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Growing a Legal System in the Post-Communist Economies

Abstract

Legal systems in the post-Communist economies are not well adapted to a market economy. This article uses the tools of law and economics to analyze contract, broadly defined to include all voluntary exchange agreements. This article identifies real problems with this body of law, problems that are most severe in Russia. This article makes three interrelated arguments. First, private mechanisms such as reputation and self-enforcing agreements can be used to facilitate exchange. Second, government can encourage the use of these mechanisms both to assist private parties in engaging in exchange and to economize on government resources. The most important such policy is a commitment by the government to enforce private arbitration decisions if parties voluntarily agree to arbitration for dispute resolution. Third, government can incorporate the results of these private decision processes into the law when legal code revisions occur. This article derives implications for efficient behavior of governments, private arbitrators, attorneys, trade associations, and private firms.

Introduction: The Problem Addressed

This article is a normative application of law and economics scholarship to the problem of securing an efficient (wealth maximizing) method of enforcing agreements and thus facilitating exchange in the post-Communist economies.
nist countries. This article does not set forth the detailed tenets of explicit law; it is not useful or even possible for anyone to do so. Rather, the reference in the title to "growing" is deliberate. This article discusses state-adopted policies which allow the law to evolve efficiently. In this scheme, no one need decide ex ante what the outcome of the process will be. This article does, however, indicate some broad principles of efficient contract law.

While it is generally agreed that all law needs improvement in post-Communist economies, most writing by economists on the "transition" has concerned property law and has focussed on privatization. The major controversy in this literature has been the optimal speed of adjustment: Should there be a "big bang" (rapid immediate privatization), or should the transition proceed at a more modest pace? Economists have devoted relatively little scholarly attention to other branches of law.

1. I deal specifically with Russia, Hungary, Poland, and the Czech Republic, countries that I have visited. I believe, however, that the general principles discussed are more widely applicable.


6. International Monetary Fund (IMF) et al., A Study of the Soviet Economy 249 (1991), indicates that "the civil dispute resolution system has, as yet, received lim-
This article primarily concerns the law governing transactions and exchange. This area of law is quite important. For example, Douglass North, a leading economic historian studying growth of western economies, indicates: "How effectively agreements are enforced is the single most important determinant of economic performance." This article also considers property rights, particularly Russian property rights, where there are particular difficulties in enforcing such rights.

"Transactions and exchange," in this context, mean more than "contract" as defined in legal literature; they include the law dealing with all voluntary agreements. Although this article focuses on contracts for exchange of goods, the principles developed apply more broadly. Securities law, the law of secured property, labor law, and bankruptcy are all areas where parties form voluntary agreements and where this article's arguments are relevant. Indeed, even product liability law, commonly treated as tort law, should be covered by contract.

Contemporary western legal systems have erred by interfering excessively with freedom of contract. For legal systems of newer economies attempting to grow quickly, it is especially desirable not to commit similar errors. For example, in the postwar period, the highly successful Erhard reforms in Germany "paid remarkably little attention to equity considerations. In marked contrast to the fashionable welfare state policies, the Erhardian reforms ... limit[ed] social concern to the provision of a minimal, though comprehensive, social security net."

Contract law is easier to reform than property law because the contracting parties ex ante are engaged in a positive sum, cooperative game. During the contract negotiation stage, the parties' interests are symmetric; both seek the most efficient contract possible to maximize the surplus to be divided between them. For example, the parties would be expected to

\[\text{iterated attention as a key component of basic market functions.}\]


agree that, in the event of breach caused by a preventable occurrence, the party who could have most cheaply prevented the breach would be liable. This allocation of fault will reduce the precautionary costs, therefore increasing the amount to be divided between the parties. There may be disputes about the division of surplus—the price term—but there will be agreement on other terms.

Interests obviously diverge if there is a dispute under the contract, but there is at least one point in time when the goals are in harmony. For example, if there is a breach due to a preventable event, the parties may have an interest-motivated factual dispute about who could have most cheaply prevented the event. Nonetheless, if the parties sign a contract in good faith, that is if neither party plans ex ante to break the contract, then they also have identical ex ante interests in methods of settling disputes ex post, when the contract has been broken. Both parties want the most efficient dispute resolution mechanism because this, again, maximizes the ex ante surplus to be divided between them. Once a dispute arises, parties' wishes with respect to enforcement may differ, but there is a confluence of interests at the time the agreement is signed.

This commonality of interests is generally much weaker or even lacking in other bodies of law. For example, the interests of most players initially diverge in the creation of property rights in post-Communist economies. Managers, workers, and ordinary citizens all want ownership rights in existing businesses, and with respect to these rights, the distribution issue is purely competitive. Therefore, even though the creation of property rights may result in substantial gains, it is difficult to form a coalition favoring any one scheme. In tort law, the parties generally are strangers before the accident occurs, so ex ante agreement is impossible. Once the accident occurs, of course, interests are purely in conflict; each party wants the other to bear the accident costs.  

Those interested in law reform can use the symmetry of interests in contract to encourage efficient exchange and to design efficient contract law. There are three related points whose elaboration forms this article's core. First, in many cases, law itself will be unnecessary. Private parties can use many available mechanisms to make agreements self-enforcing. Second, the law can facilitate the use of these mechanisms. For example, the law can enforce arbitration clauses in contracts if parties insert such clauses. This will often result in dispute settlement without relying on

10. Robert C. Ellickson analyzes tortious disputes in a context of existing relationships, and shows that in this situation cooperation is possible and indeed is the normal behavior observed. Robert C. Ellickson, Order Without Law (1991). However, his universe—disputes between adjacent landowners—is not typical of the normal tort context, although it is typical of situations governed by nuisance law.


12. "Probably some combination of private adjudication with ultimate state authority to back up its decisions is the most that a rapidly emerging free-market system can hope for." Manne, supra note 3, at 213.
the scarce resources of the judicial system. Finally, public law can adopt the rules developed privately by arbitrators and others. This will speed up the development of the legal system and will ultimately lead to a more efficient system.

A contract enforcement system is more valuable if property rights are clearly defined. Well-defined rights facilitate exchange, and the value of exchange increases with the value of the rights. Nonetheless, in designing efficient contract law, it is not true that "everything depends on everything else." It is possible to improve contract enforcement without other improvements in the economy. Large amounts of exchange take place in the post-Communist economies, even with the existing level of property rights definitions. People are not self-sufficient. More efficient contract law can facilitate the existing exchange and encourage additional welfare-improving transactions, even under current circumstances.

As one Russian broker told the New York Times, "Russian businessmen have gone ahead of the law, but goods have to move." This same story indicates that "[t]he free market, in effect, is not waiting for a legal system. Deals march on, although the contracts that are bringing the new ventures to life might be difficult to enforce." If these contracts were easier to enforce, deals would "march on" faster and there would be more deals.

As privatization proceeds, more and more transactions will come under the scope of contract principles. If mechanisms can be adopted which allow contract law to develop efficiently, then the law can evolve with the economy. The law can be useful and valuable at each step in the process and if the law becomes more efficient it will become more valuable.

Similarly, the process described here can proceed independent of the rate of privatization. Efficient contract law may be desirable in any economic or governmental system. More transactions will be covered by contract if the process of adjustment is rapid than if the process is slow. In either case, however, the principles identified here are applicable. Indeed, there are even incentives for dictatorships to design efficient principles of private exchange. Therefore, even if democracy should not survive in some countries, the principles discussed here might be relevant for policymakers. Indeed, even Communist countries have incentives for efficient contract law.

One alternative to this article's proposal for the law's gradual evolution is a method of transforming contract law analogous to the "big bang."

14. Id.
15. See Mancur Olson, Autocracy, Democracy and History With an Appendix: An Abstract Model of Autocratic Versus Democratic Government (IRIS, Univ. of Md., Working Paper No. 22, 1991). Olson claims, however, that democracies have stronger incentives, because efficient rights are relatively more valuable in democracies. Id.
Some have suggested that the post-Communist economies should adopt wholesale the commercial code of an existing market economy. Other post-Communist economies may attempt to draft such a body of law de novo. In the next section, this article discusses these proposals and indicates why neither is desirable. This article also discusses the major alternative method of legal change: the adoption by legislatures of civil codes. While the countries of interest are generally code countries, there are some advantages to a common law process. One option would use a common law process until the laws and the underlying political systems have reached some level of equilibrium. There are advantages to a private as opposed to a public common law process if this option is chosen.

In Part II, this article discusses the economics of contract law. An important function of this law is to reduce opportunism. This article first discusses the theory of opportunistic behavior. It also provides some evidence that opportunistic behavior is occurring in the post-Communist economies.

There are private mechanisms available to individuals to avoid opportunism. These mechanisms are analyzed in Part III. It is useful to characterize them as “unilateral,” actions a single party can take to certify his reputation, “bilateral,” actions two parties can jointly take to guarantee that neither will victimize the other, and “multilateral,” actions a group can jointly undertake to guarantee their reputations. This article also discusses the limits to private actions in this section.

In Part IV, this article discusses in more detail the present legal situation in the Czech Republic, Hungary, Poland, and Russia. In the first three countries, while the relevant law is flawed and incomplete, there is a sound body of commercial law in place. The law in Russia, in contrast, is much weaker and much more work is needed. Many of the problems seem to stem from insufficient central government power, so that differing levels of government cannot commit to honor agreements and the central government cannot force them to commit. This article also discusses some institutions in the post-Communist countries that already undertake the private functions discussed above, or that are in a position to begin to do so.

Part V examines government policy that can facilitate the design of efficient transactional rules. It is useful to consider policy with respect to unilateral, bilateral and multilateral mechanisms. Policies are both positive and negative. Governments should do some things to facilitate exchange, and should refrain from doing things that hinder exchange. This article discusses both kinds of policies.

Part VI relates the informal mechanisms explained earlier and the evolution process of efficient rules. The conclusion is that a combination of formal and informal mechanisms may be the fastest way to achieve these rules. For example, legal code drafters can incorporate lessons

17. See, e.g., Rudiger Dornbusch, Strategies and Priorities for Reform, in 1 The Transition to a Market Economy: The Broad Issues, supra note 4, at 169.
learned about efficient law from the informal mechanisms into code revisions.

Part VII summarizes this article’s implications. These include implications for the behavior of governments, arbitrators, private trade associations, private attorneys, and businesses.

I. Alternative Methods of Legal Change

In this section, this article discusses the major alternatives to a common law, evolutionary process for legal change. These include a “big bang” for contract law and the use of a civil code instead of a common law process. This article also discusses private and public law.

A. A “Big Bang” For Contract Law?

There are equivalents in contract law to the big bang proposals for rapid privatization of property. One is the suggestion that post-Communist economies adopt entirely the civil code of a capitalist economy. Rudiger Dornbusch, for example, argues that establishing institutions, including a legal system, is second priority to establishing the “rules of the game,” that is private property rights and freedom to transact. He suggests that countries should adopt the entire civil code, including corporate law, from a country such as Finland or the Netherlands.18

Such a code would be difficult to interpret for an economy with no market tradition. Indeed, even translating the terms from Finnish or Dutch into Russian or Polish would be difficult. Many terms are defined only by their use in a market economy and in actual existing transactions and decisions. Bruno Leoni states that these translation difficulties arise because words are rooted in institutions that may be lacking in the second culture.19 Leoni’s discussion applies to translations between languages used in relatively free economies. These problems would be exacerbated in translating terms used in market economies to languages spoken in societies that have not had markets, and the corresponding institutions, for many years. Peter Murrell similarly suggests that a legal code is embedded with large amounts of practical knowledge, so a transfer would not be feasible.20

Leoni also notes that similar words may actually have different meanings in different legal cultures.21 For example, the Russian “Arbitration Court” is the general court with business jurisdiction; the term “arbitra-

20. MURRELL, CONSERVATIVE POLITICAL PHILOSOPHY AND THE STRATEGY OF ECONOMIC TRANSITION, supra note 5, at 5. It has been suggested that a country could import judges and lawyers to operate such a code. This might solve some of the problems, but does not seem a practical alternative. Moreover, language problems would persist.
tion" is not the same as "arbitration" in English.\textsuperscript{22} "Commercial bank," "leaseholding property," and "stockholding" all have different meanings in Russian law than in other jurisdictions.\textsuperscript{23} There are undoubtedly additional such inconsistencies; if they were found after a code's adoption, substantial problems could result.

