1-1-2007

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DOING WHAT YOU SAY: CONTRACTS AND ECONOMIC DEVELOPMENT

Robert Cooter**

ABSTRACT

Making wealth requires people to do what they say. In relationships and repeat transactions, reciprocity makes people do what they say, even without contract law. Relationships and repeat transactions, however, preclude competition. Competition involving transactions with strangers invigorates an economy and enables it to flourish. Making strangers do what they say requires them to commit legally. According to the contract principle for economic cooperation, the law should enable people to commit to doing what they say. When this principle is implemented, strangers can trust each other enough to work together even when money is at stake. Implementing this principle requires effective courts or state administrators. Deficient enforcement poses a far greater obstacle to contract law in developing countries than defective doctrine. Compared to rich countries, effective enforcement in many poor countries tilts remedies towards specif-

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* This Essay is based on Chapter 3, "Make or Take—Property," in a book manuscript by Robert Cooter and Hans Bernd Schaefer entitled Law and the Poverty of Nations. This Essay is adapted from the Meador Lecture given by Professor Cooter at the University of Alabama School of Law on February 28, 2007.

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ic performance and away from damages. Similarly, good doctrine in poor countries tilts towards legal formalism and away from judicial flexibility.

The Soviet Commissar needed to cooperate with the Director of the State Steel Combine in the 1960s in Russia. They were also rivals, so the Commissar kept an eye on the Director’s movements. One day they met in the Moscow railway station. The Commissar asked the Director, “Where are you going?” The Director replied, “To Leningrad.” The Commissar thought to himself, “He says that he is going to Leningrad because he wants me to think that he is going to Minsk, but I know that he really is going to Leningrad.” So the Commissar said to the Director, “You’re a liar!”

This joke depicts the problem of credible communication. How do we know when to believe someone else? Businessmen relentlessly scrutinize the demeanor of others for clues about what they are really thinking. On the American Indian reservation in Warm Springs, Oregon, a painting on the courthouse wall shows a witness testifying while holding his fingers in a bowl of water. If his hand trembled and made ripples, according to customary belief, then he was presumably lying. The polygraph or “lie detector” used by police works on similar physiological principles. An accomplished deceiver, however, can fool a water bowl or a polygraph. Fortunately, the law invented a better mechanism than the polygraph to make people tell the truth in business transactions: the contract.

To understand how contracts work, consider what the Chinese philosopher Sun Tzu wrote in the 6th century BCE: “‘When your army has crossed the border [into hostile territory], you should burn your boats and bridges, in order to make it clear to everybody that you have no hankering after home.’”1 Burning the bridges commits the army to attack by foreclosing the opportunity to retreat. Since then, army leaders as different as Xenophon, the Greek philosopher and general, Geiserich the king of the Vandals, and Cortez the conqueror of Mexico, have used similar methods. In general, an actor commits to performing an act by raising the cost of not performing it.

When businessmen bargain, they begin with cheap talk and they often end with a contract that has material consequences. A contract is a legal obligation to keep a promise.2 A person who breaks a contract is liable for social and legal sanctions.3 Like burning bridges, an effective contract commits a person to doing what he says he will do by raising the cost of not doing it. The certainty and severity of the sanctions determine the strength of the commitment.

3. Id. §§ 1-2.
To coordinate their behavior, people must say what they will do and do what they say. Contractual commitment is the fundamental means for economic coordination provided by law. According to the contract principle for coordination, the law should enable people to commit to doing what they say.\(^4\) When this principle is implemented, people can trust each other enough to work together, even though money is at stake.\(^5\)

I will begin this Essay by explaining how people commit to keeping their promises without enforcement by the state. Next, I will show how the absence of effective state enforcement of contracts inhibits business. Then, I contrast two different ways that states enforce contracts. Court enforcement is characteristic of democratic countries like India, and administrative enforcement is characteristic of autocratic countries like China. Finally, I discuss how contract doctrine does, and should, change with the level of economic development.

I. RELATIONAL CONTRACTING

Human beings originally lived in small groups consisting of kinsmen and friends who relied on each other. Although tribal life has faded, relatives and friends remain important for economic life, even in big firms and large cities. In northern Italy and Hong Kong, kinship glues together many firms, some of which like Fiat and Sassoon have grown into business empires. In Switzerland and Israel, friendships formed by youths in the army later shape industries. And in the 19th century, men who fought together in the Civil War first created corporate America.

How do friends and relatives rely on each other without a state to enforce their promises? When chimpanzees groom each other, they apply the principal, "Clean my fur today, and I'll clean yours tomorrow." Like chimpanzees, reciprocity remains fundamental to families and friends. If you forget your promise to bring dessert for the family dinner on Sunday, your mother can punish you in a thousand small ways, without suing in court. The same is true among relatives and friends in business.

Friendship and kinship provide a framework for reciprocity. The principle of reciprocity in business is, "Create a benefit for me now, and I'll create a commensurate benefit for you in near future." The principle has two elements: (1) the promise to give a future benefit, which involves honesty, and (2) equality of receiving and giving, which involves fairness. If

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4. See Cooter & Ulen, supra note 1, at 206.
5. Id. In the language of game theory, an effective commitment transforms the payoff matrix of a game with a non-cooperation equilibrium into a game with a cooperative equilibrium that is more productive. See id. at 195-244; Hans-Bernd Schäfer & Claus Ott, The Economic Analysis of Civil Law 320-35 (Matthew Braham trans., 2004).
someone fails to keep his promise, or if the values are disproportionate, then one party accumulates moral debts to the other.

The scale of modern business, however, involves interactions with people who are not relatives or friends. In these circumstances, businessmen often use a substitute for kinship and friendship—they deal with the same people over and over again. Whether in markets or organizations, people in repeat transactions reciprocate like grooming chimpanzees. In laboratory experiments on repeated games, reciprocity is the most popular strategy, and it is often the most profitable. In a reciprocal business relationship, the victim punishes the injurer for promise breaking or unequal performance. The most common problems of contracting are non-payment of bills, late delivery, and poor performance. For non-payment, a typical reciprocation is suspension of supply; for late delivery, it is delayed payment; and for poor performance, it is reduced payment.

