

What Governments Can Do To Facilitate the Enforcement of Contracts

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Summary

Contract enforcement is crucially important for economic development. Exchange is what permits firms and individuals to specialize, and specialization, or the division of labor as Smith termed it in the *Wealth of Nations*, is the key to productivity and thus growth. Indeed, in his review of the causes of economic growth, Nobel Prize winning economist Douglass North identifies the lack of means for enforcing contracts as the single most important source of economic stagnation and underdevelopment.

Some contracts can be enforced through private mechanisms alone while others will require resort to the courts. Despite what some partisans contend, a healthy environment for enforcing contract must contain a mix of both public and private institutions. Neither private nor public means by themselves are sufficient.

Private mechanisms come in many forms. Trade marks and advertising are a way firms can unilaterally commit to keep their promises by signaling their willingness to deliver the quality of goods they promise. Besides these unilateral devices, the contracting parties have open a number of bilateral mechanisms. They can secure their promises with a pledge of land or other type of property or devise “self-enforcing” contracts by, for example, shifting the allocation of profits or tie the sale of one good to another – in both cases to provide additional incentives to one side or the other to comply. Or they can include various forms of “self-help” provisions that permit enforcement without resort to the courts. Finally, firms can refuse to do business with those who have breached their obligations in the past.

Governments can take a number of actions to foster these private mechanisms. They can: establish or strengthen registries for land, other forms of property, and trade marks; establish rules governing advertising and access to advertising media; review their laws to ensure self-enforcing and self-help contracts are permitted; and lastly they can promote the creation of credit bureaus and other credit reporting agencies to disseminate information about firms’ and consumers’ credit histories.

Courts are the most important public contract enforcement institution. Not only because they are an avenue of last resort in the event of a breach but because the threat of a lawsuit can deter breach. Court procedures should be simplified and the management and processing of cases automated. The incentives lawyers sometimes have to delay cases should be examined, and where they exist, changes should be made in the way the profession is regulated to remove such incentives. Although court reform ultimately rests with the judiciary, the executive can take the lead by ensuring that its use of the courts is efficient and consistent with the broader public interest.

Not all disputes need to go to court for resolution. Arbitration, mediation, conciliation, and other alternatives to the courts have a role. Governments should ensure that their laws do not restrict citizens’ freedoms to use these alternatives and that the law respects an award made as a result of one of these processes. Governments should also adhere to the ICSID convention and other international treaties that give parties to a contract the option of international arbitration.

What Governments Can Do to Facilitate the Enforcement of Contracts

The certainty of being able to exchange all that surplus part of the produce of his own labor ... for such parts of the produce of other men's labor as he may have occasion for, encourages every man to apply himself to a particular occupation, and to . . . bring to perfection what talent or genius he may have for that particular species of business. . . .

The greatest improvement in the productive powers of labor . . . seem to have been the effects of the division of labor. [It is this] which occasions, in a well-governed society, that universal opulence which extends to the lowest ranks of the people.

Adam Smith, *The Wealth of Nations*, 1776

Introduction

One Smith's most powerful insights is that economic growth rests upon the enforcement of contracts. "The certainty of being able to exchange," as he calls it, is what leads firms and individuals to specialize. And it is specialization, or the division of labor, "which occasions, in a well-governed society, that universal opulence which extends to the lowest ranks of the people." Growth thus depends crucially on the environment for contract enforcement. Where entrepreneurs are assured their contractual obligations will be honored, specialization and the boom in productivity and growth that it produces will follow.

Despite the force of Smith's argument for many years students of the "wealth of nations" and policymakers seeking to foster wealth in poor nations paid scant attention to its implications. Rather than pushing measures improve contract enforcement in developing countries, they simply assumed that if a contract was written, it would be enforced – effortlessly and without cost. Only recently has this view been questioned. The turning point was the 1990 publication of Douglass North's *Institutions, Institutional Change and Economic Performance*, an analysis of the causes of economic growth the Nobel committee cited in awarding him the prize in Economics. There he concluded that the absence of low-cost means of enforcing contracts was "the most important source of both historical stagnation and contemporary underdevelopment in the Third World" (1990, 54).

The pages that follow review the steps governments can take to improve the environment for contract enforcement, from removing obstacles to private enforcement devices to strengthening courts and other forms of dispute resolution. The net result in every case will be to remove "the most important source of . . . contemporary underdevelopment" and thus pave the way for "universal opulence."

