturers who reportedly find courts ineffective are more likely to use social networks to locate trading partners, and more likely to remain informed about the behavior of their trading partners. Trade associa-

tions and business networks are also associated with a better flow of information about the behavior of trading partners. But rather than acting as substitutes for courts, business networks are more often used in concert with the legal system.

## V. THE DOWNSIDE OF PRIVATE ORDER

Private-order mechanisms have costs as well as benefits. Their disadvantages range from economic inefficiencies of exclusion and collusion to social costs of racial discrimination and criminal violence.

We have seen that private order can support exchanges when market players cannot rely on the courts. Private order therefore promotes economic efficiency by giving businesspeople the confidence to transact. But it also creates economic inefficiencies in two ways. First, spontaneous private order necessitates exclusion. The corollary of ongoing relationships is a reluctance to deal with firms outside the relationship, and exclusion clearly can result in inefficiencies. Second, organized private order, changing the relative bargaining powers of buyers and sellers, can create the inefficiencies of monopolistic pricing.

Consider first the exclusion costs of spontaneous private order. Closed networks have an obvious drawback. Dealing only with a limited group limits private-sector growth. Entrepreneurial talent is wasted, as potentially productive entrepreneurs are prevented from setting up firms. Even if they can get started, efficient firms may be unable to grow, since potential new customers would not look beyond their current suppliers.

The managers we interviewed in Vietnam and Eastern Europe expressed a hesitancy to deal with trading partners with whom they had never dealt. Regarding both their longest-term supplier and their newest supplier, manufacturers were asked: "If another firm you have never purchased from offered to supply this input for a price 10% less than your current supplier, would you purchase from the new firm?" Three possible answers were offered: buy entirely from the new supplier, reject the new supplier, and buy from the new supplier but continue buying from the existing supplier as well. In Eastern Europe (Vietnam), only 38% (29%) of our respondents gave the response that simple economics would suggest, saying they would accept the bargain; 45% (53%) said they would buy from the new supplier while continuing to buy at the higher price from their accustomed supplier; and 17% (19%) said they would reject the lower-priced offer outright.

In evaluating these responses, the success of the relationship must be weighed against the failure of the market. In a (hypothetical) market with perfect information and complete contracting, the buyer would have no reason to be suspicious of a low-priced offer, and would always accept it. If there is uncertainty about the reliability of

the new supplier, however, it could be rational to reject the apparently better deal. This situation could arise in any economy, but is especially likely when the law is dysfunctional. Firms' unwillingness to take the risk of working with a new supplier, even for a much lower price, however, sometimes means foregoing a genuinely better deal. The fact that only 29% of our respondents said they would switch to buying from a new supplier offering a 10% lower price implies that considerable inefficiencies exist in this market.

How do courts and informal contract enforcement affect a firm's willingness to switch suppliers? Controlling for the complexity of the good produced, regressions using the data discussed in Part IV show that those who find courts effective are 6% less likely to reject the deal outright, and those who are members of trade associations are 9% less likely to reject the deal outright. Business networks have no significant effect on the propensity to switch. But where the initial contact came through social networks, we find some evidence that manufacturers are more likely to reject the new deal completely. Rejecting the deal is also more likely when the manufacturer's "other suppliers would learn about a dispute with this supplier."<sup>102</sup> We conclude that social networks and reputation have a dampening effect on market forces.

How does public order or organized private order affect the exclusionary costs of spontaneous private order? We showed in the regressions reported in Table 3 that market players will more likely use social networks and reputation when they cannot rely on the courts. These mechanisms, however, exact the highest cost in terms of excluding potentially efficient new entrants. Trade associations have favorable effects, and informal business networks negligible effects, on exclusion. But the evidence in Tables 3 and 4 indicates that firms use business networks and, to a lesser extent, trade associations in conjunction with courts. Thus, while firms may find substitutes for dysfunctional legal systems, public policy should not equally encourage all of these substitutes.

The exclusion costs of spontaneous private order arise in bilateral relationships with lock-in or in closed networks, such as ethnic or social groups, where entry and exit are inherently difficult or impossible. Exclusion costs do not exist in open networks that allow entry and exit, such as networks of firms in a similar line of business. But in open networks, private order must be organized. Organized private order can give rise to another kind of economic inefficiency by pushing the bargaining power of sellers and buyers out of balance.

Exclusion obtained through continued dealings with the same trading partners and reliance on social connections sometimes results

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102. McMillan & Woodruff, *Interfirm Relationships*, *supra* note 34, at 1308; Johnson et al., *Courts and Contracts*, *supra* note 87, at Table 6.

in more than missed business opportunities; it can result in discrimination against certain groups in society.<sup>103</sup> In Kenya and Zimbabwe, firms' reliance on the existing networks, while arguably done simply to facilitate contracting and not to express any preference for discrimination, nevertheless creates ethnic and gender bias.<sup>104</sup> In the white-dominated New York construction industry, African-American contractors attempting to break in are reportedly hindered by the existing social ties.<sup>105</sup> One entrepreneur complained that he could not win contracts because he was "not in the social circles where those kinds of deals are made"; he could not "play golf or go on boats with people."<sup>106</sup>

In addition, the ability to organize contract enforcement sometimes becomes the ability to collude. "Merchants of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices," according to Adam Smith's famous dictum.<sup>107</sup> Private-order organizations that share information about customers and coordinate firms' actions will find it relatively easy to fix prices. In Japan, for example, firms regularly use trade associations to organize price-fixing conspiracies, to the cost of their customers.<sup>108</sup>

The extent of price-fixing power depends on the nature of the private-order organization. Some private-order organizations are neutral intermediaries, favoring neither buyers nor sellers. The medieval law merchants,<sup>109</sup> the Taiwanese trading companies,<sup>110</sup> and the New York diamond-traders association<sup>111</sup> provide examples of this. These include both buyers and sellers as members or as clients. Some of these are constrained, moreover, by facing competition from other organizations performing similar functions; the Taiwanese trading companies provide an example of this. Other private-order organizations, however, are one-sided, favoring (usually) sellers over buyers. The medie-

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103. See Jean Tirole, *A Theory of Collective Reputations (with Applications to the Persistence of Corruption and to Firm Quality)*, 63 REV. ECON. STUD. 1 (1996).