Repeat transacting is strongest in Japan, where workers in large companies traditionally enjoyed lifetime employment, manufacturers traditionally preferred to deal with one or two suppliers for each input, and companies traditionally financed themselves through one main bank. In most countries of the world, repeat transactions dominate some sectors of the economy. Thus, a few large banks dominate finance in Switzerland, civil servants worldwide seldom change jobs, and many Apple computer users are fiercely loyal.

Some transactions repeat within a network of people. Like small towns, people in networks have reputations, and what goes with it—honor, gossip, criticism, and ostracism. Loss of reputation reduces the prospect of future gains. Foreseeing this fact, a person’s most profitable strategy tilts towards reliability and fairness. In Vietnam, managers find formal law useless to enforce contracts. Firms stop dealing with promise-breakers, and communication within the business community multiplies the effect. Thus, reputation generalizes the effects of reciprocity. Whereas reciprocity enables two people in a relationship to punish each other, a network

7. See MURRAY, supra note 2, §§ 117-20.
8. See id.
9. See COOTER & ULEN, supra note 1, at 236.
12. Id. at 648-49.
enables a group of people to punish someone who harms someone else. Brand names and advertising can extend reputation effects even beyond networks.  

"Relational contracting" refers to promises in transactions arising from kinship, friendship, repeat transactions, or networks. Relational contracts increase the payoff in the future from fair dealing in the present. In the eleventh century, the states around the Mediterranean Sea were fragmented, yet Jews based in Egypt traded extensively in the region by relational contracts among relatives and friends. Similarly, medieval merchants in many European towns or guilds held merchants collectively responsible for contracts. If merchant α in town A failed to pay debts to merchant β in town B, then the merchants in town B could seize and hold any merchant from town A until the debt to merchant β was paid. Foreseeing this fact, the merchants in town A pressured their members to repay their debts.  

Even in countries with effective state law, businessmen prefer to avoid disputes or settle them informally, with public trials as the last resort. A "self-enforcing" contract is the surest way to avoid a contract dispute. When the time comes to keep or break a promise, a contract enforces itself if each party expects to gain more by keeping the promise than breaking it. In a self-enforcing contract, the balance of self-interest always favors promise keeping, so sanctions for promise breaking are unnecessary. This

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13. The fact that a good is advertised can signal the quality of the brand. JOHN SUTTON, SUNK COSTS AND MARKET STRUCTURE 312–13 (1991). This is true when the producer needs repeat purchases to recover the cost sunk in advertising. Id. at 313.


18. Id.


21. See id.
ideal is seldom achieved, but good contracts are drafted to come as close to self-enforcement as possible. Self-enforcing mechanisms analyzed by economists include vertical integration, franchising, co-ownership, minority holdings, bonds, exchange of business hostages, and efficiency wages.

II. THE COST OF RELATIONSHIPS

Unlike simultaneous exchange, contracts are needed when the parties promise to exchange in the future, or one party gives before receiving. The gap in time creates a need for trust, which people have in relationships—family, friends, repeat transactions, and networks. Dependence on relationships is strongest when state enforcement of contracts is ineffective. Orienting towards relationships, however, involves a significant sacrifice. To sustain a business relationship, a person must deal with someone for reasons of history and sentiment, instead of dealing with the person who sells cheapest, pays the most, works hardest, or innovates best. In brief, relational contracting increases trust by reducing competition. Weak state enforcement of contracts channels transactions into long run relationships and away from potentially better deals with outsiders.

To illustrate, a survey asked businessmen in Peru how much the price of an input would have to fall to induce them to switch from their current supplier to a new supplier. The average answer was thirty percent. They explained their reluctance to change by ineffective contract enforcement. The security provided by a long run relationship with a supplier is apparently worth thirty percent of the cost of the supplies.

Another example concerns a cooperative factory in the city of Palampur, India that roasts tealeaves by burning coal. The cooperative buys coal on the spot market at the beginning of the tea harvest and stores enough on its grounds to burn over several months. Keeping a large inven-

22. Self-enforcing devices for markets and hierarchies are discussed in Williamsson, supra note 20.
23. An employer will sustain an employment relationship by paying a higher wage than the employee could obtain in alternative work. In technical terms, an "efficiency wage" is a wage higher than the employee's opportunity cost.
26. Id.
27. Id.
28. See id.
29. This example comes from professor Hans-Bernd Schaefer's observation of a tea factory at Palampur. For the statistical research prompted by his observations, see Angara V. Raja & Hans-Bernd Schaefer, Are Inventories a Buffer Against Weak Legal Systems?: A Cross-Country Study, 60 Kyklos 415 (2007).
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tory of coal ties up scarce capital. Instead of storing coal, the cooperative could develop a relationship with one reliable seller to deliver coal as needed. A relationship with one seller, however, would preclude buying from a cheaper seller. Buying from the cheapest seller apparently saves enough money to pay for storing coal. If contracts were effectively enforced, however, the cooperative could seek bids for future delivery of coal, thus combining competition and low inventories. In general, statistical research shows that companies in poor countries with weak contract law keep larger inventories than equivalent businesses in rich countries with strong contract law. Comparable enterprises like cement factories or breweries keep thirty to fifty percent higher inventories in countries with weak contract law.

Besides foregoing competition, relational contracting also has the problem that some forms of cooperation inherently resist it. The opposite of repeat transactions with reputation are one-time transactions without reputation. In the latter, unscrupulous behavior gains an immediate advantage without causing a future loss. Relationships cannot stabilize in these conditions. Similarly, when the stakes are very high in the current deal, the gain from cheating in the present overwhelms future considerations. Thus, buying used cars, real estate, or corporations is fraught with danger.

Our final example of the limits of relational contracts concerns transactions at a distance. Maintaining trust is harder with someone abroad than in your neighbourhood. Distance attenuates relationships and nearness strengthens them. Thus, a clothing manufacturer in Jakarta gathered everyone needed to produce a particular product into a single factory. Raw materials came in the door and finished clothes went out the door. Relational contracting worked inside the factory, but not outside it, so the stages of production were concentrated instead of dispersed.