I. Contract Enforcement: Two Myths

Those entering into contracts keep their promises for many reasons: internalized norms of honesty, the advantages that come from a reputation for fair dealing, the fear of a lawsuit to name but three. Sometimes the grounds for honoring a contract have nothing to do with courts or other state-backed enforcement mechanisms. In Indonesia, families often allow lenders to hold onto their pots, pans, and other household items to guaranty the repayment of a debt. In Mexico, retail shoe stores promptly pay for their inventory for if they do not, shoe manufacturers will refuse to re-supply them and they will be forced out of business (Woodruff 1998). In neither of these instances, nor in countless others, do the parties rely on the state to see that contractual obligations are fulfilled. Rather, they depend on private ordering devices.

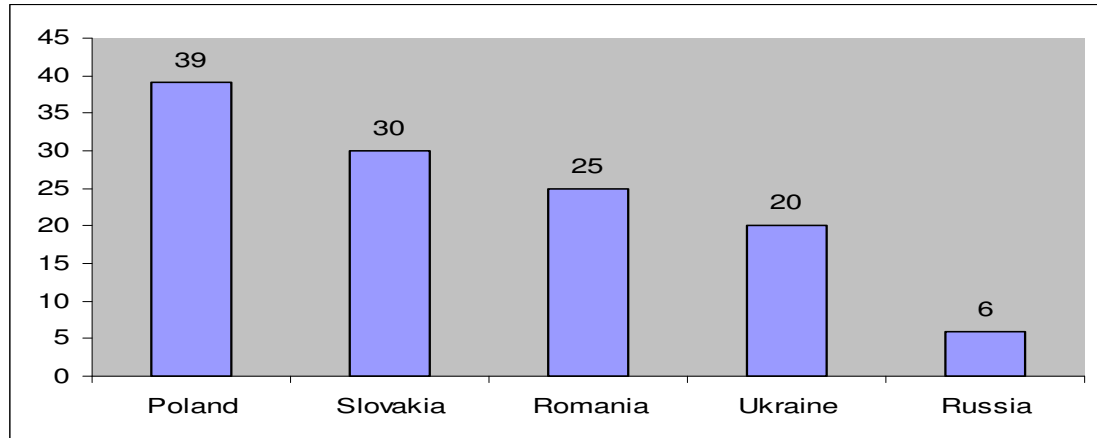
By contrast, many other contracts are honored because of the threat that the disappointed party will turn to an arm of the state to assure performance. In Chile, cell phone users who refuse to pay their monthly bill quickly find themselves forced to appear in court to explain their non-payment (Vargas, Peña, and Correa 2001). In Romania, when a debtor fails to pay on time, the creditor can have the courts seize and sell his goods (World Bank 2005).

The institutions that underpin the enforcement of contracts are of two types: those that depend upon the courts and other state-backed organizations and those that arise from private arrangements between the parties. Although as the evidence from Africa (Fafchamps 2004), Vietnam (McMillan and Woodruff 1999) and Poland and Russia (Frye forthcoming) show, entrepreneurs rely upon a mix of public and private institutions to enforce contracts, within the development community there has been tendency to give pride of place to one or the other depending upon where one sits and what programs one sponsors. Lawyers often emphasize reform of the courts, property registries, and other public institutions. By contrast, private sector specialists will stress the creation of credit bureaus and other private entities.

These contrasting approaches have given rise to two myths. The first is that courts are essential to contract enforcement. The second that they are irrelevant. The evidence supports neither.

Myth One: Courts are essential. To better understand the constraints firms face, the World Bank has surveyed businesses in 50 developing and transition countries, ranging from very poor states in Africa and South Asia to middle income countries in Latin America and East Asia. Firms were asked among other things how they had resolved their most recent dispute over the payment of an overdue bill. Fully two-thirds replied that they had reached a resolution without resorting to the courts. Table 1 shows the results from a similar question posed in surveys of entrepreneurs in transition states. The percentages of those who turned to the court ranged from 39 percent in Poland to 20 percent in Ukraine to only 6 percent in Russia. Clearly, those who assert that the courts are essential for contract enforcement are propagating a myth.