It takes three years for an American college graduate (who has grown up in a market economy) to learn, in law school, the meaning of United States law, and even longer until this knowledge is practically useful. Businessmen must then rely on discussions with trained attorneys for the law to affect their behavior. To expect this to occur simply by adopting an existing code is unrealistic. On the other hand, it would be reasonable for authorities to adopt portions of existing legal codes, as long as they made sure that these parts made sense in the adopting country and were consistent with existing law.

Similarly, it would not be feasible for authorities to generate an entire body of contract law de novo. Reliance on "top down" law will not work; laws passed by the legislature are often filled with loopholes and are internally inconsistent.\textsuperscript{24} While these problems are not necessarily a result of incorrect drafting by the legislature, contract law is, in some sense, organically grown over a long period of time. It has numerous components that must interact with each other and with other large complex bodies of law such as securities law, corporate law, and labor law, to name only a few. As Friedrich Hayek says, "[t]he parts of a legal system are not so much adjusted to each other according to a comprehensive overall view, as gradually adapted to each other by the successive application of general principles to particular problems . . . ."\textsuperscript{25} Laws must also be consistent with existing institutions in an economy. For example, Allan Schmid points out that contract law may adopt one set of risk sharing doctrines in a world where market insurance is freely available, but these institutions may not be desirable if such insurance markets are lacking.\textsuperscript{26} For anyone or any group to be able to craft such a body of law is as likely as for a decision maker to be able to design a complex economy de novo. It is of course the impossibility of this task that has caused the current situation in the relevant economies.

When a complex statute, such as the recently approved Americans with Disabilities Act,\textsuperscript{27} is adopted in the United States, it commonly takes

\begin{itemize}
\item \textsuperscript{22} Mark Tourevski & Eileen Morgan, Cutting the Red Tape: How Western Companies Can Profit in the New Russia 167 (1993).
\item \textsuperscript{23} Id.
\item \textsuperscript{24} Kathryn Hendley, Legal Development and Privatization in Russia: A Case Study, 8 Soviet Econ. 130, 131 (1992).
\item \textsuperscript{25} 1 Friedrich A. Hayek, Law, Legislation and Liberty: Rules and Order 65 (1973).
\item \textsuperscript{26} A. Allan Schmid, Legal Foundations of the Market: Implications for the Formerly Socialist Countries of Eastern Europe and Africa, 26 J. Econ. Issues 707 (1992).
\end{itemize}
years of litigation before its meaning becomes fully clear.\textsuperscript{28} While some blame this on the legislature's poor drafting and on the legal ambiguities inserted to please various interest groups, it is also true that no one can ex ante predict fully the meaning of such a major legal change and its relationship with other law. If American lawmakers with large staffs of experienced professional lawyers and input from many others cannot fully predict the implications of only one statute, how could we expect Russian or Polish lawmakers lacking experience in a private law environment to be able to craft an entire code?\textsuperscript{29}

Finally, those who advocate another body of law's wholesale adoption appear to believe that the relevant countries were indeed starting from a position of no law. As I argue later, no country is in this position. All have some sort of pre-existing contract law. Therefore, the choice is not between starting de novo or adopting a body of law. Rather, the choice is between modifying an existing body of law or adopting some other body of law. Even if some other country's law were adopted, it would require modification to tailor the law to local conditions such as many years without market institutions. Thus, in either case, the issue is finding the most efficient method to modify some currently maladapted law. This paper's proposals are useful for adapting a body of law, whatever its original source.

B. Common Law or Civil Code?

The two major methods of deriving the law governing private relations (property, contracts, tort) are common law and civil codes. Codes are largely passed by legislatures; common law is mostly judge-made law. In general, Britain and its former colonies, including the United States, use common law; most of the rest of the world uses legislative codes. The post-Communist countries are therefore basically code countries. Nonetheless, I argue here for at least a temporary use of common-law principles in these countries.

Hayek made a major theoretical argument in favor of common law.\textsuperscript{30} Richard Posner has also made such arguments.\textsuperscript{31} This author has provided a mechanism that would lead to common law efficiency.\textsuperscript{32} Gerald Scully summarizes this analysis.\textsuperscript{33} Here, this article makes a more limited claim. I argue that, for the conditions in which the post-Communist countries now find themselves, a reliance, for a time, on common law-like processes would be useful. This reliance would not preclude the use of codes, but, this article contends, would be a useful supplement. Indeed,
this article maintains below that a private common law-like process would be even more useful.

The code drafting process generally requires several valuable inputs. In particular, skilled lawyers (often, in advanced countries, academic lawyers) and the legislature's time are the major inputs. Generally, a commission of attorneys will draft a proposed code that will be submitted to the legislature. The legislature will then request comments from interested and politically relevant parties. This process may go through several iterations. In contrast, common law decisions are by-products of the dispute resolution process. The argument here is that the relative price of legislators and skilled lawyers is higher in post-Communist countries than elsewhere. Thus, whatever the optimal balance between common law and code may be in more settled countries, the optimal mix is more towards a common law process in the newer economies.

Consider first the input of lawyers. To draft a code requires a lawyer with knowledge of local conditions and laws but also with knowledge of western capitalist law. Obviously, law schools in Communist regimes did not specialize in training such attorneys, and there are relatively few of them. Moreover, their scarcity means that today such attorneys have a high opportunity cost. Code drafting is not a high paid occupation; it is commonly done as part of academic responsibility. Governments in all of the studied countries are short of funds and cannot pay high wages to attorneys to draft such codes. Private attorneys might not refuse if asked to serve on code-drafting commissions, but they would likely take longer to provide a draft. Thus, the first input into code drafting, attorney time, seems scarcer in the post-Communist economies than would be true at an equilibrium.

Legislator time is also scarce. The relevant countries are in the process of creating new economic, political and social orders. For such efforts, new laws and legislation are necessary. For example, privatization is itself a major change requiring substantial legislative input. In Russia, as this article is written, there has been a major political battle between the legislature and President Yeltsin over constitutional provisions, and legal changes in codes are not high on the political agenda. Once this dispute is resolved, the Russian legislature, in whatever form it emerges, will be busy with major political decisions, such as determining the role of the various geographic and ethnic components in the new state. Again, this means that if a commission proposes a code, the legislature is likely to take a longer time in responding to it than otherwise.

Boris Topornin, Director of the Institute of State and Law of the Russia Academy of Sciences, has addressed this issue. He indicated that the “first generation” of Russian laws, adopted in December 1990, were “insuf-

34. I met with many such attorneys in several countries. Almost all were associated with major American law firms, and many who were not seemed able to engage in significant amounts of consulting for foreign businesses. Others seemed to be in prestigious positions with important government ministries.
iciently clear” and “insufficiently systematic.”35 In general, Topornin asserted that current Russian law is inadequate, and that during the transition it will be necessary to change the law rapidly.36 However, as of now (November 1993) the first generation of laws is still governing in Russia. The legislature simply has been unable to pass a “second generation.”

Although Topornin indicated that Russian law is fundamentally a code system, he also agrees that it might be possible to “us[e] the experience of the common law.”37 While he may be referring to the results of the common law process, using the actual process itself during the transition might not be inconsistent with his arguments.

A major benefit of the common law process is that decisions and legal change occur as a byproduct of dispute resolution. Whenever an appellate court settles a dispute, new law is made (if there is a written opinion). Because courts naturally settle disputes, generating common law is relatively cheap. The only cost is that of writing an opinion, as compared with merely providing a decision.

We may view the tradeoff between code systems and common law systems in terms of the law’s adaptation rate to changing conditions. Ideally, a code achieves the optimum set of laws when it is first adopted. In contrast, the common law never reaches optimality. As soon as a code is passed, however, it begins to become obsolete, and its maladaptation becomes larger until a new code is adopted. The common law, on the other hand, is always somewhat maladapted, but its lack of adaptation is limited because it is continually changing. In deciding which form of law is most desirable, a country must balance these two kinds of costs. Since the adoption of new codes takes relatively longer in countries in legal disarray (such as the new economies) than in countries in equilibrium, the optimal balance would shift towards a common law solution.

While a shift to a common law process would be a change for legal systems not accustomed to such a process, the change need not be permanent. For example, legislatures could announce that appellate court rulings would be enforced as law until a new codification of the relevant body of law could be passed. These decisions could then be an input in the codification process, but only one input. Such a system would allow some of the benefits of a common law process without eliminating the relevant countries’ legal traditions.

C. Private Law or Public Law?
An even simpler reform would rely on a private common law system. Indeed, such a system could possibly be established with minimal state intervention. The state would need to agree to enforce arbitration decisions. Actual enforcement would seldom be required if it were well known that the state would enforce such decisions. Most parties will pay if they

36. Id. at 25.
37. Id. at 34.
know that the sheriff, or the Russian equivalent, will attach their assets if they fail to do so. If such enforcement were available, arbitrators, or associations of arbitrators, could announce that they planned to establish a common law-like system and follow precedent in decision making.

Such a system would create some difficulties. In particular, once the precedent system became established, parties would generally not rely on the arbitrators. Just as most disputes under a common law system settle "out of court," so would we expect most disputes under an arbitration system with a body of common law precedents to settle without a formal hearing. This problem could be easily solved, however. The arbitration association could charge a fee for being named in an agreement as the final arbitrator of potential disputes. It would refuse to arbitrate any dispute between parties who had not named it as the final authority. In this way, the arbitration association could be compensated for the public good provided when decisions were written.

Later, this article discusses some benefits of arbitration. Many benefits arise, however, because the courts in many relevant countries are in some disarray. The lack of skilled personnel—lawyers and judges—for dealing with commercial dispute resolution and contract enforcement is a major problem. This is because of inexperience with appropriate law and institutions. While the main contract law principles in many relevant countries are consistent with a market economy, the "broad general principles have never applied directly to contracts between enterprises involved in the planning process." Thus, as one study concludes, "the civil courts have a very limited experience of commercial disputes, and almost no experience with the resolution of complex business matters." Although current judges do not have the needed experience, "[t]o date, no substantial steps have been undertaken that will provide training to judges on the handling of complex commercial cases and there have been no plans announced for the hiring and training of the large number of new judges and other personnel that will be needed as the burden on the civil dispute-resolution system expands." Moreover, business operators and even lawyers are not "contract literate" because of the nature of the Soviet system. In the Soviet system, although some contract law existed, it was of a different form than is needed in a market economy.

Russian courts currently lack sufficient power. Janos Kornai indicates that Hungarian courts lack experience with a market economy and sufficient resources to adjudicate all disputes that arise in a market economy. Cheryl Gray, in her discussions of law in Poland, Hungary, and the Czech Republic indicates that, in all cases, trained judges are lacking, and that both the legal system and the population at large lack experience in a

39. IMF, supra note 6, at 247.
40. Id. at 251.
41. Id. at 255.
42. Hendley, supra note 24, at 153.
43. Kornai, supra note 3, at 3.
market economy.\textsuperscript{44} Anders Aslund is even more pessimistic: "To require the state to do anything means to ask the uninformed and corrupt for assistance . . . . Therefore, the only defensible recommendation is that the role of the state should be limited to a bare minimum in the period of transition to capitalism."\textsuperscript{45}

The current situation in Hungary seems to have improved. Judges' salaries have recently been raised, and apparently well qualified people are becoming and remaining judges. On the other hand, salaries for Polish judges are low. Moreover, after three years, a judge can become a barrister, a much more lucrative position, so many judges leave the bench at this time. While the possibility of becoming a barrister may attract better qualified individuals to the bench, the net result will be less experienced judges.

Thus, there are severe difficulties in drafting and enforcing public law for contract enforcement. Moreover, the skilled resources needed for this project might be better employed elsewhere. This is particularly true because private mechanisms could go a fair way towards creating such law. The proposals set forth here rely much less on a formal judiciary than do proposals for more explicit public law, and they may be easier to begin applying.

II. Purpose of Contract Enforcement

The key class of problems facing potential traders in a world with no legal contract enforcement are caused by opportunism.\textsuperscript{46} This article first discusses this problem's theoretical nature, and then presents some evidence of the problem's existence in the post-Communist countries.