The difficulty of relational contracting at a distance creates profitable opportunities for "middlemen." They specialize in filling the gap in the sales chain between producer and retailer, or between producer and consumer. Studies of Ghana, Southeast Asia, and Overseas Chinese show that middlemen form relationships with many producers, retailers,
and consumers. Relationships allow them to trade over distances without enforceable contracts.\textsuperscript{37} Besides performing this valuable service, however, middlemen sometimes acquire monopoly power and use it to exploit consumers—another example of relational contracts reducing competition.\textsuperscript{38} In addition, dealing with relatives and friends can channel commerce according to ethnicity, which some states consider ethnic discrimination.\textsuperscript{39}

The problem of relational contracting at a distance creates a characteristic distortion in trade. Thus, a textile manufacturer in Accra, Ghana, does not need formal contracts for his business to flourish locally.\textsuperscript{40} He has relationships with local shops to buy his cloth and sell it.\textsuperscript{41} But suppose he would like to sell to retailers in Tamale in northern Ghana. A convenient transaction will involve credit, not simultaneous exchange. The relationship between seller and buyer is too thin to support trust in some potentially profitable transactions. Weak contract law thus inhibits national trade in Ghana.\textsuperscript{42} The problem is less severe for large-scale trade between Ghana and Britain.\textsuperscript{43} A Ghanaian textile exporter can make contracts with British importers that British courts enforce.\textsuperscript{44} So, I arrive at the paradox that trade is easier with distant countries than other parts of the same country.\textsuperscript{45}

According to Avinash Dixit, this distortion in the spatial distribution of trade is common in developing nations.\textsuperscript{46} Relational contracting flourishes locally, which boosts the local sector.\textsuperscript{47} The national economy involves distances that attenuate relational contracting, which inhibits the national sector.\textsuperscript{48} The international sector solves the contracting problem by exporting to countries with effective state law.\textsuperscript{49}

### III. LIABILITY INSTEAD OF RECIPROCITY

People do not have enough relatives, friends, or repeat customers to achieve the scale of production and trade required for affluence. Economic

\begin{itemize}
  \item [37.] See Fachamps, supra note 34, at 428.
  \item [38.] See Landa, supra note 19, at 356.
  \item [39.] See id.
  \item [40.] See Fachamps, supra note 34, at 444.
  \item [41.] See id. at 445–46.
  \item [42.] See id. at 437.
  \item [43.] See id. at 446.
  \item [44.] See id.
  \item [45.] I am grateful to David Leonard, who is an expert on Africa, for helping me to improve the realism of this hypothetical example.
  \item [47.] See id. at 66.
  \item [48.] See id. at 80–83.
\end{itemize}
development requires extending the sphere of cooperation beyond relationships to encompass strangers. To extend the sphere of economic cooperation, people need law to protect them from unreliable, careless, mistaken, confused, or misleading promises, as well as from rationalizers, dissemblers, liars, frauds, and cheats.

When relationships attenuate, how can the state enable people to commit to keeping their promises? A startup firm in Silicon Valley often goes through three stages of finance: relational, private, and public.50 These three stages in a firm correspond to three levels of development in countries.51 Finance in states with ineffective state law relies on relationships.52 As law improves, private finance supplements relational finance, and public finance supplements private finance.53

Much the same is true of contracts in general. Figure 1 summarizes three types of contracts. Most contracting is relational in countries with weak legal systems, and the enforcement mechanism is reciprocity.54 With reciprocity, the parties can proceed according to vague principles and adapt their behavior to circumstances as they arise, without specifying the details of their mutual obligations. So, the terms in relational contracts are mostly implicit.

When the legal system strengthens, private contracts become more important. Private contracts are individually negotiated among small groups of people. With attenuated relationships, they need to make the terms more explicit. Later, I explain that the way judges interpret contracts affects how explicit and how long contracts must be.55 Only a few people who make the contracts usually know their terms. With private contracts, the ultimate enforcement mechanism is legal liability.56

Having discussed relational and private contracts, I turn to public contracts. In public markets, people buy oranges, knives, and shoes, which involve simultaneous exchange, so contracts are unnecessary. When the legal system strengthens, they also buy stocks, insurance, and refrigerators on credit, so contracts are necessary. Instead of individual negotiation, the contracts in public markets are standardized. Sellers disclose the terms to the public as they advertise to attract business or bid in auctions. Information about contracts ceases to be private as in investment banks, and it becomes public as in the Frankfurt bourse. Public terms intensify competition beyond the levels possible with private terms. People focus on getting

51. See id.
52. See id. at 384–87.
53. See id. at 375.
55. See *infra* notes 127–33 and accompanying text.
56. See Fafchamps, *supra* note 34, at 428.
the best terms, not on who is making the offer. In public markets, enforcement includes state regulations, as I will explain.

![Diagram of contract types, terms, and enforcement](image)

**Figure 1. Contract Types, Terms, and Enforcement**

**IV. ENFORCING CONTRACTS THROUGH CIVIL SUITS**

I will explain what liability law must do to enforce contracts. By definition, a commitment to keeping a promise raises the cost of breaking it, and a *sufficient* commitment tips the balance of costs in favor of keeping it.\(^57\) After sufficient commitment, the promise-giver advances his self-interest by keeping the promise.\(^58\) To see how state enforcement tips the balance, consider some details about the relevant costs. If the promise-giver decides to breach, the victim may sue; a suit may lead to a trial; a trial may end in a judgment against the defendant; and the officers of the court may execute the judgment. These events are costly to the defendant. When a promise-giver decides whether or not to breach, however, these events are possibilities that lie in the future, not certainties.\(^59\) A rational promise-giver discounts the cost of these events by their uncertainty.\(^60\)

To illustrate, assume that a borrower in Mexico contracts with a bank for a loan of 10,000 pesos. In exchange, the contract obligates the borrower to pay 1,000 pesos each month for 12 months. Having received the loan, the borrower makes his first eight monthly payments and then stops paying. He still owes 4,000 pesos, and he faces the possibility that the bank will go through all the legal proceedings to collect its debt. If the probability of these events is low enough, however, the borrower expects to gain by not completing repayment of his debt.\(^61\) Promise-breakers in

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57. COOTER & ULEN, supra note 1, at 205-06.
58. *Id.* at 210.
59. *Id.* at 203.
60. See *id*.
61. Assume that the probability that the bank will bring suit and proceed to trial equals 0.5, and a trial costs to the borrower of 3,000, resulting in an expected cost of 1,500. The judgment of 4,000 will
countries with weak legal systems discount the costs of suit, trial, judgment, and execution much more than promise-breakers in countries with strong legal systems.\(^{62}\)