Table 1. Percentage of Firms that Resorted to Court in their Last Dispute



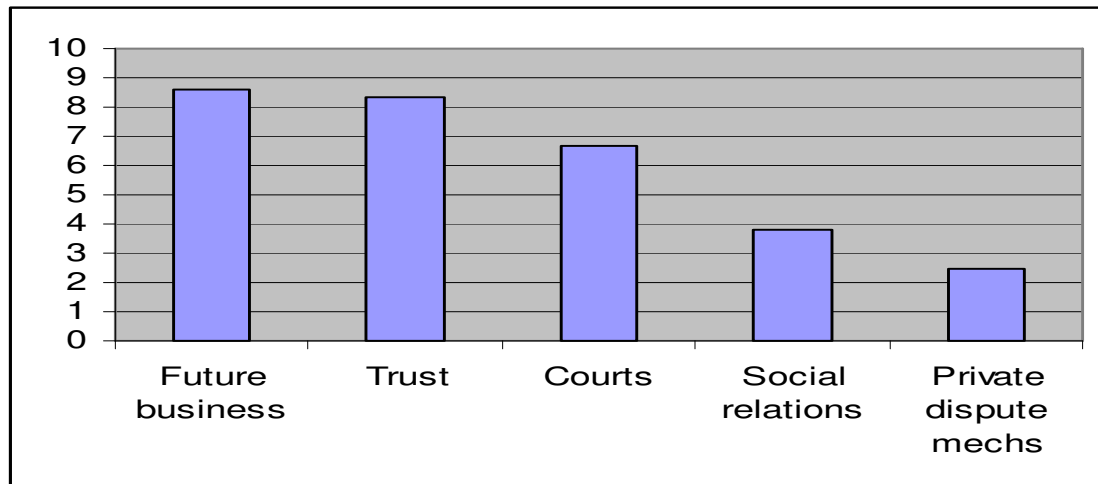
Source: Johnson, McMillan, and Woodruff (2002).

Myth Two: Courts are Irrelevant. Just as erroneous is the contrary belief: that the role of courts in enforcing contracts is insignificant. One reason for this view is that, particularly in developed countries, few contract disputes make it to court. But as Galanter (1981, 42) has observed, to equate formal litigation with the importance of courts is to misapprehend their role in ordering relations in society:

The contribution of courts to resolving disputes cannot be equated with their resolution of disputes that are fully adjudicated. The principle contribution of courts . . . is providing a background of norms and procedures against which negotiation and regulation in both private and governmental settings take place. This contribution includes, but is not exhausted by, communication to prospective litigants of what might transpire if one of them sought a judicial resolution.

In one of the few efforts to determine how important courts are for contract enforcement, Murrell (2003) asked Romanian entrepreneurs to judge on scale of 1 – 10 the importance of different mechanisms for contract enforcement. Table 2 shows the results of that work. As it indicates, while the promise of future business and trust are more important considerations, to Romanians at least courts are by no means insignificant.

Table 2. How Romanian Firms Enforce Contracts.



Source: Murrell (2003).

II. Strengthening Private Order Institutions

Private order institutions mean all those measures the parties themselves can take to increase the likelihood of performance without direct resort to the state. They are of three kinds: unilateral, bilateral, and multilateral (Rubin 1994).

A. Unilateral Measures

Expenditures on advertising, the development of a trademark or brand-name, or the ownership or long-term lease of a facility are all means one party to a contract can use to commit itself to honoring it. Each of these unilateral measures is a form of investment in a firm's reputation for providing quality goods or services, and the failure to live up to that promise would render its investment less valuable (Klein and Leffler 1981). Consumer products companies are familiar examples. Take MacDonald's. The company has invested substantial sums in advertising and in developing the Golden Arches trademark. The purpose is to persuade consumers that they can trust that what they buy at a MacDonald's will meet certain quality standards. Were MacDonald's to breach its contract to provide food that met these standards, consumers would stop patronizing its outlets and the value of its investments would soon decline.

The hope of repeat business also explains why retailers invest in a location. A retailer who owns her store, or at least has a long-term lease on it, will prosper if customers return again and again. This provides her with a reason for ensuring that she sells quality products or that she will refund the purchase price if they do not.

There are three steps policymakers can take to help firms wishing to invest in these unilateral mechanisms. One is to ensure that there exists a registry where firms can

register their trademarks and that there are sufficient legal protections to ensure that valid marks are protected against infringement. A second is to establish rules governing advertising and access to advertising media (Azcuena 1997). In unregulated environments opportunistic operators will make unsubstantiated or patently false claims to garner a quick profit. Such an environment will degrade the value of advertising generally and thus dissuade legitimate firms from investing in it. Finally, governments should review their policies on land holding. If retailers cannot own or lease on a long-term basis their premises, their incentive to provide quality products and stand behind what they sell will be weakened.

