

Paul G. Mahoney

Outline for AALS Conference on Contract Law

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Why is contract enforcement often weak in developing countries and how can it be improved? I will argue that poor contract enforcement is at root a political problem that does not have a technocratic solution.

Although the theory of economic growth used to focus on technology and other inputs as key determinants, there is now a growing understanding among development economists that bad government is an important cause of low growth (Easterly 2001). Poor policies and institutions are sometimes the result of bad policy advice or “confusion,” but more often they are pursued deliberately because they provide benefits to the rulers (Shleifer 2005). In particular, policies that give bureaucrats broad discretion to permit or block economic activity allow the government to reward supporters and punish opponents. Alternatively, they give the bureaucrats themselves the ability to collect bribes. Often the extent of the center’s control over the bureaucracy determines which of these forms of corruption will dominate (witness the difference between early and late Soviet practice).

Why would rulers desire poor contract enforcement? Enforcement of property and contract rights is one of the most important ways in which governments expand the scope of the private economy. In principle, a self-interested ruler could pursue policies (including reliable and impartial contract enforcement) that maximize the size of the private economy and then extract all benefits in the form of taxation. However, it is usually difficult to pursue this strategy. Running a predictable tax system puts severe informational and administrative demands on the government. Private transactions must be measured and the collectors must be carefully monitored. Giving administrators the right to interfere in transactions through licensing and regulation is relatively easier. Thus, governments in many less developed countries choose to extract benefits through an intrusive regulatory state—the so-called “grabbing hand.” (Shleifer and Vishny 1998).

In a heavily regulated “grabbing hand” economy, disputes are generally resolved through administrative rather than judicial channels. The administrators are “on the spot” to hand out permissions and collect bribes, and therefore the marginal cost of having them resolve disputes about transactions is low. More important, the government typically wants disputes resolved according to a political calculation in which supporters are helped and opponents are hindered, rather than according to stable rules. Finally, the bureaucracy will resist introducing a separate adjudicator. After all, if the adjudicator is honest, she may unmask bureaucratic corruption and perhaps even seek to remedy it; if she is dishonest, she will likely demand a cut of the spoils.

How, then, can enforcement be improved? Clearly writing better codes will not help because it will not resolve the political problem. Introducing an independent and competent judiciary certainly will help (Klerman and Mahoney 2005), but for that very reason a “grabbing hand” government will resist it. In my view, the best strategy for any actor with leverage (such as aid donors or powerful neighboring countries) is to encourage democratization whenever possible—by encouraging a free press, protesting harassment of opposition parties, and so on. Democracy is an important and perhaps underappreciated weapon for property and contract enforcement (Olson 1993).

Corruption usually breeds popular resentment which will disadvantage the incumbent government in a competitive political system, and thus greater democracy will tend to produce less corruption. The possibility of electoral defeat also likely reduces corruption because administrators fear prosecution if the opposition takes power. As I will illustrate, there is an empirical link between democracy, economic freedom, and low corruption.

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