What causes weakness in state enforcement of contract law? Written contract law in poor countries mostly resembles written contract law in rich countries.\(^{63}\) For contract law-on-the-books, Mexico and Columbia resemble Spain and France, India and Nigeria resemble England, and Taiwan, China, and Korea resemble Germany.\(^{64}\) The writing is similar, but its application is dissimilar.\(^{65}\) Application of law causes the most important differences in legal outcomes of contract disputes.\(^{66}\) Applied law is weakened by high court fees that discourage meritorious suits, low court fees that encourage meritless suits, long delays in trials, formalistic proceedings, the absence of streamlined courts for small claims, judges who are corrupt or politicized, and clumsy procedures to execute court judgments by corrupt officials.\(^{67}\) These problems undermine contracts by causing the promise-giver to discount steeply the probability that breach will result in suit, trial, judgment, and execution.\(^{68}\)

One of the most important items on this list is delays in trial. A young Johann Wolfgang von Goethe, who became Germany’s greatest poet, worked as lawyer at the Imperial Court in 1771.\(^{69}\) He noticed “[a] monstrous chaos of papers lay swelled up and increased every year.”\(^{70}\) Some cases remained “on the docket for more than 100 years. One case, filed in 1459, was still awaiting a decision in 1734.”\(^{71}\) Using survey data collected by the World Bank, Figure 2 ranks contemporary countries according to the number of days required to enforce a contract by means of a law suit. No contemporary country came close to Goethe’s worst case of 275 years. The data, however, show large differences around the world that correlate roughly with per capita income. The countries with enforcement delays exceeding 500 days are low and middle-income countries, and the high-income countries have shorter delays with a few exceptions (Italy and

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\(^{62}\) See Raja & Schaefer, supra note 29, at 415.

\(^{63}\) Cooter, supra note 50, at 385.

\(^{64}\) Id.

\(^{65}\) See id. at 385–86.

\(^{66}\) See id.

\(^{67}\) See id.

\(^{68}\) See id. at 385.


\(^{70}\) Id. at 44–45.

\(^{71}\) Id. at 45.
Israel). (The general pattern of these results is persuasive, but comparisons between individual countries, or reliance on exact numbers, demand caution.)

<table>
<thead>
<tr>
<th>Country</th>
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<td>292</td>
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<td>Bolivia</td>
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<td>Vietnam</td>
<td>295</td>
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<td>Peru</td>
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<td>Bulgaria</td>
<td>440</td>
<td>South Africa</td>
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<td>300</td>
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<td>450</td>
<td>Morocco</td>
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<td>Brazil</td>
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<td>France</td>
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<td>Chile</td>
<td>480</td>
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<td>Portugal</td>
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<tr>
<td>Hong</td>
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<td>Romania</td>
<td>335</td>
<td>Botswana</td>
<td>501</td>
<td>Greece</td>
<td>730</td>
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72. Id.
73. The first reason for caution is that the measure of speed in the survey is imperfect. Some countries like the United States or the United Kingdom have small claims courts with a streamlined and swift procedure. Only larger claims go to the ordinary courts. In China and Russia, court decisions are swift, but enforcement is unreliable. The second reason is that speed of resolution says nothing about its quality. A court could resolve each case in a flash by flipping a coin.
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<th>Czech Rep</th>
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<td>397</td>
<td>Rep.Congo</td>
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<td>1210</td>
<td>Korea</td>
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<td>Netherlands</td>
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HeinOnline -- 59 Ala. L. Rev. 1119 2007-2008
Figure 2. Time in Days to Enforce a Contract By Means of a Suit\textsuperscript{74}

In Great Britain in the 1960s, the railroad unions sometimes shut down the system for a few days without going on strike by following all of its rules.\textsuperscript{75} Getting the trains to run required disobeying some rules, so “work-to-rule,” as it was called, paralyzed the system.\textsuperscript{76} Similarly, businessmen and workers in many poor countries must violate impractical regulations in order to get things done.\textsuperscript{77} Thus, a builder in Cairo violates building restrictions, a worker and employer in Brazil evade employment taxes, and a manufacturer in Russia runs a factory without a permit to do business. Much of the economy operates in the “gray market” between the “white market” of legality and the “black market” of criminality.\textsuperscript{78}

Like other human activities, crimes often require people to cooperate. Like legitimate businessmen, drug dealers could market their goods more efficiently if they could use courts from time to time to enforce their contracts. A civil court, however, would refuse to enforce a drug contract and probably report the parties to the public prosecutor. Applied to drug contracts, the principle of “void for illegality” apparently lowers the quality and increases the price of illegal drugs, which shrinks the market as intended by state officials. (An unintended result is a lot more murders and deaths from impure drugs, as noted by the critics of the criminalization of drugs.)\textsuperscript{79}

Developing countries apparently produce approximately thirty to forty percent of their GDP in the informal sector.\textsuperscript{80} Employment is even higher, as the informal sector produces less per worker than the formal sector.\textsuperscript{81} Illegal drugs cause a lot of harm, whereas gray market activities produce many valuable goods and services. Nevertheless, some developing countries systematically apply the principle of void for illegality to gray market

\textsuperscript{75} Cooter, supra note 50, at 388.
\textsuperscript{76} Id.
\textsuperscript{77} See id.
\textsuperscript{78} See id. at 387–88.
\textsuperscript{81} See id.
contracts that involve regulatory infractions. In some countries, an outdated version of the “ultra vires” doctrine of company law still prevails. The contract is void for illegality unless it is covered by the business purpose in the corporate charter. Thus, the manufacturer of a cement mixer may be unable to enforce a sales contract with a fitness studio. The contract is void for illegality if the business charter of the fitness studio does not encompass using a cement mixer. Before relying on a contract, prudent parties need to be familiar with each other’s corporate charter.

When a gray market business goes to court, officials may notice that some of its operations violate regulations. The plaintiff often loses more by bringing himself to the attention of government regulators than he can win in a civil suit. Parties avoid civil courts because their contract might be void and the state may prosecute their regulatory violations. Voiding gray market contracts thus drives much of the economy deeper underground.

Regulatory violations seldom void contracts in Germany. A housecleaner or gardener in the informal sector who does not pay income or social security taxes can sue an employer for unpaid wages without fear of triggering regulatory prosecution. A customer who buys a restaurant meal at an hour when regulations forbid it to serve food still has to pay his credit card bill for the meal. The same applies for a construction contract that violates zoning regulations, or a credit contract that violates banking regulations. Although seldom discussed in constitutional law, separating the civil courts from the regulators and police is an important part of the separation of powers, especially in countries with a large gray market. Germany achieves separation by a law that regulatory violations often do not void a contract, a practice of not prosecuting regulatory violations revealed in a civil trial, and by having fewer regulations to violate than many developing countries. However, German courts void a contract if it is a malum in se such as a cartel or a drug deal.