B. Bilateral Mechanisms

The parties to a contract also have means for assuring that each lives up to its bargain. One is the taking of hostages. An example is when a lender demands that a family deposit some household item with it to guarantee repayment of the loan. The lender can actually take physical possession, in which case the procedure is termed “pawning” or the lender can claim a legal interest in the property, either through the filing of a mortgage or other security interest or by maintaining formal ownership and leasing the good. As the steps governments can take to improve the environment for this type of bilateral mechanism are covered in a companion paper, no more will be said here.

Contracts can also be designed to be “self-enforcing.” Contracts are self-enforcing when the threat of termination is sufficient to deter breach. The terms are manipulated to increase the loss to one side from termination and thus reduce the chances one side will breach it. One example is resale price maintenance. Here a manufacturer forbids the retailers or distributors to which it sells to cut the price on the goods it sells them. They must maintain the agreed upon resale price. Such a practice increases the retailer or distributor’s profits and gives it an incentive to continue dealing with the manufacturer. Exclusive rights to sell the product in a designated territory are to the same effect.

Tying agreements is another example of a self-enforcing mechanism. An example is the sale of grain and the provision of credit in rural agricultural markets. A credit provider also contracts to buy the borrower’s entire crop. When the crop is sold, he deducts the loan amount from the sale price. By “tying” credit and crop sale together, the risk of default on the loan vanishes (Hoff and Stiglitz 1990).

A third bilateral mechanism for contract enforcement is “self-help.” The parties provide private remedies in the contract in the event of a breach. A car dealer, or one who lends for the purchase of the car, can insert a clause stating that in the event of non-payment the purchaser will allow the car to be repossessed. Employees of the World Bank and the International Finance Corporation who borrow from the employee credit union to buy a car will find such a provision in their loan agreement.

While most bilateral mechanisms operate without the need of state involvement, outdated laws can sometimes make them more difficult to use. Thus governments should review their policies to ensure that they do not unintentionally retard the use of bilateral

mechanisms. Competition laws are one place to look. Under the influence of now rejected competition law doctrines in developed states, many developing states ban resale price maintenance and exclusive dealing and tying contracts. Reglement 2/2002 of the West African Union thus outlaws all these practices in its member states. Similar bans are in effect in a number of Latin American and Asian countries.

A second step governments can take is the establishment or strengthening of registries for land and moveable property. Restraints on the use of debt collection agencies or private, non-judicial repossession should also be reviewed although in the latter the benefits of private repossession need to be weighed against the potential for violent disputes that can sometimes result.

C. Reputation Mechanisms.

For firms who wish to conduct business over time, it is the gains from repeat dealings that provide the incentive to ensure contract performance. That is, the discounted present value of the earnings stream that can be realized from future transactions exceeds the one-time wealth increase realizable from breaching the current agreement (Klein 1985). Hence, in deciding whether to contract with a new partner, firms are guided by what they know about the potential contracting partner's history of complying with contractual obligations. A firm is more likely to contract with those who have a good reputation, and various entities have emerged to meet the demand for such information. They collect information on the creditworthiness and reliability of individuals and firms and provide it to financial institutions, industrial companies, and others in the business community. Those who contemplate breaching their obligations know that if they do, all will soon know.

Nor does the incentive to maintain a good reputation operate only in merchant-to-merchant relations. Credit bureaus, business associations that exchange information about the payment history of their customers, count on consumers' desire to buy on credit in the future to assure payment of current obligations (Klein 1992). A similar principle is behind consumer testing laboratories, better business bureaus, and other groups that market seals of approval or provide quality guarantees (Klein 1997). When these groups certify that a product or business meets a certain standard, they are providing a visible sign of good reputation that can be used to generate future sales.

Government policy sometimes hinders the creation of firms that market reputation information by restricting the flow of commercial or financial data. Free-rider problems, highly concentrated financial systems, and other market failures can also retard the emergence of private organizations that gather and disseminate reputation information. Governments should first remove the impediments to circulating accurate data on creditworthiness. If private firms still do not enter the market, government can. In Bangladesh, Bolivia, Bulgaria, Nigeria, Romania, and Vietnam government-owned reporting agencies have been established, building on data collected by the central bank (Jappelli and Pagano 1999).