A. Opportunism: Theory

In many transactions, one party performs his part of the deal before the other, who then has an incentive to cheat. One key purpose of contract law is to discourage such opportunism.\textsuperscript{47} Examples of opportunism can be as crude as a simple refusal to make an agreed upon payment. More sophisticated forms of cheating include offering high quality goods for sale and delivering low quality.\textsuperscript{48} A firm may also make a trading partner dependent on the firm for some input, and then raise its price; this action is called a "holdup." The general form of opportunism is appropriating

\textsuperscript{44} POLAND, supra note 6, at 27-28; CZECH AND SLOVAK REPUBLIC, supra note 6, at 24; HUNGARY, supra note 6, at 42-44.
\textsuperscript{45} ASLUND, supra note 5, at 21.
the "quasi-rents" associated with some transaction.49

The main cost of opportunism, when it cannot effectively be prevented, is neither the cost of cheating, nor even the precautionary cost taken to avoid being victimized. Rather, it is the lost social value from the otherwise profitable deals that are not made. For example, in economies with no contractual possibilities, transactors often deal with long-term associates or relatives for additional contractual performance assurances.50 But this means that many potential transactions will not occur because otherwise suitable parties lack the appropriate relationships and so cannot guarantee performance, even though such transactions would be value increasing. Similarly, if sellers cannot credibly promise to deliver high quality goods, then consumers will not be willing to pay a higher price for alleged higher quality, and manufacturers will therefore not produce it.

Lack of contractual enforcement mechanisms leads to another cost in the post-Communist economies. As Ronald Coase long ago pointed out, if transaction costs between firms are high, then more activity will occur within the firm and less in markets.51 But lack of enforcement mechanisms means that firms will be relatively larger because they will internalize more functions. Many authorities have remarked on the inefficiently large size of firms in these economies and have argued for breaking these firms into smaller parts. Until efficient contract enforcement mechanisms are available, however, the incentive for such restructuring will be reduced; managers can anticipate difficulties in using external contracts to achieve the coordination that they now achieve by internal command.

In general, less formal enforcement mechanisms can work better for shorter term transactions and for transactions involving smaller amounts of money. As the contract's time horizon becomes longer or the amount at issue becomes larger, the value of formal enforcement increases. Thus, an additional cost of lack of enforcement mechanisms is the loss of long term investments and large investments deterred by the lack of enforceability. Social wealth can be greatly increased to the extent that mechanisms can be designed and adopted to reduce or eliminate opportunism.

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B. Opportunism: Evidence

These problems all exist to a greater or lesser extent in the post-Communist economies. During the Communist period, informal small scale trading networks based on family, ethnicity, friendship, reciprocity, long term obligations, and barter supported trade.\(^5\) Personal relations and trust remain important because contracts cannot be enforced through the legal system.\(^5\) The importance of personal contacts in supporting exchange in Russia is a major theme of Mark Tourevski and Eileen Morgan, whose writings provide practical advice to western businessmen considering investing in Russia. For example, "[t]he crucial impact on the business sphere will still be the impact of the importance of the business connections with its system."\(^5\) Such networks are of substantial importance principally where possibilities for more formal governance mechanisms are limited.

There is evidence that inferior quality goods are produced in post-Communist economies.\(^5\) There is no recourse for disgruntled consumers, unhappy with the quality of these goods.\(^5\) Courts deal primarily with criminal matters, and thus cannot handle a large increase in complex civil litigation engendered by cooperatives (Russian private firms) and private markets. In one survey, 44% of respondents complained of the low quality of goods and services produced by cooperatives.\(^5\) If these respondents meant that they would be willing to pay higher prices for higher quality, a fact we cannot learn from the reported question, then this would indicate a market failure. Paul Goldberg discusses quality efforts in consumer and other markets.\(^5\) He mentions several new legislative proposals, currently under consideration, for increasing quality. However, none of these involves proper incentives, and none creates proper reputation effects. Reliance on legislation to achieve goals that markets can better accomplish is evidence of a carryover of thought processes from the previous economic system.

One major survey found people in ex-Communist societies to be less confident about the future and more likely to believe that institutions are

\(^{52}\) Maria Los, From Underground to Legitimacy: The Normative Dilemmas of Post-Communist Marketization, in Privatization and Entrepreneurship in Post-Socialist Countries: Economy, Law and Society, supra note 4, at 111.


\(^{54}\) Tourevski & Morgan, supra note 22, at 8.


\(^{56}\) Louise I. Shelley, Entrepreneurship: Some Legal and Social Problems, in Privatization and Entrepreneurship in Post-Socialist Countries: Economy, Law and Society, supra note 4, at 308.


\(^{58}\) Goldberg, supra note 55, at 113.
likely to change than people in capitalist societies. This would explain in part the unwillingness of firms' owners to invest in brand name capital and is consistent with other behavior, discussed in more detail later, as well.

Gary Burandt reports that an American firm was induced to invest in developing a promotional program involving the Soviet Space Station based on assurances that a particular Russian group had exclusive promotional rights. The rights did not belong to the group, and the results of the promotion campaign were appropriated with no compensation. Burandt suggests that this occurred because of business practice ignorance rather than intentional dishonesty, but the behavior is consistent with opportunism.

Foreign businessmen indicate that, in doing business in Eastern Europe, they are cautious. For example, a firm will take longer to do a job so that less investment is at risk. It will also move more slowly in working with partners and subcontractors than would be true in a world with more legal certainty. Many foreign firms are investing in distribution networks in these countries, but not in manufacturing capacity. The fear of investment loss is a principal reason for this.

There is even evidence of opportunism in its simplest forms. Firms in Russia sometimes take money and provide nothing; at other times, they accept goods and then do not pay. Enforcement in even these cases is apparently difficult. Lewis Uchitelle indicates that buyers operating on commodity exchanges often renege. In Hungary, two-thirds of the 700,000 lawsuits filed in 1991 involved debt collection. Indeed, the most significant form of opportunism in the post-Communist societies may be simple failure to pay debts. In Hungary, creditors can use bankruptcy law for debt collection, but such mechanisms are less developed in other countries.

There is also evidence that the structure of new private firms partly reflects uncertainty about contract enforcement. Many new firms in Russia are forming holding companies or using vertical integration to guarantee needed supplies. Indeed, one "consultant" claimed that this was the motivation for organizing a large firm containing many otherwise independent firms. Many new firms are associated with existing state firms, again to obtain contractual performance guarantees.

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63. HUNGARY, supra note 6, at 44.
64. The Czech Republic has just passed a bankruptcy law, but it is too early to determine if this will be effective as a debt collection mechanism.
65. Johnson & Kroll, supra note 53, at 293.
66. Id. at 303.
III. Private Mechanisms

Anthony Kronman examined the possibility of exchange in a regime with no legal contract enforcement, a "state of nature." He identified several mechanisms that parties could use to facilitate exchange in such a regime. To a certain extent, conditions in the post-Communist economies represent a state of nature. Even in developed countries, explicit enforceable and enforced contracts are relatively unimportant for much exchange. To the extent possible—and it is a large extent—businesses rely on agreements and do not use enforceable contracts. In the United States, 75% of commercial disputes are settled privately through arbitration and mediation. Moreover, most potential "disputes" never even reach this stage. Thus, the lack of enforceability in many circumstances will present less of a problem and imply less difference between developed and new economies than might appear. However, businesses in developed economies have learned, perhaps through trial and error, to do substantial business without relying on contracts. Of course, some disagreements are not litigated because parties know what the results would be. The enforcement system's existence thus facilitates settlement without use of the system. Businesses in new economies will have less experience with such techniques.

This article deals in part with private mechanisms for solving the problems associated with opportunism in transactions. Private mechanisms are limited in their power; they cannot achieve an optimum. Without efficient government enforcement, it will be impossible to realize all potential gains from trade. For example, long term investments and large investments may be particularly discouraged when contract enforcement is uncertain. Thus, the arguments advanced here can be viewed as second best approaches to efficient transacting where the state does not efficiently enforce contracts.

On the other hand, it is possible to underestimate the power of such mechanisms. Olson discusses trade in Communist regimes between managers where markets were explicitly illegal. He indicates that reputations and self-enforcing agreements were possible and useful to a certain extent, but less efficient than state enforcement. In a world where trade is legal

70. "Without solid contract law, it is a rare business executive, Russian or foreign, who is willing to risk investing, say, $100 million to construct a modern appliance factory that will not generate revenue for a year." Uchitelle, supra note 13, at A1.
71. Mancur Olson, The Hidden Path to a Successful Economy, in THE EMERGENCE OF MARKET ECONOMIES IN EASTERN EUROPE, supra note 4, at 55-75.
72. Id.
but contracts are not enforced, however, there are more possibilities than in a world where trade is illegal. This is because agents need not rely only on secret mechanisms. For example, reputations can become public knowledge, giving much more power to these mechanisms. Olson's point is still correct, but some deals will be completed under current conditions that could not have been achieved under full Communism.

There are three classes of private mechanisms to make agreements credible. All three rely on reputations. This article now discusses these mechanisms.

A. Unilateral Mechanisms

These are mechanisms that one firm can unilaterally use to keep itself from cheating. Firms selling consumer goods represent a common application of unilateral mechanisms. Sellers can be manufacturers, who will create reputations in their product's brand name, or retailers, who will create reputations in their store's name. The general principle—that reputations can guarantee that the firm will not cheat—applies in the bilateral and multilateral context as well.

A reputation is a valuable asset, and the asset's value is lost if the firm cheats. A firm wants to credibly offer a given quality level of goods for sale. Cheating is claiming to offer high quality goods but actually selling low quality. This can be profitable in the short run. Unless there is some reason not to do so, sellers often cheat in this way. Buyers that are aware of this form of cheating, however, will not believe the firm's promise to offer high quality goods. Therefore, since some buyers would be willing to pay for high quality if they could be sure of getting it, there is a real social loss if the firm cannot credibly promise to offer high quality.

If a firm can invest in creating a reputation for high quality, then there will be a return on this investment. The investment will pay as long as the firm does not cheat. There are various unilateral mechanisms a firm can use to create a reputation. The key is to create some firm-specific capital that will become worthless if the firm cheats. This capital is the investment in reputation guaranteeing that the firm will not cheat.

Advertising is one such investment form. Advertising the firm's brand name, even if the advertisements convey no additional information, indicates that the firm plans to offer high quality. If it does not, then the investment in advertising becomes worthless because consumers will no longer shop at the firm. There are other investments that serve a similar

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73. "There is already a blacklist of people with whom we don't deal anymore [because they have reneged on payment]." Uchitelle, supra note 13, at A10 (quoting a Russian broker).

74. This material is based on Rubin, Private Mechanisms, in THE POLITICAL ECONOMY OF THE TRANSITION PROCESS IN EASTERN EUROPE, supra note 4.

75. David M. Kreps, Corporate Culture and Economic Theory, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 106-08 (James E. Alt & Kenneth A. Shepsle eds., 1990); Rubin, supra note 46.

function. Firms can invest in expensive signs or logos, which also become worthless if the firm cheats. Coca-Cola, in selling its product in Russia, is building custom-made kiosks shaped like a Coke can. Law firms invest in expensive decor, which serves the same function.

Firms can also offer high quality items for sale at the price of low quality items for a time to induce consumers to try the product. The losses incurred are the investment. Consumers will try the product because they have nothing to lose even if the firm cheats (since they are paying the price for low quality). Once a firm creates a reputation in a brand name, it can extend this reputation to additional products. Some western companies selling in the post-Communist economies are selling at low prices in order to establish such reputations.

Firms can also take advantage of trading partners' reputations. Reputations can be created either at the manufacturing or the retail level. A retailer can benefit by carrying manufacturers' products with already established reputations. Conversely, a manufacturer can benefit by selling his product through a retailer who has established a reputation. Actions are bilateral if there is explicit contracting regarding reputation transfers, as discussed in the next section, but a firm can also unilaterally benefit from this mechanism.

While firms can privately invest in reputation creation, there appear to be some difficulties in the Eastern countries, particularly in Russia, with this process. Firms here have traditionally valued secrecy rather than the openness needed for reputations to work. As Tourevski and Morgan point out, "[v]ery often Soviet participants take a closed or secretive position and the attempts to hide information can reach ridiculous levels." Vladimir Kvint warns that "[f]oreign investors need to be aggressive about getting information, because by inclination and long-standing habit, companies won’t divulge it." It is not clear why firms are excessively secretive, but such behavior can be counterproductive. One possible explanation is that, in bargaining, firms are often concerned with guaranteeing that their partner does not make a profit rather than maximizing joint profits. As discussed below, this bargaining strategy may be due to short-time horizons caused by uncertainty.