84. See Hay et al., supra note 82, at 560–61.
85. See id. at 560.
86. See id. at 561–62.
88. See id. at 246.
89. See id.
90. See id.
91. See JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 3.5 (7th ed. 2004) (emphasizing the importance of the separation of powers).
93. See id. at 250–61 (noting that contracts which violate the interests of the community at large, including the commission of crimes, are void because they violate good morals).
Besides regulatory violations, another danger to contract enforcement is vague laws that give judges too much discretion when deciding whether or not a contract is enforceable. In China, Article 7 of the Civil Code stipulates that “[i]n concluding or performing a contract, the parties shall abide by the relevant laws and administrative regulations, as well as observe social ethics, and may not disrupt social and economic order or harm the public interests.” Is there any private activity that a court could not construe as harming ethics, social order, or the public interest? This comprehensive rule casts a long shadow over any private contract. Best to keep your head down and hope the authorities do not notice what you are doing. Communist countries historically marginalized the state protection of contracts, and they have not fully re-established it today.

India does somewhat better. § 23 of the Indian Contract Act regards any contract as void that “would defeat the provisions of any law . . . or [that] the Court regards . . . as immoral, or opposed to public policy.” This proposition is open ended, but at least it refers to laws and policies, rather than referring to ethics, social order, and public interest.

V. ADMINISTRATIVE ENFORCEMENT OF CONTRACT REGULATIONS

I have discussed some reasons why a promise-breaker will discount the costs of a potential civil suit. Now, I turn from private litigation to public regulation. Many grocers in Old Delhi bazaars sell rice, wheat, peas, cookies, nuts, curry, and other foods in highly competitive conditions. Buyers can quickly compare the price of the goods, but comparing quality is more difficult. Traditionally, Indian consumers do not trust the quality of pre-packaged food. A bag of rice might contain small white stones to increase its weight, a bag of peas might contain rat feces, or fruit might be old. The consumers want to see the food and taste it before buying, so items are sold in open bags or piled on counters.

Earlier, I explained that relational contracting builds trust and reduces competition. The consumers and sellers in the bazaars of Old Delhi mostly search for the best deal. They apparently prefer competition to relationships in these transactions. Thus, they forego the advantages of reciprocity, including protection against impure, unclean, or spoiled food. (Poverty is generally dangerous to your health, but the data on longevity contains surprises. Thus, life expectancy has fallen in Russia and risen in India to the point that they are close to each other.)

95. See COOTER & ULEN, supra note 1, at 238–39.
97. Life Expectancy at Birth in Selected Counties:
Unlike Old Delhi, food in supermarkets is mostly pre-packaged and pre-weighed, which saves transaction time. Regulators punish sellers of food that is impure, unsafe, unhealthy, falsely labeled, or under-weighed. To avoid customers complaining to regulators, many sellers willingly give consumers their money back or a replacement item when they complain about the quality of a purchased good. Regulations of consumer transactions ideally promote purity, safety, health, truthfulness, and accurate weights and measures. Such regulations can provide the foundation of confidence that consumers need to search for the best price instead of transacting through relationships. The Old Delhi grocers could presumably sell more pre-packed food if regulators gave better protection to consumers.

In markets for bottled drinks, rice, wheat, peas, and cookies, the sellers know more about the quality of the goods than the buyers. The asymmetry in information increases with the complexity of the goods, as with insurance, loans, mortgages, and employment contracts. People who buy health insurance must trust that their insurer will reimburse reasonable claims, lenders must trust that borrowers will repay their loans, people who buy stocks must trust that firms have honest audits of their accounts, and employees and employers must trust that the employment contract is enforceable. Regulations play a role, especially by protecting consumers from unfair surprises. One of the brightest triumphs of economic theory in recent decades was explaining how asymmetrical information affects markets.98 Without trust, markets for complex services atrophy, so most people in poor countries are unbanked and uninsured.99

VI. INFORMAL ADMINISTRATIVE ENFORCEMENT OF CONTRACTS

I have discussed liability as a sanction from courts for private wrongdoing, and I have discussed regulatory sanctions by administrators for

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99 For access to health insurance, see WORLD HEALTH ORGANIZATION, WORLD HEALTH REPORT STATISTICAL ANNEX (2005). Access to banking data is scattered and depends on household surveys. The quota of people with a bank account in developing countries varies between 25% in Mexico City and 48% in Uttar Pradesh (India), whereas it is higher than 85% in rich countries. Stijn Claessens, World Bank, Access to Finance: A Review of the Obstacles in the Way of Access to Finance, http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/AccesstoFinanceBrusselsOctober.pdf (last visited Mar. 26, 2008).
public wrongdoing. Now, I turn to an important hybrid of the two: Informal appeals to administrators, who threaten regulatory sanctions for private wrongdoing. The state bureaucracy in contemporary China and the Communist Party that stands behind it enforce some contracts. Here is a hypothetical example to show how it works.

Fungu, a manufacturer of electronic components in Wuhan, China, buys the right to use some state land to construct an apartment building. Fungu asks an old, experienced businessman to serve as middleman and find a builder. The middleman finds an acceptable builder named Hubei Construction Company, who constructs the apartment building. Fungu sells the apartments at subsidized prices to its employees. After the employees move in, they find that the water pipes are defective throughout the building. Repairing them will be very expensive. The employees complain to Fungu, who asks the middleman to get Hubei to replace the pipes. After lengthy negotiations, the middleman fails to reach an agreement acceptable to Fungu and Hubei.

Fungu, who wants to avoid the expense and uncertainty of going to court, decides to proceed informally against Hubei. Fungu's manager asks a senior politician in the city government of Wuhan to pressure the builder to replace the pipes. The politician suggests to Hubei that settling with Fungu will make it easier to get future building permits in Wuhan. Again, the parties fail to reach an agreement. Finally, Fungu's manager contacts someone whom he knew a little in college, who has become a powerful politician attached to the Politburo in Beijing. After receiving some gifts from Fungu, the politician in Beijing contacts Hubei and suggests that settling with Fungu will avoid serious problems from the central government in the future. Hubei agrees to replace the pipes in exchange for a small payment from Fungu.