III. Strengthening Courts and Other Dispute Resolution Mechanisms

As the survey of Romanian firms showed, private order mechanisms based on reputations have their limits. For one thing, firms without a history of creditworthiness will have difficulty gaining a foothold in the market. Reputation mechanisms also depend on participants being willing to collectively boycott anyone with a bad reputation. As economies expand, however, the difficulties of enforcing a group boycott increases. More information on more individuals and firms must be collected and disseminated, and the temptation to cheat, or free-ride, on the agreement grows. Eventually, a centralized contract-enforcement mechanism operated by the state becomes a less costly alternative. Rather than incurring substantial costs before entering into a transaction, firms find it less expensive to turn to a court after the fact to resolve differences over performance. The importance of courts grows as the number of large and complex long-term transactions increases (Milgrom, North and Weingast 1990).

Furthermore, as noted above the impact of a well-functioning court system extends far beyond the number of cases it resolves. The more timely and predictable a court's decisions, the better able firms are to predict the outcome of any dispute. As predictability and timeliness improve, the number of disputes filed may decline, because a credible threat of pursuing a remedy in court provides incentives for the parties to honor their obligations. Bargaining takes place in the shadow cast by the courts and the laws they enforce. The stronger the shadow they cast, the lower the risk of transacting, the larger the number of transactions, and the lower their cost (Mnookin and Kornhauser 1979).

Where the shadow is weak, a firm's costs and risks increase. In India those whose contracts have been breached or who have suffered other injury must either accept a sharply discounted settlement or wait years, if not decades, to have their case resolved in court (Galanter and Krishnan 2004). A weak shadow can also make some transactions so risky that they never occur, for if there is no way to assure performance, the risk of going forward may simply be too great. Or firms may circumvent the judicial system altogether, taking the costly but less risky route of purchasing their suppliers or customers and so turning arms-length transaction into transactions within firms (Williamson 1995).

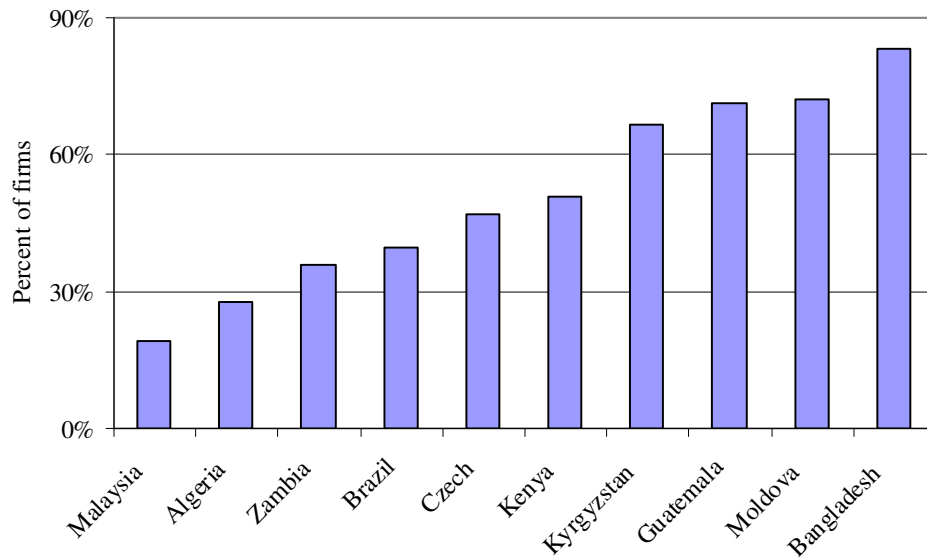
As summarized in the 2005 World Development Report (World Bank 2004), new research underlines the importance of well-performing courts for a better investment climate. Studies from Argentina and Brazil show that firms doing business in provinces with better performing courts enjoy greater access to credit. New work in Mexico demonstrates that larger, more efficient firms are found in states with better court systems. Better courts reduce the risks firms face, and so increase the willingness to invest more in their enterprises.

- Firms in Brazil, Peru, and the Philippines report that they would be willing to increase investment if they had more confidence in their nation's courts.