B. Bilateral Mechanisms

This article deals with three issues relating to bilateral arrangements: self-enforcing contracts, vertical relationships between dealers and manufacturers, and the use of "hostages." Contracts, including private arbitration clauses, are not relevant here since they fit better into the multilateral analysis.

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78. TOUREVSKI & MORGAN, supra note 22, at 245.
1. Self-Enforcing Agreements

The most important type of bilateral mechanism is the creation of what has been called a "self-enforcing agreement." This is an agreement between two firms containing no external enforcement provisions. The agreement operates as long as it is in the interest of both firms to maintain it. For each firm, the agreement's value is the value of the expected future business from "maintaining the relationship." If a firm cheats, then it gains in the short run but loses future business value.

As long as transactions are correctly structured, then external enforcement is unnecessary. Correct structuring requires two major conditions. First, the parties must have some reasonable expectation that the agreement will last for some time. If there is a clearly specified last period, or if parties expect the agreement to end at a particular time, then a firm will have an incentive to cheat in that period because there is no future business to lose. If both sides know that cheating will occur in the last period, however, then there is an incentive to cheat in the second-to-last period, since cheating will occur in the last period anyway. In other words, self-enforcing contracts with specified termination dates "unravel" and are not stable.

Second, each party must make some return on the transaction that is somewhat greater than a competitive or normal return. The excess return must be large enough to make the present discounted value of the future profits, discounted both for time and for the probability that the sequence of transactions will end, greater than the one-time gain from cheating. If these conditions can be met, then contracts can be self-enforcing with no requirement for external legal enforcement.

Uchitelle reveals that exactly this sort of contracting occurs in Russia: "[T]wo concepts—mutual benefit and trust—have come to play a major role in these early days of Russian capitalism. What these concepts come down to is this: If both parties to an agreement are benefiting from the deal, presumably they will not break the contract." Nonetheless, Tourieiki and Morgan argue that there seems to be a tradition in Russia of hard bargaining: "Soviets see business deals as fixed and finite entities. Only when ensuring that they will end up with more and the negotiating partners end up with less do they feel the negotiations are successful." They add that "[o]ne of the chief criteria for evaluating how foreign trade officials do their job is the discount they generate during negotiations, which is supposed to show how persistent and uncompromising they are as businessmen." As long as this sort of bargaining occurs, it will be difficult to establish self-enforcing agreements.

Burandt discusses the formation of a joint venture for advertising between a Russian organization and the American advertising agency,

80. Telser, supra note 68, at 27.
82. TOUROVSKI & MORGAN, supra note 22, at 246.
83. Id. at 243.
Young and Rubicam. He indicates that Young and Rubicam would price its services and pay the media "fairly" because the goal was to "establish [itself] as a reputable and leading company in this business for the long haul." On the other hand, "[i]t wasn't atypical in the Soviet Union for organizations to overcharge customers and underpay suppliers." In other words, Burandt is arguing for prices that would make agreements self-enforcing, and such prices seem to be less common in Russia.

A costly way for exchange to occur is for individuals to trade only with close associates or with relatives. This pattern of trade was common under Communism. It is likely to persist unless and until institutions for dispute resolution become available. Large gains may be realized, however, if the mechanisms can be generalized to additional trading partners.

2. **Vertical Controls**

An interesting class of bilateral transactions are between product manufacturers and retailers. Manufacturers with brand name capital might want retailers to carry out various policies such as: demonstrating and advertising the product, certification of quality, maintaining freshness, promoting the product to marginal consumers, maintenance of complete inventories, and refraining from "switching" customers to alternative product lines when consumers respond to manufacturers' advertisements.

Numerous mechanisms can achieve these goals, including: establishment of maximum or minimum prices for sale of goods (resale price maintenance); territorial restrictions, including exclusive territories; requirements that dealers carry only the manufacturer's brands (exclusive dealing); and requiring certain retailing practices, such as shelf space requirements. Manufacturers also may integrate directly into retailing or may establish franchises for selling their product. It is not the purpose of this article to discuss the business reasons for these restrictions; such discussions are available elsewhere. These restrictions can be carried out as self-enforcing agreements, with a termination threat as the only sanction. There is no need for state enforcement of these arrangements. However, state hostility (as, for example, through much American antitrust law) can threaten the viability of such agreements.

Franchising might particularly be useful in the former Communist economies. There are many excessively large and excessively centralized enterprises. Splitting some of these entities into separate firms linked through franchise contracts could be a useful way to decentralize without losing the common brand name benefits.

3. **Hostages**

A firm can commit to not cheating by offering a hostage to its trading partner. A simple hostage is a cash deposit that will be lost if the firm

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84. Burandt, supra note 60, at 20.
85. Id.
86. Rubin, supra note 46, ch. 6.
cheats. Such a hostage requires some outside enforcement, but not by the state. For example, the firms could jointly hire an attorney, empower him to decide if cheating had occurred and, if so, have him award the payment to the victim. Of course, there is a problem in trusting the attorney not to expropriate the hostage. However, firms might exist whose sole value is their reputation capital for enforcing such agreements, and who therefore would have no incentive to cheat as long as their reputation were worth more than any one hostage. Law firms or investment banking firms might be able to perform this function. International firms might be particularly well suited for this role because of their established valuable reputations.

A more natural method is the creation of bilateral hostages. If firm $A$ is dependent on firm $B$ for some input, then firm $A$ would have an incentive to make firm $B$ dependent on firm $A$ as well. Moreover, firm $B$ would have an incentive to be put in this position to keep itself from cheating. For example, firms making cardboard boxes commonly trade components with each other across geographic areas; in this case neither firm can hold up the other without also putting itself at risk.

C. Multilateral Mechanisms

This is the most interesting class of adaptations, and the least studied. A well-defined multilateral arrangement involving a group of member firms can enforce honest dealing, both between members of the group and between members and outsiders. The Law Merchant, the medieval body of commercial law, was exactly this sort of multilateral private legal system that enforced honesty by threats of reputation loss.\(^7\) The Law Merchant was subsequently adopted into the English common law. Similar institutions survive today in advanced countries. The Better Business Bureau, for example, is a reputation guaranteeing device with properties similar to those of the Law Merchant. Many trade associations' ethics codes contain many of the properties of the Law Merchant.\(^8\)

Private contracts requiring arbitration of disputes require similar enforcement mechanisms. Much international commercial law is based on arbitration, with reputation loss as the major sanction for breach.\(^9\) The following section begins with an analysis of how private arbitration demonstrates the need for multilateral enforcement.

1. Arbitration

Arbitration is feasible for most contracts. The parties to a contract can specify in the contract that, in the event of a dispute, they will settle the issue through arbitration. Moreover, and equally important, they can


\(^{88}\) For a collection of essays on ethics, business, and trade associations, see The Ethical Basis of Economic Freedom (Ivan Hill ed., 1976).

\(^{89}\) Benson, Customary Law as Social Contract, supra note 68, at 23.
specify ex ante which arbitrator or forum they will use. Thus, if there are competing “court” systems, or competing groups of arbitrators, the parties can select the one they desire. Parties to contracts written in good faith will not expect to breach at the time the agreement is drafted, and will not plan on a future breach. Breach will occur only in the event of unexpected events, which can affect either side to the contract. Therefore, ex ante the parties will desire to select the forum for dispute resolution that they expect will yield the most efficient results, so that ex ante competition among arbitrators will favor those with a reputation for providing the most efficient (wealth maximizing) decisions.

Parties can also select the body of law they wish to govern. Arbitrators can then enforce this law with respect to the contract. If parties commonly choose one body of law, this will be evidence that this law might be the most efficient for use as public law. Where law is not specified or relevant, arbitrators can use industry custom as a method of determining liability. Indeed, much common law and most commercial law is based on custom.

Note, however, that in the post-Communist societies, custom is likely to be less useful as a basis for law than has traditionally been true. Those who write of custom as a basis for law have in mind a situation in which trade is already occurring and a lawmaker arrives, or rises to power, and begins to use the existing customs as a basis for law. This is, for example, the approximate way in which the commercial code incorporated the Law Merchant. In the Communist economies, however, existing custom has evolved largely in circumstances in which trade was illegal, and it was necessary to hide or disguise the terms and even the existence of exchange. Thus, existing customs may not be as well-suited to adoption into formal law as has traditionally been true.

Indeed, those who were entrepreneurs under Communism may be true criminals today. This depends on whether their skill was engaging in trade and market transactions (at that time illegal), or in other illegal activities. Moreover, the excess secrecy custom, mentioned above, would be counterproductive in a market economy. Nonetheless, customs developed since liberation should be useful.

There is a limit to purely private arbitration, however; the party who loses in a dispute has an incentive to ignore the decision. In countries with an established body of contract law, the courts will often enforce the arbitrator’s decree. In a society where there is no court enforcement of such decrees, the only recourse is a reputation remedy. In small societies where reputation is common knowledge among all parties, simply publicizing the cheating may work. In larger societies, however, where there are many trading partners, it may be necessary to devise more complex devices for private enforcement of arbitration decrees. This is the topic of the next section.

90. E.g., BENSON, supra note 38.
91. KVINT, supra note 79, at 196-200; TOUREVSKI & MORGAN, supra note 22, at 210-11.
2. **Multilateral Enforcement Devices**

Consider a trade association with the following policies:

1. The association collects dues from all members. These dues subsidize part of the arbitration proceedings' costs in resolving disputes among members and between members and customers or suppliers. Disputants also pay part of the costs.

2. Information is made available to all potential customers and suppliers regarding the list of members so that it is possible for a potential customer to ascertain at low cost if a potential seller is a trade association member.

3. If the arbitrator’s decision goes against a party, and the party ignores the decision (e.g., refuses to pay damages as ordered by the arbitrator), then the party will be expelled from the association.

4. Therefore, when an expelled party’s potential trading partner queries the association, he will learn that the seller is not a member, and will accordingly be able to avoid trading with the party, or will trade on different terms.

This mechanism’s structure corresponds to the Law Merchant mechanism. Milgrom provides a game theory analysis of this mechanism and shows that the outcome is stable and will lead to efficient trading patterns.

Many trade associations that engage in self-policing also follow this pattern. The Code of Ethics and Interpretations of the Public Relations Society of America calls for an investigation of allegations of misconduct, with expulsion and publicity as potential remedies. Moreover, this code includes interpretations based on actual cases, which form a “body of law.” Similarly, the Code of Ethics of the National Association of Realtors has a provision for expulsion of members who do not accept the findings of review boards.

Diamond “bourses” (diamond exchange markets) such as the New York Diamond Dealers Club, and the World Federation of Diamond Bourses, follow this same pattern. These associations generally provide arbitration proceedings, and the ultimate sanction for violation of an arbitrated agreement is expulsion, although sometimes formal law will be used as well. Information about violators is also made public. Better Business Bureaus (B.B.B.s), private reputation enforcing groups in the United States, also follow this procedure, although these organizations also provide information about non-member firms. A simple mechanism would

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92. Milgrom et al., supra note 87, at 5-6. It is similar to the mechanism used by the Maghribi traders. See Greif, supra note 50.

93. Id.

94. THE ETHICAL BASIS OF ECONOMIC FREEDOM, supra note 88, at 257-308.

95. Id.

96. Id. at 285.

97. Id.

be for member firms to display, on their doors or in their advertising, a logo indicating that the B.B.B. approves them.

Trade associations and B.B.B.s illustrate the usefulness of reputation guaranteeing associations. Trade associations commonly include members of a given business, irrespective of geographic location. Conversely, B.B.B.s include businesses in a particular area, irrespective of the nature of the business. The latter type of organization is more likely to be useful to guarantee reputations of those who sell to consumers; the former is likely to be more useful to guarantee reputations of business transactors.

D. Limits to Private Mechanisms

While private mechanisms can support some exchange, there are limits to their power. In general, a party will behave opportunistically whenever it pays to do so. Explicit enforceable agreements can mean that opportunism will be prohibitively expensive. A court order or an enforceable arbitration decree can remove any profit from opportunistic behavior. Other mechanisms are less reliable.