This progression of appeals to a third party—middleman, local politician, central politician—is common in China.

In most cases, the parties to a contract dispute in China do not have to go through these steps because they can foresee the outcome. Foreseeing the outcome, they can save themselves time and money by agreeing between themselves without appealing to a third party.

When anthropology developed as a subject in the nineteenth century, anthropologists wanted to characterize how different cultures organize families. Anthropologists eventually arranged the names that different cultures use for biological relationships on a diagram that revealed its structure. For example, the person whom an Italian calls his "maternal aunt"
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(biological mother's biological sister) is called "mother" by a traditional Cherokee Indian. Kinship structure is easier to describe than the informal norms that control interactions among kin. Does a traditional Cherokee behave the same way towards the "mother" who is his biological mother and the "mother" who is her biological sister? It would require much research to find the answer.

Much the same is true of dispute resolution in modern societies. The formal structure for resolving disputes through negotiation, trial, and appeal is relatively easy to describe. In contrast, describing the informal practice of resolving disputes requires more difficult sociological research. Without research, scholars are uncertain about typical results, and so the parties in real disputes do not know what to expect. In our example, Fun-gu does not know what response it will get by appealing to a powerful politician in Beijing. Compared to an independent judge, informal appeal to a politician makes the result turn more on power and money, and less on the legal and moral merits of the case. An effective and economical court system should produce more predictable resolution of disputes than informal appeals to power. Perhaps this is why Singapore, which shares so many cultural affinities with China, has invested so much in strengthening its courts. To promote neutrality and discourage bribes, Singapore apparently pays its judges the most in the world, and Singapore apparently gets the desired result.

VII. CONTRACT DOCTRINE IN POOR COUNTRIES

Having discussed contract practice, I now turn to an easier topic to research—contract doctrine. The doctrines of contract law must answer two questions: What promises should the state enforce? What should be the remedy for breaking a contract? I will discuss answers that distinguish poor countries from rich countries, beginning with remedies.

In most cases of a broken contract, the court’s remedy is money damages. Courts usually set damages equal to the cost that the breach caused the plaintiff, or the benefit that the breach caused the defendant, or the amount stipulated in the contract for breaching its terms. The economic analysis of contract law has taken great pains to work out differences in

104. See Li-Ann Thio, Lex Rex or Rex Lex? Competing Conceptions of the Rule of Law in Singapore, 20 UCLA PAC. BASIN L.J. 1, 17 (2002) (noting the salaries of certain Singapore judges); YAK, supra note 103, at 5.
105. Murray, supra note 2, § 117, at 772–73.
106. Id. § 117, at 772–75.
the incentive effects of alternative measures of damages. Our concern, however, is different: How does poverty affect damages?

About twenty percent of all people living in low and middle income countries live in absolute poverty, defined as less than one dollar a day, and about half of all people live in poverty, defined as less than two dollars a day. Figure 3 gives some examples poverty’s extent in some developing countries.

Collecting damages from poor people is impractical. People in poverty do not have the money to pay damages, or the little money that they have is easily hidden, or they work informally without any records of their earnings, or they have no bank accounts where wages can be garnished, or their property cannot be separated from the property of their relatives. When collecting damages by legal means is impractical, they are “judgment proof.” Little income, or gray-market income, tends to make people judgment proof. The proportion of judgment proof people is much larger in developing countries than in rich countries.

What about a different court remedy other than damages? The alternative remedy is a court order requiring the defendant to perform as promised, which is called “specific performance.” Thus, a poor person might

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107. For an overview, see COOTER & ULEN, supra note 1, at 195–321. See also SCHÄFER & OTT, supra note 5, at 320–35.


109. THE WORLD BANK, supra note 97, at 64–66 tbl.2.5.


111. According to legal theory, the basic remedy in civil law countries for breach of contracts is specific performance, and the basic remedy in common law countries is expectation damages, but one legal system almost always applies the same remedy as the other in the same circumstances. John M. Catalano, Comment, More Fiction than Fact: The Perceived Differences in the Application of Specific
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receive money from his neighbor in exchange for a promise to sell his bicycle. If the seller does not deliver the bicycle, a policeman can execute the court’s order. Specific performance has two advantages over damages in this case. First, the policeman can probably find the bicycle more easily than the court can find the seller’s money. Second, the court can order the defendant to deliver the bicycle without having to ascertain its market value. Poverty thus makes specific performance a feasible remedy in some circumstances where damages are an infeasible remedy. (This is the opposite of the usual cases in law books where damages are a feasible remedy and specific performance is infeasible.)

Besides poverty, another characteristic of some poor countries favors the remedy of specific performance instead of damages. In the planned economies of socialist countries, stores sold goods at official prices, but the goods were in short supply. A person with money might not be able to find anyone willing to sell a good at its official price. People sometimes got into the end of a line to buy things in Soviet Russia before they found out what was for sale at the front of the line. Little wonder that, instead of compensation at official prices, communist enterprises preferred specific performance as the remedy for broken contracts. Legal scholars in communist countries associated “socialist contract law” with specific performance and “capitalist contract law” with money compensation.

In developing countries, people queue for some goods because of price controls, import licenses, multiple exchange rates, and different buying rights for different people. For buying such goods, transaction costs include time spent queuing. For breach of promise to deliver such a good, compensatory damages ideally include the price of the good and the transaction cost of buying it. The official price of the good may be easy to determine, but the transaction cost of buying it is uncertain. Instead of trying to determine compensatory damages, the court can order the breaching party to perform. In general, thin markets, regulations, and administered


112. Thus, a seller may promise to deliver a rare book and then sell it to someone else, or a worker may promise to meet a deadline and then miss it, or a programmer may promise to solve a computer program that is impossible. In these cases, the promise-giver can pay damages but cannot perform as promised.


114. Joke: A woman enters the ground floor of the GUM department store on Red Square in Moscow and says to the person behind the counter, “Don’t you sell shoes here?” The attendant replies, “No, on the ground floor we don’t sell pants. On the third floor they don’t sell shoes.”


pricing tilt the preferred remedy for breach of contract towards specific performance and away from money damages. Conversely, thick markets and liberalization tilt the preferred remedy for breach of contract towards money damages. (This argument especially applies to contracts for the sale of goods, rather than contracts to perform services.)