- Those in Albania, Bulgaria, Croatia, Ecuador, Moldova, Peru, Poland, Romania, Russia, Slovakia, Ukraine, and Vietnam say they would be reluctant to switch suppliers, even if offered a lower price, for fear they could not turn to the courts to enforce the agreement.
- Firms with confidence in the courts in Poland, Romania, Russia, Slovakia, and Ukraine are more likely to extend trade credit and to enter new relations with local firms.
- In Bangladesh and Pakistan the World Bank's Investment Climate Surveys show that while firms with confidence in the courts make half their sales on credit, those with little confidence extend credit on only one-fourth of their sales.
- In Burundi, Cameroon, Côte d'Ivoire, Kenya, Madagascar, Zambia, and Zimbabwe, where firms have little confidence in the courts, they are unwilling to expand trade by doing business with any one other than those they know well.

The investment climate surveys show that in many countries firms have little confidence in courts (figure 1). One reason may be the length of time and the cost required in many countries to resolve even simple cases. The World Bank's Doing Business Project shows that for 2003 the time required to collect an overdue payment ranges from 50 days in Singapore to 1000 in Poland, with costs ranging as high as five times the income per capita in Malawi. Nor does the evidence show that slower, more costly courts deliver better results than less expensive, more expeditious ones.

Figure 1 Share of firms that do not believe the courts will uphold their property rights



Source: World Bank Investment Climate Surveys.

A. Reform courts

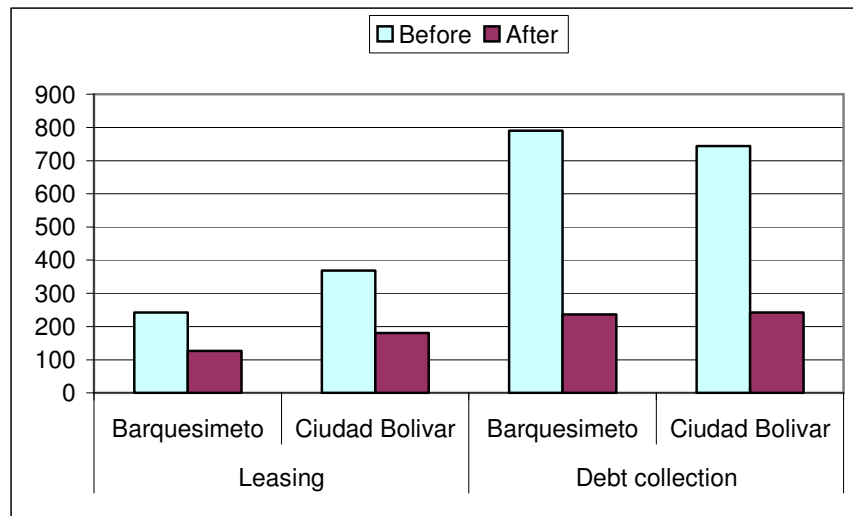
As the 2004 World Development Report (World Bank 2003) showed, agencies that provide a public service perform better when they are accountable to users, when users have a say in the policies governing the delivery of the service, and when those providing the service have a strong incentive to deliver quality services. These same principles apply to courts.

A common result of giving users more voice in the operation of the courts is procedural simplification. Court procedures in many developing and transition countries are more complex and costlier than those in industrial nations. Not only does the evidence show these lengthier and more expensive procedures provide no offsetting benefits, but they often are simply a further drag on entrepreneurial activity. In Brazil, complex court procedures retard credit markets and increase the cost of credit transactions.

Procedural reform can be coupled with computerization and other information technology. Such reforms help courts become more efficient by automating tasks previously done manually (figure 2). They make courts more transparent as well, enhancing accountability. In the Venezuelan cities of Barquesimeto and Ciudad Bolivar, the median time to resolve leasing and debt collection cases fell sharply, from 790 days for debt collection cases in Barquesimeto to 237 days, after automation and related reforms were introduced. In Quito, Ecuador, procedural changes making proceedings more compact and immediate reduced the median time required to resolve cases by 85 percent.

Figure 2 Reforms speed up business in Venezuelan courts

(Days from initiation to termination)



Source: Supreme Court of Venezuela.

One frequently considered option for speeding up commercial cases is the creation of either a separate court or the separate division or chamber within an existing court to handle business disputes. Tanzania's recently created commercial court draws praise from lawyers who appear before it, and although its filing fees are higher than the ordinary courts, to which litigants can also turn, its case load continues to grow.