Consider reputation or hostages as enforcement devices. If a trading partner cheats, the most that can be lost is the value of the reputation. This means that it will usually not pay for one party to trust the other party with any sum worth more than the second party’s reputation. This provides an upper limit to the investment amount. Similarly, as returns occur further in the future, the present value is also smaller. This limits the length of time for which transactions can be committed. Such problems may be more acute in new economies since relatively more enterprises are new and therefore have relatively low-valued reputations.

Similarly, the amount that can be put at risk in a self-enforcing agreement is the value of the stream of quasi-rents (excess returns) generated by the stream of transactions. If more than this is put at risk, it will pay for one party to cheat and expropriate the excess investment. Again, to the extent that there is greater uncertainty in new economies about future events than in more mature economies, the expected future values are less reliable, and self-enforcement mechanisms will therefore support less exchange than would otherwise be the case.

This does not mean that such mechanisms are valueless. On the contrary, they are common, even in developed economies. It is important, however, to realize their limits. Formal enforcement devices should support such mechanisms whenever possible.

IV. The Current Situation

It is incorrect to view all post-Communist countries as starting from the same point. Of those countries specifically considered in this report, the Czech Republic, Hungary, and Poland are more similar to each other than any is to Russia. It is likely that the Baltic Republics (Latvia, Estonia, Lithuania) are similar to the first three countries, while the Ukraine and Belorussia may be similar to Russia. Some of the Asiatic republics (Uzbeki-
stan, Turkmenistan, Kirghizstan, Tadjikistan) may be relatively less developed than Russia.\textsuperscript{99} The exact ranking is not important; what is relevant is that the countries considered may provide examples for others.

A. The Czech Republic, Poland, and Hungary

The civil codes of the countries in the former Soviet Union are based on pre-Soviet European Civil Codes and "many of the principles are not inconsistent with a market economy."\textsuperscript{100} In many cases, these codes have been adopted from pre-Communist codes. This is true of the Czech Republic, Poland, and Hungary. These three countries have a set of basic contract laws in place.

Poland adopted a code in 1964 that was in turn based on a 1933 code, but with various Socialist additions; these additions were removed in 1990.\textsuperscript{101} Thus, current Polish contract law is a 1933 Western law. A commission is currently redrafting this code to update it. In Hungary, those parts of the Civil Code originally written to govern small, non-commercial private transactions now govern all transactions.\textsuperscript{102} The Hungarian legal system appears to be the most well-adapted for market transactions of the three countries considered.\textsuperscript{103} The Czech and Slovak Federal Republics (C.S.F.R.) had a system more adapted to Communism, so it had less law on which to build than other countries. The C.S.F.R. adopted a new civil code and a new commercial code in 1991.

Thus, in many of the Eastern countries there now exist indigenous bodies of contract law. These are deficient in that they are either crafted de novo (Czech Republic) or adapted from earlier law (Poland, Hungary.) Thus, none are fully adapted to contemporary business. For example, Polish limited liability firms were small family-type businesses, and there was little formal law dealing with larger business.\textsuperscript{104} Nonetheless, beginning with the existing body of contract law and allowing modifications, as discussed below, is likely to be the most efficient and most expeditious way to achieve a body of contract law suited to market conditions in the post-Communist economies. Alexei Klishin discusses such an evolutionary process, although state control was more powerful when he wrote than

\textsuperscript{99} This rough ordering is consistent with a table in Tourevski & Morgan, supra note 22, at 115. This table, based on analysis from Moskovskie Novosti, does not explicitly rate legal systems, but does rate "Development of Infrastructure" only of former Soviet Republics. \textit{Id.} Vladimir Kvint provides a similar ranking. Kvint, supra note 79, at 207-08. Ernst & Young has rated additional countries. In this ranking, Poland, the Czech Republic, and Hungary are rated first in "Business Infrastructure"; the Former USSR is rated significantly lower. Ryam Tutak, \textit{Once Preeminent for Foreign Investment, Hungary Is Now Slipping in Status}, \textit{Budapest Sun}, May 13-19, 1993, at 6.

\textsuperscript{100} IMF, supra note 6, at 247.

\textsuperscript{101} Poland, supra note 6, at 19.

\textsuperscript{102} Hungary, supra note 6, at 34.


\textsuperscript{104} Poland, supra note 6, at 9.
now. Commerce can function with a relatively small body of contract law. Most contract terms are written privately by the parties themselves. As Benson points out, parties actually make "law" by writing a contract. Explicit public law serves two functions in addition to enforcing private terms. First, it fills gaps; it covers situations that the parties did not anticipate. Second, it supplies defaults; if the law provides certain terms or indicates certain results, the parties to a private agreement can save resources by not dealing with these issues directly, or by paying lawyers to deal with them. The major part of the contract, however, is the result of private agreement. Thus, parties can engage in substantial amounts of contractually based commerce with little explicit "law" on the books.

Gray provides a summary of the situation in Poland that seems to apply more generally:

Although the legal structure is generally satisfactory in most areas, practice is still uncertain in all areas. The generality of the laws leaves wide discretion for administrators and courts, and there has not yet been time to build up a body of cases and practice to further define the rules of the game. Although the courts are in general honest and are used by the population, they have little experience in economic matters. Judges are not well paid, and the best lawyers have a strong incentive to go into private practice. The wide discretion and general lack of precedent and competence create tremendous legal uncertainty that is sure to hamper private sector development.

B. Russia

The Russian body of law seems less well-adapted than the first three countries. This may be because Russia was Communist longer than the others; existing pre-Communist law is thus older than in the other countries, and there is an additional generation since people have had actual exposure to markets. Russia was also less economically advanced at the time of the Revolution than other countries; its body of capitalist law is consequently less well-developed.

The major legal weaknesses do not seem to be in the contract law area. A large body of Russian contract law used under the Soviet system to govern transactions between enterprises. This law differs from contract law in market economies. It is not as different as we might expect, however. "More surprising, perhaps, is the substantial convergence of contractual norms in Soviet and Anglo-American legal systems despite significant

106. BENSON, supra note 38.
107. POLAND, supra note 6, at 2.
108. Much of this section is based on IMF, supra note 6, ch. IV.7. Other important sources are KNY, supra note 80 and TOUREVSKI & MORGAN, supra note 22. Andrei Shleifer and Robert W. Vishny provide a general theory of corruption. Their discussion of the case of Russia is consistent with the observations discussed in this section. Andrei Shleifer & Robert W. Vishny, Corruption, 108 Q.J. ECON. 599 (1993).
differences in the organization of capitalist and socialist economies."\(^\text{109}\)
Attorneys and businessmen in Russia indicate that difficulties in doing business are due more to uncertainty about government actions than contractual weaknesses.

Pervasive difficulties in the Russian legal system weaken the functioning of contract law. These difficulties apparently stem from the December 1990 law "On Property in the R.S.F.S.R."\(^\text{110}\) This law was seriously incomplete, and the needed subordinate legislation was not passed because of political difficulties. Moreover, "[t]here was no clear distribution of state property between the Federation and its member republics, districts, and regions."\(^\text{111}\) These problems in property rights allocation and conflict between governmental units still plague the country today. Moreover, in Russia, more than in the other countries, people with some hostility towards the adoption of a market system remain in authority.

The so-called "war of laws" is another force leading to legal uncertainty in Russia. Various levels of government may pass conflicting laws, and there is no mechanism for resolving such conflicts. This makes business planning difficult:\(^\text{112}\)

At the time of this writing, the problem of lack of clarity and uniformity exists at all levels of government and involves uncertainty concerning the location of authority to legislate and implement the laws, the nature and extent of the legislative and executive powers, and the appropriate means and methods for enforcement.\(^\text{113}\)

While the splitting of the Soviet Union into independent countries may have reduced these problems, it has not solved them all, and local laws are continually changing.\(^\text{114}\) There are inconsistencies in rules and interpretations of various Russian ministries and departments.\(^\text{115}\) The multiplicity of fora for commercial dispute resolution is more severe in economies lacking "a well-developed body of commercial law."\(^\text{116}\) There are over 800 ministries, and many of these can stop any given deal.\(^\text{117}\)

Only eight percent of potential joint ventures begin operating.\(^\text{118}\) Kvint estimates that ten percent of joint venture failures are due to legal problems.\(^\text{119}\) Kvint also estimates that twenty-eight percent of the failures

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\(^{109}\) Kroll, \textit{supra} note 16, at 147.

\(^{110}\) Topornin, \textit{supra} note 35.

\(^{111}\) \textit{Id.} at 17.


\(^{113}\) IMF, \textit{supra} note 6, at 226.

\(^{114}\) \textit{Id. Kuz'minov, Soviet Economic Culture: The Legacy and the Paths of Modernization, 35 PROBS. ECON. TRANSITION 5, 18-19 (1993).}

\(^{115}\) V. Chernogorodski & A. Tsyganov, \textit{Economic and Organizational Conditions for the Support of Entrepreneurship in Russia, 35 PROBS. ECON. TRANSITION 71, 72 (1992).}

\(^{116}\) IMF, \textit{supra} note 6, at 254.

\(^{117}\) Kvint, \textit{supra} note 79, at 26.

\(^{118}\) \textit{Id.} at 181. Tourevski and Morgan indicate 20-30% of licensed joint ventures "have been actually operating enterprises." Tourevski & Morgan, \textit{supra} note 22, at 65.

\(^{119}\) Kvint, \textit{supra} note 79, at 186.
are due to the inability to find an appropriate partner,\textsuperscript{120} and twenty percent to "financing."\textsuperscript{121} Legal problems may exacerbate these difficulties. For example, difficulty in finding financing may be caused by poor property rights definitions, or by difficulty in foreclosing, making it difficult to use property as collateral. Contractual uncertainty may make finding a partner more difficult. Thus, the legal system may be responsible for a greater percentage of failures than is immediately apparent. Sixteen percent of the failures are due to "bureaucratic problems,"\textsuperscript{122} which may also relate to legal uncertainty.

Tourevski and Morgan identify several areas in which respondents to interviews (Russian and foreign businessmen) have indicated weaknesses in the law.\textsuperscript{123} Indeed, these weaknesses are a major theme of their book. For one set of examples, they cite:

1. Vague, contradictory, inconsistent formulations.
2. Dependence of the laws on ideological trends and tendencies.
3. Isolated lawmaking, divorced from international legislation.
4. The conflict between laws which had been centralized and the republics, between the republics themselves, or between the republics and their autonomous territories. According to the prognosis expressed in the interview, this tendency will be increasing.
5. The instability of laws which are unclear and change from day to day.\textsuperscript{124}

New laws are passed with no thought to their consistency with existing law.\textsuperscript{125} Moreover, there are no legal provisions for ending joint ventures and allocating their property; some potential transactors are consequently reluctant to form such ventures.\textsuperscript{126} One strategy for dealing with such legal inconsistency is to enter the market on a small scale and observe what happens.\textsuperscript{127} Many foreign firms, for example, have small investments in Russia, often involving only the retailing of products. To the extent that quicker or larger investments would occur if certainty increased, then uncertainty imposes real costs on the Russian economy.

Numerous examples of such inconsistencies exist. In one randomly selected week, the \textit{Moscow Times}, a daily English language newspaper, reported the following examples of market interference and contractual uncertainty:

From April 9 to May 25, oil prices were controlled at levels well below market prices as a result of a politically-motivated decree imposed before the election.\textsuperscript{128} As a result of the decree maintaining prices at the March 1 level, Moscow suffered severe gasoline shortages. Some refineries refused to sell in Moscow; two refineries closed down. Even though the

\begin{footnotes}
\item[120.] \textit{id.} at 182.
\item[121.] \textit{id.} at 221.
\item[122.] \textit{id.} at 221.
\item[123.] Tourevski & Morgan, supra note 22, at 166-92.
\item[124.] \textit{id.} at 166-67.
\item[125.] \textit{id.} at 168.
\item[126.] \textit{id.} at 73.
\item[127.] \textit{id.} at 39-40.
\end{footnotes}
price was allowed to rise to 70 rubles per liter, mobile tanks were selling the same grade for 120 to 150 rubles per liter.  