The final advantage of specific performance concerns corruption. Damages allow judges to vary the award over a continuous range, which makes disguising bribes easier. Thus, the defendant might pay the judge a bribe equal to ten percent of the stakes in exchange for the judge reducing damages by twenty percent of the stakes. Specific performance precludes a bribe in this form.

As an economy becomes more commercialized and monetized, the preferred remedy should shift away from specific performance and towards damages. I observe this tendency in most European countries that replaced communism with capitalism after 1989. Damages become the preferred remedy for many contracts, especially for sales contracts. China has apparently moved in the same direction. The traditional rule was specific performance. The contract law reform of 1999 includes damages and specific performance and leaves the choice at the discretion of the plaintiff. Allowing a successful plaintiff to choose between the two remedies is a good way to strike the balance in their use. If the development in China recapitulates continental Europe, more and more plaintiffs will prefer damages to specific performance, and specific performance will slowly fade away for many types of contracts.

Our final doctrinal topic concerns “good faith” (bona fides), or its opposite “bad faith” (exceptio doli generalis). This concept originated in classical Roman law and developed in early modern Europe as part of the ius commune. Judges mostly created the ius commune. In the late eighteenth and early nineteenth centuries, rationalism, the French revolution, and Napoleon’s armies brought a legal revolution that replaced the ius commune with law codes. Legislatures mostly enacted the law

117. Even in countries like France that prefer specific performance as a remedy, it is not given for breach of a service contract. See CONTRACT LAW TODAY: ANGLO-FRENCH COMPARISONS 285 (Donald Harris & Denis Tallon eds., 1989). A court order forcing a person to perform a service has many practical objections, as does an attempt to put a money value on an unperformed service where quality varies widely in the market. See id. at 284–85.
118. I thank Henrik Lando for this insight.
120. Id.
121. Id. at 1147.
122. See James Gordley, Good Faith in Contract Law in the Medieval Ius Commune, in GOOD FAITH IN EUROPEAN CONTRACT LAW 93, 95–96 (Reinhard Zimmermann & Simon Whittaker eds., 2000).
123. See id. at 93–95.
124. See Simon Whitaker & Reinhard Zimmermann, Good Faith in European Contract Law:
To secure supremacy of the revolutionary legislatures over judges, whom the revolutionaries identified with pre-revolutionary government, the revolutionaries aspired to reduce the importance of general clauses like good faith.

They failed. Over the last 100 years, supreme civil courts developed good faith into an instrument of judicial flexibility and power, especially in Germany. Using “good faith,” judges can alter almost any aspect of a contract that they regard as dishonest, unfair, unreasonable, or bad for business. They can impose an obligation not stipulated in the contract, create a duty to disclose information, set damages to under-compensate the victim, set damages to over-compensate the victim, fix specific levels of due care, or render a contract void.

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Surveying the Legal Landscape, in Good Faith in European Contract Law, supra note 122, at 7, 32-33.
125. See id. at 36-37.
126. See id. at 33-35.
127. See id. at 29-32.
128. See id.
129. See id. at 24-25. Here are some German examples from Zimmermann and Whittaker’s Good Faith in European Contract Law:

—A farmer contracts to deliver 100 bags of grain on a particular date to a grain dealer, but he miscounts and brings 99 bags. The principle of “good faith” prevents the grain dealer from refusing to accept any bags until all 100 are delivered. See Good Faith in European Contract Law, supra note 122, at 292-93.

—A and B form a partnership. Its terms stipulate that either of them can dissolve the partnership if its profits fall below $40,000 in any year. A’s gross negligence causes profits to fall to $25,000. Good faith prevents A from dissolving the partnership in these circumstances, although B can dissolve it. See id. at 348.

—A buys a machine from B. B delivers the machine and falsely asserts that he tested it to make sure that it works. A accepts the machine and finds that it works well. Later A decides that he wants a different kind of machine. Good faith blocks A from rescinding the contract on grounds of B’s falsehood. See id. at 362.

—A sells a quarry to B, receiving ten percent of B’s revenues for ten years and the right to check B’s accounts. After three years, A buys a new quarry and starts competing with B. To take customers away from B, A wants to see the list of B’s customers, who are also the source of B’s revenues. Good faith prevents A from extracting this information from B. See id. at 391.

—A medical doctor buys a used x-ray machine from a colleague. Both parties are unaware of a new regulation that prohibits use of this machine. Under good faith, the buyer can rescind the contract. See id. at 578. (It is questionable whether the result would be the same in English contract law.) See id. at 589-91.

—Car manufacturer A concludes a sales contract to buy fenders from B. To make the fenders, B invests in retooling his factory. After seven months, car manufacturer A terminates the contract with B. Under the good faith doctrine, B can make A pay his losses on retooling. See id. at 404. (In England, this is not the case unless the parties write this protection into the contract.) See id. at 412.

Here are two examples from the German Federal Court of Justice:

—If one party makes a calculation error and offers a price that is implausibly low, the rule of good faith requires the informed party to tell the uninformed party about the error. Otherwise, the uninformed party can rescind the contract. Bundesgerichtshof [BGH] [Federal Court of Justice] July 7, 1998, 139 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 177 (F.R.G.).
A series of very influential papers in development economics that contrast civil law and common law characterize the former as formalistic and inflexible compared to the latter. This claim will surprise German judges who apply the good faith rule so freely, as well as the judges in most countries of continental Europe. It will also surprise English judges who refuse to incorporate good faith into the common law because it is too flexible, as well as judges in Russia, Australia, and Scotland who concur with the English. It will surprise bankers who write long contracts in London where the judges interpret contracts literally. It will surprise bankers who write short contracts in Frankfurt where the judges interpret contracts flexibly.

In fact, the civil codes of contracts are not inherently formal or informal, or flexible or inflexible. Civil codes contain precise rules and also general rules. By stressing precise rules, courts can decide cases formally and inflexibly. By stressing general rules like good faith, courts can decide cases informally and flexibly.

Acceptance of the good faith rule has spread across developed nations in recent decades. Are developing countries adopting it? The answer is

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Company A sells real estate for a bargain price to its former employee B. The contract is not notarized, but A's manager insists that his signature is worth more than notarization. Later, A claims that the contract is void for lack of notarization as required by law. The German Federal Court of Justice decided that company A acted in bad faith and awarded the real estate to B. This decision strikes down the legal requirement of a notarized form in real estate contracts. Bundesgerichtshof [BGH] [Federal Court of Justice] Oct. 27, 1967, 48 Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 396 (F.R.G.)