104. See Fafchamps, *supra* note 44, at 205.

105. See Alejandro Portes & Patricia Landolt, *The Downside of Social Capital*, AM. PROSPECT, May-June 1996, at 18.

106. *Id.* at 20.

107. ADAM SMITH, 1 AN ENQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 144 (1976).

108. See Schaede, *supra* note 59, at ch. 3 & ch. 5; John McMillan, *Dango: Japan's Price-Fixing Conspiracies*, 3 ECON. & POL. 201 (1991).

109. See Milgrom et al., *supra* note 17.

110. See Hsing, *supra* note 62.

111. See Bernstein, *supra* note 81.

val guilds,<sup>112</sup> the Japanese bank clearinghouse, the Fur Dressers' and Fur Dyers' Association, and other US trade associations discussed in Section III.B above, and the Mexican shoe-industry association provide examples of this.

In one sense, a one-sided association has an incentive to promote contracting efficiency because it furthers the interest of even a one-sided association for its members to be able to credibly make promises. Firms can generally structure contracts so that either side receives most of the gain from defecting. In Mexican footwear, for example, retailers could pay at the time orders are placed. This would put the burden of cooperation on the manufacturer rather than the retailer. Since the manufacturers are organized, and a retailer's reputation spreads more quickly, having the retailer move last (that is, pay after delivery) makes cooperation easier to sustain.

That industry associations may go beyond contract enforcement to coalitional bargaining helps answer a puzzle: Why might wholesalers replace trade associations in ensuring cooperation? At first glance, wholesalers are at a disadvantage. They have no direct sanctions. Moreover, because they represent only a portion of the buyers and sellers, they are less effective in transmitting information than an association comprised solely of one side of the transaction. But competition among wholesalers gives them an incentive to be fair and honest. Those with reputations for fairly arbitrating disputes between buyers and sellers will see their business grow and their profits increase. Competition gives the middlemen stronger incentives than a monopolistic trade association to monitor the suppliers and clients they deal with (their "members") and to be honest in arbitrating disputes between suppliers and clients.

The downside of private order goes farther than discrimination or mere economic inefficiencies. A corollary of private order in some cases is socially destructive activities. Private-order organizations usually limit their sanctioning techniques to boycotting offenders, but sometimes effective contract enforcement needs stronger sanctions. In situations involving a large initial investment with a long-delayed return, for example, the shadow of the future may not be strong enough to deter renegeing. In the absence of a functioning legal system, then, private-order organizations might be tempted to expand their enforcement techniques. Some private-order organizations use threats of physical violence. The Sicilian and Russian Mafias, for example, offer contract-supporting services, but a lot else besides.<sup>113</sup> Or-

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112. See Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745 (1994).

113. See generally DIEGO GAMBETTA, *THE SICILIAN MAFIA* (1993); Avner Greif & Eugene Kandel, *Contract Enforcement Institutions: Historical Perspective and Current Status in Russia*, in *ECONOMIC TRANSITION IN EASTERN EUROPE AND RUSSIA: REALITIES OF*

ganized crime, according to Curtis Milhaupt and Mark West, “is the dark side of private ordering — an entrepreneurial response to inefficiencies in the property rights and enforcement framework supplied by the state.”<sup>114</sup> We thus need public order to limit these abuses of private order.

## VI. SUMMARY

People’s concern for their own reputation can support contracting between a pair of trading partners when one or both are locked in, and among multiple trading partners in close-knit communities where information flows freely. In countries making a transition from planned to market economies, such spontaneous private ordering substitutes for the lack of functioning legal systems. The underdevelopment of the private sector makes cooperation easier to sustain by locking trading partners together. The market frictions fall as the private sector develops, creating the need for more formal contract enforcement.

In communities where people can hide behind their anonymity, private order, if it is to operate at all, must be organized. Private-order organizations in notably diverse settings, from medieval Europe to present-day Mexico, work in similar ways. An organization such as a market intermediary or a trade association disseminates information about contractual breaches and coordinates the community’s response to breaches. The usual sanction is to boycott the offender.

The data from our survey of firms in five transition economies in Eastern Europe and the former Soviet Union show that social networks and informal gossip substitute for the formal legal system, while business networks and trade associations work in conjunction with the formal legal system.

While private order fosters economic efficiency by making gains from trade realizable, it sometimes also harms efficiency by excluding new entrants from trading or by achieving price collusion. Private order can cause racial or gender discrimination. Some private-order organizations’ enforcement techniques overflow into criminal violence. Private order can usefully supplement public law, but cannot replace it.

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REFORM (Edward P. Lazear ed., 1995); Ekaterina Zhuravskaya & Timothy Frye, *The Rise of the Racket in Russia* (1998) (unpublished manuscript) (on file with authors).

114. Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 U. CHI. L. REV. 41, 43 (2000).