A Korean-Russian joint venture has invested $70 million in a timber project in eastern Russia since 1990. An environmental dispute went to the Russian Supreme Court, which "failed to come to any concrete conclusion, sending the case back to the regional court." There has also been a "worsening tax situation." While original estimates were that the venture would earn a profit by the fourth year, "under current conditions it could take seven to 10 years." Other potential investors are closely monitoring this situation.

De Beers had signed a five-year contract with the Russian diamond marketing agency. Now, the "Precious Metals and Stones Committee" is attempting to renegotiate this contract.

The Moscow city government changed the method of taxing land owned by joint ventures. The joint ventures were previously taxed at the same rate as Russians, about $3500 per hectare. Now, the rate will range up to $465,000 per hectare, the same rate paid by foreigners. The exact rate will depend on the degree of foreign ownership of the joint venture. The Moscow Times reported that:

The new decree is the latest in a series of changes in tax and land-ownership laws that have made it difficult for foreign and Russian firms to lease property for office space and development in the capital. In recent months, for example, the City Council has annulled leases signed by the mayor's office and passed legislation calling for lease agreements to be renegotiated. These new tax rates mean that some past investments may not be profitable, and would therefore not have been undertaken.

Other examples of new laws that are inconsistent with existing law include:

The Ministry of Foreign Economic Relations is creating an auditing board that will have the right to control or even shut down any independent entity engaged in foreign economic relations. This board will be able to question the business decision of the entities subject to its control.

Russian customs officials, and later the KGB, seized automobile batteries produced by an American-Russian joint venture because of a technicality in the joint venture charter.

Customs officials refused permission for a Leningrad company to export scrap metal, even though the company had permission from the

131. Id.
132. Id.
135. Id.
136. TOUREVSKI & MORGAN, supra note 22, at 42.
137. Id. at 44-45.
A cooperative began to recover and process timber that sunk during the downstream floating process and which was otherwise wasted. Within six months, the government shut down the operation, leaving the timber to rot.\textsuperscript{139}

A Russian magazine publisher contracted to trade waste paper for computers, but it was denied a license to export waste. Even if one ministry had granted such a license, approval of another would also have been required.\textsuperscript{140}

Western oil companies might spend up to $70 billion annually to develop Russian oil fields were it not for fears of opportunism.\textsuperscript{141} Much of this opportunism comes from the government, which seems to change rules or increase export taxes to appropriate past investments opportunistically. There is, however, private opportunism as well. For example, after one company had invested in machinery for drilling for Russian oil, the firm that controlled the pipeline providing the only route to the sea doubled its rates.\textsuperscript{142}

The Raddison Corporation negotiated an agreement with the Kremlin to build a hotel in Moscow. Once the property was completed, however, the Moscow city council demanded a partnership before allowing the hotel to open. Negotiations delayed the opening for about one year, with the city finally getting its partnership.\textsuperscript{143}

Even where investment occurs, investors are aware that contracts are subject to great political uncertainty. Elf Aquitane, the French company, has signed a contract to explore for oil in Russia and Kazakhstan.\textsuperscript{144} Other American oil companies have also signed contracts, but Elf's endeavor is the only one not part of a joint venture.

Elf has the first of what is called a production agreement with Russia...but whether the contract will remain in effect as written remains uncertain. It took Elf about a year to get the deal approved by the Russian Parliament, but whether this gives the contract any legal force is still murky, given the struggle between President Boris Yeltsin and some leaders of the Parliament.

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A High official in the Tyumen Region, Russia's largest oil area, said there was a continuing tug of war between local officials and the ministers in Moscow over control of new ventures.

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\textsuperscript{138} Id. at 170.
\textsuperscript{139} Id. at 209.
\textsuperscript{140} Kvint, supra note 79, at 194.
\textsuperscript{142} Id. at 57.
\textsuperscript{143} Bill Thomas & Charles Sutherland, Red Tape: Adventure Capitalism in the New Russia 145-46 (1992).
\textsuperscript{144} Agis Salpukas, In an Oil Rush to the East, Elf Plays Pied Piper, N.Y. Times, June 27, 1993, at F7.
In such an atmosphere, Elf's straightforward contract could be bent out of shape.  

Ikea, the Swedish furniture company, planned to invest in producing as well as selling goods in Russia.  

In 1988, Ikea agreed to renovate a dozen Russian furniture factories to produce furniture that it planned to sell in stores scheduled to open by 1991. The plan failed, however, when the U.S.S.R. collapsed. Ikea is currently involved in litigation and in arbitration in Stockholm. Ikea's chief executive, Anders Moberg, said that, "[t]errible problems untangling various obligations between the old U.S.S.R. and the new republics have us much more cautious."  

Ikea now plans to invest in Poland, Hungary, and the Czech and Slovak republics, but not Russia.  

These examples indicate difficulties with the Russian political system, rather than with the legal system itself. Political reform is needed to correct these problems. The remedies proposed in this paper are only available in economies where decision makers have the power and will to impose reforms; they will not work where such will is lacking. 

Political stability will support legal reform in another way. Part of the difficulty with law enforcement is undoubtedly due to uncertainty. Many mechanisms discussed here depend on reputations and on other long-term investments (e.g., in self-enforcing agreements). If parties believe that property or legal institutions are likely to change in the near future, they will be less willing to invest in such agreements. This may explain the widely noted tendency of Russian negotiators to drive excessively difficult bargains, as discussed above. Such bargaining may mean that Russian participants receive less long-term returns from the agreement, but if parties have shorter time horizons, this consideration will be less significant. 

Short time horizons may also explain some otherwise puzzling behavior of political authorities. If a political authority radically changes the tax rate faced by businesses, that authority may profit in the short run because the jurisdiction can appropriate the quasi-rents from the completed investment. This policy has long-term costs, however, because other businesses will be less willing to invest in this jurisdiction. But a short time horizon means that the appropriated investment's present value can outweigh the long-term losses from lost future investments.

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145. Elf is 50.79% owned by the French government. Thus, officials in charge of investing might put weight on political factors rather than expected profits in deciding where to invest. Normally, major stockholders would be expected to monitor such activity, but Elf's "management has been making its own decisions for many years—including its journey to the East—with little supervision by the state." This may also be attributed to the fact that the French government is actively seeking to sell many state owned companies, such as Renault and Air France. See Salpukas, supra note 144, at F7.  


147. Id.  

148. Id.  

The famous Coase Theorem shows that with well-defined property rights and sufficiently low transaction costs, the final use of resources is efficient and invariant with respect to initial rights assignments. Most criticisms of the theorem have focused on the second condition, the magnitude of transaction costs. The theorem may not hold in the present Russian situation, however, because the first condition, the existence of well-defined property rights, is not satisfied. The problem is not anarchy; it is rather the existence of too many governments, with insufficiently defined lines of power between them. Property rights are not well-defined because it is unclear who has the power to define them. The result is an inefficient use of resources. This problem must be solved for any degree of economic progress to be feasible.

The situation in Russia is perhaps typical of what, as Joseph Tainter indicates, commonly occurs after the collapse of a complex society:

With disintegration, central direction is no longer possible. The former political center undergoes a significant loss of prominence and power. It is often ransacked and may ultimately be abandoned. Small, petty states emerge in the formerly unified territory, of which the former capital may be one. Quite often these contend for domination, so that a period of perpetual conflict ensues. The umbrella of law and protection erected over the populace is eliminated. Lawlessness may prevail for a time . . . but order will ultimately be restored.

Although the Soviet Union's collapse fulfills many of Tainter's conditions, it is hoped that Russia can avoid these grim ramifications.

C. Some Possible Beginnings

Agents already exist in the post-Communist economies who could possibly perform the functions sketched out above. It appears that some are already doing so.

Cooperatives in Russia have formed two types of associations for lobbying purposes. Some are geographically organized and include businesses in a particular area. Others are essentially trade associations and include cooperatives in the same business sector. Cooperative associations provide services to members, including legal assistance, and pursue a political program. Two such major organizations are the U.S.S.R. Union of Amalgamated Cooperatives (founded in 1989) and the Union of Lease-
holders and Entrepreneurs (founded in 1990). Representatives of the cooperative movement were involved in legislative decision making. Again, these structures correspond to the potential multilateral organizations discussed above, but there is no evidence that these organizations presently perform such functions.

A class of agencies performing exactly the functions identified above is the “commodity exchange.” These exchanges are trading centers with many firms as members. Stefan Zhurek indicates that the International Food Exchange offers a variety of services, including “arbitration for the rapid settlement of trade disputes.” He also indicates, however, that volume on this exchange is low. On the other hand, the Moscow Commodities Exchange did over $550 million in business in May of 1991.

The Soviet Chamber of Commerce has begun performing an informational function. This organization publishes a directory of foreign trade participants, including information about financial positions and business reputations. Other organizations perform similar functions. Some private organizations also provide such business information. The accounting firm of Ernst & Young has established a joint venture providing information about various aspects of doing business in Russia, including information about “reliability of the partners.” Several other private ventures also provide such information. In general, however, Tourevski and Morgan believe that there is a dearth of useful business information. This gap has been exacerbated because, for a time, cooperatives (Soviet private firms) were forbidden from performing “middleman” functions.

V. Government Policy

Thus far, the discussion has focused on private actions to create mechanisms for private enforcement. But government can also facilitate these mechanisms in various ways. Such facilitation can have two beneficial effects. First, by increasing the agent’s ability to enter into agreements, the amount of beneficial transactions can increase. Second, by choosing proper policies, government can facilitate the creation of a body of precedent that can ultimately form the beginnings of an efficient body of laws.

This article envisions the following rough institutional structure. There is a court system in existence. This system has some rough notion of contract law. It may, for example, believe in “freedom of contract” and

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155. Stefan Zhurek, Commodity Exchanges in Russia: Success or Failure, 2 RADIO LIBERTY RES. REP. 41, 42 (1993).
156. THOMAS & SUTHERLAND, supra note 143, at 136.
157. TOUREVSKI & MORGAN, supra note 22, at 49.
158. Id. at 201.
159. Id. at 103.
160. Id. at 104.
161. Id. at 52.
162. Id. at 195.
in allowing voluntary private exchanges. A complete body of contract law is not in place, however, so decisions of the court system in resolving actual disputes will be somewhat uncertain. "It is entirely permissible to adopt a kind of skeleton law in the situation where the law on a given subject is being drafted and only the most general provisions are certain, on the basis that the answers to the more concrete questions can only emerge from practice."163

In addition, there are probably delays in reaching the court system. In a world of high inflation, these delays may be particularly costly if court awards are in nominal currency units, which may be happening in Russia.164 Unindexed contracts and court unwillingness to alter contractual terms were responsible for a nonpayment epidemic in interwar Germany.165

In this section, this article deals with two types of policies. Some policies will facilitate formation of private agreements. It is also possible, however, for incorrect government policies to penalize efficient conduct. Past experience in the United States shows that misuse of antitrust policies is particularly likely to be costly; antitrust law has often erred and punished procompetitive conduct. In post-Communist economies, where an excessive fear of "monopoly capitalism" may exist, such misuse may be particularly likely. Moreover, the current Russian antitrust statute contains provisions that could lead to inefficient rulings.166 Antitrust laws in other countries also contain provisions that could lead to inefficiency.167

This article analyzes policy in the same tripartite framework used for analyzing private enforcement mechanisms.