See, e.g., supra note 129.

In Walford v. Miles, the British House of Lords rejected the principle as being inconsistent with the adversarial position of the parties. [1992] 2 A.C. 128 (H.L.). English judges favor more specific rules like "implied terms," "misrepresentation," "fraud," "custom," and "usage."

An Indian visitor to the United States, whorents a car at the airport, has to give many signatures on a many pages contract. If the same visitor goes to Berlin, in Germany, and rents a car there, he gets along with one signature under a relatively short contract. In the contract, he will find several references to the good faith principle. Contracts in civil law countries are shorter and contain more references to general clauses as compared to common law countries where good faith does not exist or has no tradition.

complicated. In India, according to the Manupatra database, good faith exists as a principle, and the Indian Supreme Court used it 731 times from 1950 to March 2007. Brazil adopted good faith in a reform of 1990. I do not know whether or not Brazilian judges use it flexibly in deciding contract disputes. The Chinese Contract Law of 1999 recognizes the good faith principle, but apparently they have not applied it directly as of yet. The Russian Federation borrowed its contract law of 1994 from the Dutch Civil Code of 1992 but did not transplant the good faith rule. The Russian Supreme Court seems reluctant to develop civil law along general principles of fairness, and this reluctance is consistent with Russian practice from Czarist times.

Legal theorists differ sharply about the better approach. Some see the good faith rule as a monster that replaces the contracts that businesses make with contracts that judges want. Judges with little understanding of markets can use good faith to redistribute wealth and distort incentives. In extreme situations, totalitarian states like Nazi Germany and communist Russia used compliant judges applying the good faith rule to subordinate contract law to their ideology. Others see the good faith rule as the...
queen of contract law,\textsuperscript{144} which replaces literalness with fairness, sustains trust among people, and allows flexibility in times of change.\textsuperscript{145}

Now, I relate good faith to relational, private, and public contracting. Personal relationships, such as uncle and niece, husband and wife, or friend and neighbor, enable people to interact based on individual attributes. Private contracting is often too impersonal for the parties to know each other as individuals. In these circumstances, coordination in business depends on economic roles such as accountant, secretary, advisor, technician, sweeper, salesman, assistant, chief, board member, consultant, farmer, electrician, gardener, etc. Without knowing personal attributes, an accountant knows what to expect from a secretary, a secretary knows what to expect from a plumber, a plumber knows what to expect from a salesman, and so on.

Roles encompass technical skills and social norms. A good plumber knows how to repair a pipe and how strong the repair must be. Good faith is an instrument for courts to transform role expectations concerning technical skill and social norms into contractual obligations. The Uniform Commercial Code in the United States defines “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”\textsuperscript{146} When courts find commercial standards of fair dealing and read them into contract law, they extract legal obligations from business roles.

Should developing countries rely on flexible standards like good faith or on precise rules? Good faith can be compared with a Lamborghini—the best cars demand the best drivers, or else expect a crash. The power to interpret contracts flexibly works well in the hands of high quality judges. High quality judges have good educations, understand business and markets, do not take bribes, nor bend to political influence. If judges fall far short on quality, however, formalistic rules will work better than flexible standards. India has an attractive principle that responds to these facts: only the Supreme Court and the High Court, not the lower courts, have

\textsuperscript{144} Some authors have claimed that the principle of good faith and the principle of self interest exclude each other and that both of them cannot govern the contract. See Whittaker & Zimmermann, \textit{supra} note 124, at 47–48. Some critics, however, go even further and want to leave retaliation for unfairness to self help. Scott proposes to return to clear and simple rules of contract law and to leave the sanctioning of dishonest and opportunistic behaviour to self-enforcement. See Robert E. Scott, \textit{The Death of Contract Law}, 54 U. TORONTO L.J. 369, 389 (2004). Therefore, he rejects the good faith principle. See id. The problem is that this cannot work for anonymous transactions.

\textsuperscript{145} One of the most important subcategories of good faith, “culpa in contrahendo,” or pre-contractual obligations, was originally invented in the nineteenth century to respond to new problems in sales caused by using an innovative, unreliable technology—Morse code sent over the telegraph. See Rodrigo Novoa, \textit{Culpa in Contrahendo: A Comparative Law Study: Chilean Law and the United Nations Convention on Contracts for the International Sales of Goods (CISG)}, 22 ARIZ. J. INT’L & COMP. L. 583, 583–600 (2005).

\textsuperscript{146} U.C.C. § 2-103(1)(j) (2005).
authority to develop law by using the principle of good faith.\textsuperscript{147} This rule responds to the fact that the high court judges are skilled and probably more honest, and the lower courts judges are poorly trained and probably more corrupt.

I also note that in authoritarian regimes, the Russian solution of making the courts follow formal laws strictly has advantages. Legal formalism can protect the judge, as well as the citizen, against political intrusion.

\textbf{VIII. CONCLUSION}

Making wealth requires people to do what they say. In relationships and repeat transactions, reciprocity makes people do what they say, even without contract law. Relationships and repeat transactions, however, preclude competition. Competition involving transactions with strangers invigorates an economy and enables it to flourish. Making strangers do what they say requires them to commit legally. According to the \textit{contract principle for economic cooperation, the law should enable people to commit to doing what they say}. When this principle is implemented, strangers can trust each other enough to work together even when money is at stake. Implementing this principle requires effective courts or state administrators. Deficient enforcement poses a far greater obstacle to contract law in developing countries than defective doctrine. Compared to rich countries, effective enforcement in many poor countries tilts remedies towards specific performance and away from damages. Similarly, good doctrine in poor countries tilts towards legal formalism and away from judicial flexibility.

\footnote{\textit{India Const.} art. 141, \textit{available at} http://indiacode.nic.in/coiweb/coifiles/part.htm ("The law declared by the Supreme Court shall be binding on all courts within the territory of India."). A similar solution giving more, but not full authority, to lower courts could allow a lower court judge to present the case to the Supreme Court if he believes that the law contradicts the principle of good faith. Referral is the procedure in the European Union where every national court can refer a case to the European Court of Justice.}