But efforts to create specialized commercial courts in Bangladesh, Indonesia, Cape Verde, Côte d'Ivoire, Pakistan, and Rwanda have so far been less successful. The difference often lies in the political support courts enjoy. In Tanzania the court handles cases filed by banks and other financial institutions and they constitute a powerful lobby in support of the court. But in Bangladesh, Indonesia, and Pakistan the reverse is true. In these countries, it is the targets of court action that hold the power. In Bangladesh and Pakistan the defendants are influential citizens being asked to repay millions of dollars in loans from state-run banks. In Indonesia the defendants are being asked to accept significant losses in court-ordered reorganization and liquidation proceedings. In all three countries, the courts have not enjoyed the political backing required to overcome this opposition.

Court performance depends on judges, lawyers, clerks, and other participants working to ensure the timely and accurate resolution of disputes. Differences in court performance are largely a function of different incentives (Messick 1999). When participants have strong incentives to see that cases are decided expeditiously, accurately, and at a reasonable cost, court performance improves dramatically

Legal professionals who work in and around courts often fear that changing incentives will affect their incomes. In Tanzania reformers overcame the lawyers' opposition by persuading key members of the profession that they would benefit from reform. As

confidence in the courts increased, reformers argued, more cases would be filed, so the demand for legal services would increase. In several countries, working groups of senior judges, prestigious members of the bar, and civil society have come together to develop a consensus on the benefits of reform.

A special challenge in court reform is that the judiciary is usually a separate and independent branch of government. Officials in the executive can urge judges to reform, and the legislature can pass laws to streamline procedures, but implementation depends on the courts. One step the executive can take on its own is to review its use of the courts. Governments are often the largest single user of the courts, and as a study in the Indian state of Andhra Pradesh shows, government often contributes to delays by pursuing matters it has no chance of winning and lodging appeals it is sure to lose. Curbing such behavior can reduce the demands on the courts and allow them to concentrate on genuine disputes.

B. Remove impediments to private dispute settlement.

Fostering private resolution through arbitration, mediation, or conciliation will also improve the contracting environment. Not only are these methods often less expensive than a lawsuit, they can produce more accurate decisions as well. Where the dispute involves technical issues, the parties can select an engineer or other expert versed in the relevant issues to decide the matter.

Some governments discourage private dispute resolution mechanisms through regulations dictating the procedures that must be followed and limiting who can serve as an arbitrator or mediator. In Bolivia and Tanzania various restrictions on alternative dispute resolution mechanisms prevent firms from taking full advantage of them (Kahkonen, Lee, Meagher, and Semboja 2001; Fleisig and Pena 2003). By contrast, in Colombia and Peru—where government has enacted legislation enabling the use of alternatives, the results have been promising. A commercial arbitration chamber run by the Bogotá Chamber of Commerce handled 371 cases in 2001 involving claims of Col\$3.2 billion. The Lima Chamber of Commerce resolved 182 commercial disputes in 2000 in an average time of less than six months (IDB 2002).

Where the parties to arbitration or other alternative dispute resolution mechanism contemplate continued dealings, each has an incentive to abide by the arbitrator's award. Each may also comply because of the effect on its reputation if it refuses to do so. If a party refuses to honor an arbiter's decision, it runs the risk that other firms will decline to do business with it in the future.

Where the incentives of repeat dealing or reputation are not present, the courts can backstop arbitration by permitting the prevailing party to bring an enforcement action. To be an effective backstop, the law must not give the loser in an arbitration proceeding a long period or numerous ways to challenge the award. The United Nations Commission on International Trade Law recommends that courts should be permitted to set aside awards only in limited and precisely defined situations. Otherwise, as has happened in

India, litigation over the validity of awards can spiral out of control as the losing side seeks to win in court what it lost at the arbitration table (Ahmadi 1999).

Access to arbitration in a neutral country is often important to foreign investors, who may fear that the courts in the country of the investment are biased against them, or too slow or too inexperienced to hand down a timely and accurate decision. International arbitration has emerged as an important way for investors to reduce the risks of submitting disputes to local courts (UNCTAD 2003). To improve the investment climate, governments should remove obstacles to international arbitration as well, by joining relevant international conventions and ensuring effective mechanisms exist to enforce the resulting awards. For example, the Russian government recently clarified that awards by international arbiters in disputes involving minority shareholders in Russian corporations are enforceable in domestic courts.

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