A. Unilateral Mechanisms

The most important assistance governments can give to private firms to create reputation capital is a willingness to enforce trademark property rights. Trademarks allow buyers to determine the quality of purchased goods, therefore enabling sellers to invest in provisions of high quality.168 The Russian antitrust law prohibits unauthorized use of trademarks.169 Russian trademark law also allows civil damages and fines, but these penalties are currently too small to provide an effective deterrent. This law presently contains no injunctive provisions.170 At least one action, against

164. Harold Berman of Emory Law School brought this to my attention.
167. Pittman, supra note 6. See generally Czech and Slovak Republic, supra note 6, at 23; Hungary, supra note 6; Poland, supra note 6, at 26.
169. RSFSR, supra note 166, at 1.
counterfeit Levis, has been brought.\textsuperscript{171} In another case, however, a violation of an exclusivity agreement to export Stolichnaya vodka to Greece resulted in only a 300 ruble fine to the violator.\textsuperscript{172}

Czechoslovakia passed a trademark law in 1988, but trademark registration is slow, and the law is untested.\textsuperscript{173} Poland has a body of trademark law, but its enforcement may be weak.\textsuperscript{174} Nevertheless, Wrangler jeans successfully sued a manufacturer of labels used in counterfeit products. The situation in Hungary is similar,\textsuperscript{175} although Hungarian authorities have recently destroyed 15,000 pirated cassettes to indicate that they plan stricter enforcement of copyright laws.\textsuperscript{176}

If counterfeiting and trademark infringement are not sufficiently penalized, firms will have reduced incentives to invest in the creation of brand name capital. Given that law enforcement authorities apparently lack adequate resources to enforce laws against counterfeiting optimally, a second best solution must be considered. This alternative would allow firms whose products are the subject of counterfeiting to enforce trademark rights privately. Such firms would have the right to seize counterfeit goods and sell them on the market, presumably after removing the counterfeit trademark. This policy will generally not lead to optimal enforcement against counterfeiting, but it is preferable to minimal or no public enforcement.\textsuperscript{177} Some western movie companies (including MGM, Warner, Sony and Paramount) “have been training and financing full-time, private anti-piracy investigators” to enforce their rights in Hungary.\textsuperscript{178} Such private enforcement, however, must be subject to ultimate control by the state, perhaps by allowing an appeal from the targeted counterfeiters.

Beyond this, governments can facilitate other investments in valuable brand name creation. Advertising is one such prominent investment method. Government owned radio and TV channels (if they cannot feasibly be privatized) should allow advertising. In Russia, as of now, “the three television stations are government owned and run very limited advertising.”\textsuperscript{179} The Moscow city government passed a law requiring that, as of April 1, 1993, foreign language signs carry the same words in Russian (Cyrillic) script, and that the Russian words must be twice as large as the others;\textsuperscript{180} St. Petersburg passed a similar law in December 1992.\textsuperscript{181} Such a law is harmful for several reasons. First, it increases advertising costs by

\textsuperscript{172} TouREVSKI & MORGAN, \textit{supra} note 22, at 186.
\textsuperscript{173} CZECH AND SLOVAK REPUBLIC, \textit{supra} note 6, at 9-10.
\textsuperscript{174} POLAND, \textit{supra} note 6, at 8-9.
\textsuperscript{175} Id. at 19.
\textsuperscript{176} 15,000 Pirate Cassettes Destroyed, \textit{DAILY NEWS} (Budapest), May 14, 1993, at 4.
\textsuperscript{179} TouREVSKI & MORGAN, \textit{supra} note 22, at 105.
\textsuperscript{180} Joanne Levine, Cyrillic Rights, \textit{Bus. CENT. EUR.}, May 1993, at 32.
\textsuperscript{181} Id.
requiring reconstruction of many signs. Second, it reduces the value of brand names. Companies advertise in whatever way is most informative to consumers; mandated changes in advertising will thus provide less information. Finally, the government reduces incentives for future investments in brand names by indicating to advertisers their willingness arbitrarily and capriciously to destroy part of the value of past advertising.

In enforcing laws against deception, authorities should be careful not to over-regulate and deter provision of valuable information. The anti-trust law in Russia contains provisions regarding deception. These provisions are sufficiently open ended so excess regulation is possible. A certain provision prohibits "misleading consumers concerning the character, mode and place of manufacture, consumer properties, and quality of products."

The major danger of over-regulating advertising, on the basis of the U.S. experience, is the suppression of true information that regulatory authorities judge to be deceptive. One example is price advertising. A common form of advertising is the claim: "Regularly $10, now $5." Regulatory authorities often find such advertising deceptive if not "enough" sales have taken place at the $10 price. Yet this type of regulation has the effect of reducing price competition and increasing consumer prices. Regulators also occasionally limit claims if advertisers pay insufficient attention to a product's negative characteristics. This is often called "deception by omission." In a market equilibrium, however, there are strong incentives to advertise a product's negative characteristics by claiming that the advertiser's product is less bad than others. The market will thus disclose such information. Mandating disclosure is counterproductive and can actually reduce information available to consumers.

It is particularly important to note that advertising will most likely appear deceptive in a market out of equilibrium. Advertising in this context can be a powerful force for moving these markets closer to equilibrium. In the post-Communist economies, all markets are likely out of equilibrium, and will probably remain so for some time. Moreover, consumers probably have relatively little experience or sophistication in dealing with advertising. Thus, in the short run, much advertising might appear deceptive. However, excess regulation will reduce the market convergence rate towards equilibrium, and increase the time it takes for consumers to learn to deal effectively with advertising. Over-regulation is thus particularly likely and particularly costly in these economies.

Indeed, although evidence to make a firm determination is lacking, some evidence of such over-regulation exists. Major firms, such as Saattchi & Saattchi and Unilever, have been fined in Hungary for offenses that do not appear to be serious. There are also efforts to increase advertising

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183. RSFSR, supra note 166, at 5.
regulation in Poland and in the Czech Republic.\textsuperscript{184}

Governments should keep in mind that an important incentive for providing quality is the higher price a firm can command for higher quality. At times, and particularly until markets have adjusted, those firms providing high quality will earn high profits. These profits will signal other potential market entrants that provision of quality products is worthwhile. Authorities must be very careful, however, not to reduce these incentives by regulating such aspects as the prices charged (perhaps in the name of antitrust laws). For example, a Polish antimonopoly law prohibits charging "exorbitant prices" and the Antimonopoly Office can roll back prices.\textsuperscript{185} Polish and Hungarian laws have the most explicit price control provisions, and the Russian, Czech, and Slovak laws similarly contain language that may be interpreted to allow price controls.\textsuperscript{186} Prices will naturally fall as entry occurs, but entrepreneurs who first learn techniques valuable in a market economy must be rewarded.

B. Bilateral Mechanisms

Government can do relatively little to facilitate bilateral agreements. Self-enforcing agreements, for example, do not need government assistance. The improper use of antitrust policy, however, could hinder creation of bilateral arrangements. This fear is not based on pure speculation. Improper antitrust policies in the United States have greatly hindered the creation of valuable vertical relationships between manufacturers and retailers. Recall some of the mechanisms that manufacturers might find useful: establishment of maximum or minimum resale prices; territorial restrictions on where retailers might sell, including exclusive territories; requirements that dealers carry only the brand of the manufacturer (exclusive dealing); and requirements of certain methods of retailing, such as shelf space requirements. Manufacturers may also vertically integrate directly into retailing, and some may establish franchises. All of these methods should be legal.\textsuperscript{187} Any contract between a manufacturer and a retailer should be strictly enforced by whatever enforcement mechanism is specified. Excessive regulation of these vertical relationships or limits on freedom of contract can reduce incentives to produce quality goods, subsequently harming consumers.

The antitrust law in Russia may err in not allowing sufficient vertical restrictions. There are restrictions on "writing discriminatory clauses into a contract that put the other party at a disadvantage as compared with other business persons"\textsuperscript{188} and on "impeding other business persons in

\textsuperscript{185} \textit{Poland}, supra note 6, at 26.
\textsuperscript{186} Pittman, supra note 6, at 501-02.
\textsuperscript{188} RSFSR, supra note 166, at 31.
entering market[s] (withdrawing from market[s]).” This easily could be interpreted as forbidding certain vertical practices, such as exclusive dealing. Decision-makers are unskilled at distinguishing between vertical and horizontal restraints, and are therefore likely to regulate vertical restrictions excessively.\footnote{190}

Other antimonopoly laws have similar provisions. Czech law does not distinguish between horizontal and vertical restrictions.\footnote{191} Polish law sometimes bans tied sales, resale price maintenance, and other vertical relationships.\footnote{192} Hungary also has similar provisions.\footnote{193} Hungarian and Russian laws are, in general, relatively less hostile to vertical restrictions than the Polish and Czech Republic laws, although both Polish and Hungarian laws ban tying arrangements independent of market share.\footnote{194}

More generally, many of these laws apply only to firms with “dominant” positions, commonly defined as market shares of thirty percent or more. Market shares are difficult to measure, however, without sophisticated methods of defining markets. In enforcing U.S. antitrust laws, market definition is often the most difficult and contested part of an enforcement action. Excessive enforcement is possible if decision makers define markets too narrowly, and U.S. antitrust authorities have traditionally done just this. The Hungarian and C.F.R. laws make it easier for a firm to be defined as a “dominant” firm than in Poland and Russia, although any of the laws could be interpreted as excessively enforcing rules penalizing dominance.\footnote{195}

As mentioned above, one method of establishing credible commitments for bilateral relationships is the use of hostages. This requires reciprocal dealing between firms. Antitrust laws have sometimes penalized this behavior. The Russian antitrust law forbids “imposing on the other party contractual terms which are disadvantageous to him or which are irrelevant to the subject-matter of the contract.”\footnote{196} Other countries also forbid such practices. This can be interpreted as forbidding reciprocal transactions and the use of hostages. Again, there should be no such restriction; all reciprocal transactions between firms should be legal.

It does not appear that the antitrust laws are currently being abused. Many businessmen and attorneys indicate the potential for abuse, but a record of such behavior is lacking. The Czech antitrust agency is located outside of Prague, perhaps to minimize the danger of such behavior. Similarly, the Polish antitrust agency is in Krakow, not Warsaw.

\footnote{189} Id.
\footnote{190} IMF, supra note 6, at 283.
\footnote{191} CZECH AND SLOVAK REPUBLICS, supra note 6, at 22.
\footnote{192} POLAND, supra note 6, at 26.
\footnote{193} HUNGARY, supra note 6, at 41.
\footnote{194} Pittman, supra note 6, at 489.
\footnote{195} Id. at 495.
\footnote{196} RSFSR, supra note 166, at 4.
Multilateral Arrangements

Governments have the greatest ability to be helpful in facilitating multilateral enforcement mechanisms. Assistance can enable parties to benefit from such enforcement methods. Moreover, if properly done, governments can use the results of multilateral processes to generate efficient law.

Arbitration is a natural method of dispute resolution. All courts need do is credibly promise to recognize contractually specified arbitration decisions as if they were court decisions. This will provide incentives for parties to include such clauses in their agreements. There will be three benefits to parties from such clauses.

First, an arbitration decision is likely to be available with less delay than a court decision. Second, the parties can choose arbitrators. In a world where judges may lack experience with business disputes and where legal precedents may be weak, it should be possible to choose arbitrators who will be more likely to reach efficient decisions. Future business provides an incentive to reach correct decisions because arbitrators will be paid only if hired. Moreover, parties can specify the amount to be paid to arbitrators. This means that arbitrators in more important (costly) disputes can be paid more, so parties will have access to the quality of arbitrator appropriate to the value of the case.

Third, parties can choose the body of law or rules to govern a dispute. If the law in place is inefficient or vague, the parties can choose to have their dispute governed by a different body of law, or by the rules of the arbitration association. This allows more choice of law flexibility and increases the probability that an efficient law will govern.

Thus, a decision by the courts or a statutory announcement that the courts will honor and enforce arbitration agreements may be the single most powerful method available for achieving efficient short run decisions and also for generating efficient long run precedents. For reasons discussed below, the government may want to announce that it will enforce arbitration agreements only if there is a written opinion from the arbitrator in addition to a decision.

Allyn Enderlyn and Oliver Dziggel indicate that foreign trade ventures in the Czech Republic have the right to arbitration provided for in agreements under any internationally recognized rules. The Czech Chamber of Commerce and Industry has an Arbitration Court, but the parties may name other arbitrators in their contract instead. Rules of procedure are proposed by the Board and announced by the Federal Ministry of Foreign Trade in the Collection of Laws, thus giving arbitration procedures the force of law. Similar policies apply to disputes between joint ventures and other Czech enterprises. Joint Venture Law also allows the choice of legal codes other than Czech law. This set of policies seems well

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designed to achieve the goals discussed above with respect to investments involving foreign firms.

No such provisions exist, however, for arbitration between Czech firms. The C.F.R. initially drafted a code allowing arbitration of disputes between Czech enterprises, but this provision was not adopted and is not currently in place. It would be highly useful to adopt such a provision as soon as possible. Indeed, practicing attorneys in the Czech Republic have indicated that opportunism is common because of the difficulty of court enforcement; they have argued that enforcement of private arbitration clauses would be very useful.

Hungary also allows businesses operating in conjunction with foreign firms to specify arbitration in their contracts. Nonetheless, contracts between Hungarian firms do not presently allow for arbitration. This may be less of a problem than otherwise since Hungarian courts apparently function fairly well.

Poland seems to have a well-developed arbitration system, and arbitration provisions can be applied to contracts between domestic firms. Parties are allowed to specify whose law will govern and who will be the arbitrator of a dispute. The Union of Polish Banks has established an arbitration court for disputes involving banks and their customers. The Polish economy is currently performing better than any other formerly Communist economy. Much of this success is due to the productivity of Polish domestic firms, since the country has received relatively little foreign investment. While all the countries studied have efficient arbitration rules for dealings with foreign investors, Poland has the most efficient system for contract enforcement involving domestic firms.

Russia also has arbitration provisions for agreements between Russian and foreign firms. Enforcement is lacking, however. Western legal experts recommend that all corporate charters include provisions for arbitration. These should include provisions for the arbitrator, the location of the arbitration, and the body of law to be used. This authority also indicates that "it is typical of the enabling laws of the emerging Eastern and Central European countries, that only broad outlines are provided in the statutes—and a great deal is left to negotiations and contractual agreements."200

Russian courts will not enforce arbitration agreements between domestic firms. Rather, the courts will hear the dispute de novo if the arbitration decree is contested. This is consistent with the general interventionist tendencies of Russian authorities. Russian subsidiaries of foreign firms, as opposed to joint ventures, are treated like Russian firms,

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and the courts therefore will not enforce arbitration agreements between these firms and domestic firms. As a result, some foreign firms may form joint ventures when subsidiaries would be a preferable form of organization.

Trade associations and Better Business Bureaus, or their equivalent, can also serve as a source of regulation and contract enforcement. Much of their power comes through private mechanisms and provision of information about reputations. There may be little scope for government assistance in this effort. Government could possibly certify the association itself, giving its announcements more force than otherwise. That is, government can guarantee the reputation of the organization that will guarantee its members' reputations. Government may also provide some payment to these organizations to induce them to undertake more careful investigations than is in the pure private interest of their members. This is because members will not capture the full value created by the information provided, since information is partially a public good. This strategy is somewhat risky, however, and if it is chosen, governments should have clear criteria for terminating relationships with associations. Moreover, restrictions on political activities of chosen associations would also be useful; otherwise government may find itself subsidizing special interest lobbying organizations.

As with other mechanisms, there is a danger of misuse of antitrust law with respect to trade associations. In particular, it will sometimes be necessary to exclude some firms from the association in order to maintain quality. Incorrect antitrust law, however, can interpret such exclusion as an anticompetitive boycott. Moreover, the Russian antitrust law requires that all such associations be approved by the antitrust authorities. This could make formation of such organizations more difficult. Nonetheless, correct interpretation will be difficult, as such laws can be used for anticompetitive exclusion. Such anticompetitive exclusion has apparently been practiced in Leningrad.

VI. Creation of Efficient Rules

The private mechanisms discussed here can form the basis for an efficient body of law. This article first discusses the mechanisms for such law creation, as well as some of the benefits of private law creation. In particular, private law may have some advantages over public law, at least as practiced in the United States.

A. Mechanisms

One advantage of the proposed set of institutions, and in particular of the multilateral institutions, is their propensity to lead to the evolution of efficient rules. Mechanisms that might lead a formal legal system to yield

201. RSFSR, supra note 166, at 7.
202. IMF, supra note 6, at 279.
efficient rules exist, but these mechanisms possess limited power.\textsuperscript{203} Competing jurisdictions and competition between judges may be the most efficient method of achieving efficient rules quickly.\textsuperscript{204} Indeed, the common law adopted the Law Merchant in order to obtain the legal business, and associated fees, of merchants.

When parties are negotiating contracts, they will consider enforcement methods. Generally speaking, breach of a contract will occur only as a result of unanticipated events, so parties cannot know ex ante the nature of breach or the desired remedies. Therefore, the interest of parties ex ante is to choose those arbitrators who will maximize the ex post joint wealth of the parties—that is, arbitrators who will choose the most efficient rules for enforcement. For example, arbitrators are commonly successful businessmen, rather than lawyers, so they are familiar with business practices and industry customs. If these arbitrators establish rules by announcing the reasons for their decisions, the rules will tend to be efficient. If they are not, then future disputants will choose different arbitrators. There will thus be strong pressures for arbitrators to use efficient rules.

Will the arbitrators establish rules, or will they only settle disputes? Landes and Posner argue that there are sometimes inadequate incentives for arbitration to produce rules, as opposed to decisions, because the creation of a rule does not benefit the parties who pay for dispute settlement.\textsuperscript{205} They argue that the parties to a dispute want a settlement of the dispute, not a rule. The rule is a public good whose private value is less than the cost to the disputants. Benson has questioned this claim, and points out that the Law Merchant did produce rules which were later adopted into the common law. Moreover, Benson suggests that if parties contract in advance with arbitrators, then arbitrators have an incentive to clarify the rules they will use in the event of a dispute in order to facilitate settlement and reduce the number of cases actually arbitrated.\textsuperscript{206} In the diamond example, arbitrators do not generally provide rules, but this is because parties prefer secrecy in this market. More recently, some bourses have begun publishing rules, but omitting party names.\textsuperscript{207}

In fact, Landes and Posner indicate that there are circumstances in which rules will be created. If the arbitration is performed for an association, then rule creation is feasible because the association can collect dues and use these to pay for rules. The Law Merchant evolved at least in part in connection with trade fairs (one example is the Champagne Fairs). Therefore, there was a possibility of creating efficient rules because all par-


\textsuperscript{204} Landes & Posner, supra note 203; see also Benson, supra note 38, at 253-59.

\textsuperscript{205} Landes & Posner, supra note 203, at 280.

\textsuperscript{206} Benson, supra note 38.

\textsuperscript{207} Bernstein, supra note 98, at 157.
icipants in the Fairs would have been willing to pay a share for such rule creations and the organizers could have charged a premium to support this outcome.\textsuperscript{208} As suggested above, a useful method to generate rules would be for the state to agree to enforce arbitration agreements only if the arbitrator agrees to write an opinion.

For private associations, dues could be used to supplement fees paid by disputants, thus paying for rule creation and promulgation. The rules would benefit all association members, not merely those with a dispute at issue; members would therefore be willing to pay dues to obtain such rules. We would also expect associations to develop efficient rules. Associations depend on members for dues. Firms would be more likely to join associations if the associations credibly promised them efficient rules. Customary rules used in an industry are a likely source of efficient precedents,\textsuperscript{209} and the mechanisms identified here are useful to generate formal records of such customs.

B. Characteristics of Private Law

Private law will have other advantages. Although it is impossible to describe the details of efficient contract law for each country at each point in time, some broad legal principles can be described. This is particularly true since American contract law is, in some respects, inefficient, and these inefficient areas can be identified.

Law can err, in particular, by refusing to enforce voluntarily agreed upon contract terms. In the United States and elsewhere today, courts brand certain types of contracts as being "against public policy." Such contracts may be considered "unconscionable." The courts claim that the parties had "unequal bargaining power" or that the relevant contracts were "contracts of adhesion." Such rulings are particularly common in contracts between individuals and business firms but sometimes apply to other contracts as well. In these cases, courts will refuse to enforce the contracts.

None of these doctrines are economically desirable. In all cases, they make the parties to the transactions worse off.\textsuperscript{210} Courts have imposed these doctrines on parties who have signed contracts with provisions that, ex post (after breach, or after an accident), one of the parties has regretted. If there is private enforcement of contracts, then courts will not adopt any such inefficient provisions; courts will enforce contracts as written. Thus, private enforcement will lead to a more efficient contract law

\textsuperscript{208} Milgrom et al., supra note 87.


\textsuperscript{210} For a discussion of the costs of one set of doctrines in the context of products liability, see Rubin, supra note 8; see also Priest, supra note 8. For a discussion of their origin, see Paul H. Rubin & Martin J. Bailey, \textit{The Role of Lawyers in Changing the Law}, 23 J. LEGAL STUD. (forthcoming June 1994).
than would public enforcement, if public enforcement follows the U.S. example.

There are, of course, some inefficient contracts. These are generally inefficient, however, with respect to third parties. Two examples are contracts to fix prices and contracts to commit a crime. The antitrust laws and the criminal laws can regulate these sorts of agreements. Moreover, since such contracts are illegal, the parties would want to keep them secret, and thus would not rely on the sort of private mechanisms discussed here, even if these mechanisms could lead to enforcement. Thus, with respect to those contracts that are economically efficient and socially desirable, there would likely be some advantages to private enforcement relative to public enforcement. Indeed, the best approach might be private determination of liability, as by arbitrators or trade associations, with public enforcement of the private decrees.

Two-party contracts might be inefficient if one party to the contract is incompetent. This might apply to contracts with children or with the mentally incompetent. Contracts will also be inefficient if there is fraud or duress (where duress is defined as involving force, not "unequal bargaining power" or "unconscionability"). The medieval Law Merchant, a voluntary body of contract law, invalidated a contract based on "fraud, duress, or other abuses of the will or knowledge of either party." Thus, private law should be able to handle these problems of inefficient contract formation.

VII. Implications

This article provides suggestions for behavior for governments, arbitrators, private trade associations, private attorneys, and businesses in the post-Communist economies. This article considers each.

Governments. For governments, the major implication is that enforcement of private agreements to arbitrate disputes between domestic firms, as well as between domestic and foreign firms, is useful and desirable. This simple policy, followed in Poland but not in the other countries, would be the most powerful device for quickly adapting the dispute resolution system to a market economy. Government might want to consider paying a small subsidy to arbitrators if they agree to write opinions, but this is of secondary importance. If arbitrators begin adopting a set of rules and precedents, then governments should consider these in revisions of commercial codes. Governments may also want to make provisions for a common law type process for the court system during code revisions.

Other government policies have mainly negative implications. Governments should refrain from excessive enforcement of antitrust laws, including regulation of vertical relationships, and laws against deception.

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211. Posner, supra note 2, at 114-17.
Western economies established market institutions and developed large economies before such inefficient law enforcement became fashionable; if new economies unduly burden themselves with such costly policies, growth would be retarded or even precluded. Of course, in the case of Russia, a strengthening of the central government is necessary before government itself can credibly commit to policies facilitating growth.

** Arbitrators.** If government will enforce arbitration decrees, then arbitrators can play a major role in the system. An arbitration association will be rewarded if it announces that it will establish precedents and decide cases based on these precedents. If this policy is successful, and if parties begin using this association, then the association might begin to charge ex ante for being named in contracts as the arbitrator of choice. Law firms might find providing such arbitration a valuable specialty.

**Trade Associations.** Private trade associations can begin to play an informational role. Such associations can keep records of behavior of industry members and make this information available to potential transactors. Those seeking the information can pay a fee covering the costs. Alternatively, the trade association can charge members for listing; any firm not listed would signal potential partners that it was unwilling to be rated by the association. Trade associations can also establish formal arbitration procedures with enforcement through information and reputation mechanisms. Organizations such as Better Business Bureaus can perform a similar function for businesses (perhaps retail businesses) in a geographic location.

**Attorneys.** Private attorneys advising firms can utilize information regarding reputations as it is generated. Attorneys can also include arbitration clauses in contracts for their clients. Indeed, attorneys could currently include clauses indicating that arbitration will be used if arbitration decrees should become enforceable in the future. If certain arbitration associations begin to generate precedents, and if these seem useful and efficient, attorneys can name these associations in contracts.

**Businesses.** Businesses can utilize all of the information generated by the processes mentioned above. In addition, certain business behaviors in post-Communist economies are now outdated and counterproductive. First, businesses should avoid excessive secrecy. The best way to guarantee performance is to establish a reputation for fair and honest dealing. Creation of reputations is, by definition, an activity requiring information sharing, and excessive secrecy can hinder or stop this activity. Second, businesses should become more accommodating in their bargaining strategies. For agreements to be self-enforcing, both parties must value the expected future benefits of continuing the sequence of transacting more than the one-time benefits of cheating. Businesses with long-term horizons should realize this and allow trading partners to make a reasonable return on the stream of transactions.

While the transition from a planned economy to a market economy will take a long time, adoption of the policies suggested here can speed up
the process and also increase wealth, and thus consumer welfare, during the transition period.