

Knowledge, trust and recourse: imperfect substitutes as sources of assurance in emerging economies

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Uncertainty prevents voluntary interactions, but institutions of trust and/or recourse can substitute for knowledge by making promises relatively credible. Trust and various sources of recourse are imperfect substitutes, however, as demonstrated by consideration of the trade-offs between trust based on repeated dealings, recourse to informal private sanctions such as reputation threats, ostracism sanctions and third-party dispute resolution through formal commercial organisations operating under customary law, and the state's coercive legal system. The problems of knowledge and interest imply that, though not perfect, private sources of trust and recourse are superior in emerging markets to state-provided recourse.

Introduction¹

There is no assurance problem when information is free and complete, but such perfect knowledge does not exist anywhere except in some economists' mathematical models. Information is so scarce in the real world that trust or recourse often must *substitute* for knowledge in order to make promises credible. While trust and recourse are both substitutes for knowledge, however, they are not perfect substitutes for each other. Trade-offs mean that under some circumstances trust provides a superior solution to assurance problems, while recourse may be more desirable under other conditions. Furthermore, there are alternative institutional mechanisms for the provision of recourse, and they also are imperfect substitutes. The following paper examines some of the trade-offs between alternative institutional sources of trust and recourse in emerging markets.

Some of the economies of formerly communist and newly independent Eastern Europe, still-communist China and Vietnam, and non-communist Asia, the East Indies, Africa and Latin America may be growing, but some are stagnant and others are in decline. While 'experts' point to many factors that slow or prevent economic growth, many now recognise that the pace of development is a function of the institutional environment. The fact is that many of these economies can be described as *low-trust societies*.

Trust, a willingness to make oneself vulnerable to another even in the absence of external constraints, certainly can evolve to support trade, as explained below, but it takes time and it can be limited to relatively small trading communities. If traders are going to be willing to deal with others that they do not trust, recourse in the form of credibly threatened sanctions against breaches of contract (perhaps supported by third-party dispute resolution) is a necessary substitute. The legal systems in many countries with emerging economies do not provide consistent and predictable recourse, however. Nonetheless, many consultants and academics contend that the solution to the assurance problem must come from the state. In writing about law in the newly independent countries of the former Soviet Union, for instance, Ioffe maintains that legislation of commercial law 'must now be comprehensive [due to]... the emergence of gaps in the law [and] the restructuring of the former Soviet economy which requires new legal regulation'; and later that 'the commercial code, not taken literally, must encompass all forms of economic activity, both

in production and trade.'² Arguments such as these fail to recognise that trust is an alternative to recourse, and that there are non-state sources of recourse.

Building trust

It is widely recognised that repeated dealings create an environment conducive to the development of trust, because incentives to employ co-operative strategies (for example, live up to promises) arise. In emerging economies, repeated-dealing arrangements must be established, however. For instance, McMillan and Woodruff, in their study of emerging trade in Vietnam explain that an entrepreneur tends to be very cautious when considering a potential trading partner.³ He often visits the plant of the firm he is considering in order to see if the facility appears to be permanent and efficient. He inspects the output of the plant, asks other trusted traders if they have dealt with or know about the potential partner, and so on. The information gathered can never be perfect but if it is positive, a small trade is often arranged. If that one works out, the next one is larger. It is only after several deals that the transactions reach a level that involves a substantial commitment. This can take time, of course, and that is obviously one of the drawbacks of relying on trust relationships.

Traders may be able to gain the trust of others relatively quickly by investing in signals that demonstrate a commitment to fair dealing. For instance, Nelson explains that the advertising of experience goods serves two primary functions for the rational buyer, and neither of these functions focuses on the provision of direct information about the experience quality of commodities that are advertised: *first*, 'advertising relates brand to function' and provides information about the general uses of the product, but *second* and more important, the volume of advertising is a signal to buyers that shows the extent of committed investment by the seller.⁴ According to Nelson, then, what matters most to a rational buyer is not what advertising says about quality, but simply that it is a recognisable investment in non-salvageable capital: brand name. Advertising may not be as important in an emerging economy as it is in a developed economy, but there are other non-salvageable assets (such as elaborate store fronts, charitable contributions, community service) that can serve the same function. Essentially, investments in non-salvageable assets are offered as a bond to ensure credibility. Buyers must be aware of such commitments, and if so, as Klein and Leffler explain,

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the marginal cost to buyers of measuring such specialised or non-salvageable investments must also be less than the prospective gains: 'If the consumer estimate of the initial sunk expenditure made by the firm is greater than the consumer estimate of the firm's possible short-run cheating gain' then they will tend to trust the seller.⁵ Furthermore, when effective recourse is not available, firms have very strong *incentives* to make such investments (incentives that could be much weaker if they were relying on some third party to impose sanctions).

From trust to reputation and recourse

Most arguments about the inability of private parties to co-operate without the backing of a coercive power are explicitly or implicitly prisoners' dilemma arguments. As suggested above, however, the one-shot prisoners' dilemma analogy does not characterise most kinds of commercial interactions, even in emerging economies. When repeated dealing arrangements and/or non-salvageable investments are valuable, traders obviously have recourse. If a trader partner fails to live up to a promise, commits fraud or behaves opportunistically, the victim can threaten punishment. Sanctions can involve tit-for-tat or exit in repeated dealing arrangements, for instance, but non-salvageable investments create a potential threat that is even stronger: a threat to spread information about non-cooperative behaviour. Traders have strong incentives to avoid dealing with a firm they believe may not be trustworthy, so if the spread of information is sufficiently effective a spontaneous boycott can be anticipated. Such an ostracism threat can be a very powerful source of recourse, since the offending firm will lose all of the value that attaches to its non-salvageable asset. Therefore, in order to maintain a reputation for fair and ethical dealings, each transactor's dominant strategy is likely to co-operate throughout each transaction that he is involved in, whether it is a repeated or a one-shot deal. Under these circumstances recourse is not likely to be required very often, although it is always available.

Time is also required to build reputations, of course, so emerging markets may not have many transactors that can offer valuable reputation bonds to contractual partners. Firms with international reputations may enter an emerging market and become established very quickly, but new firms may have to suffer through a considerable period of losses before they can expect to see investments in reputation building pay off. Indeed, since the pay-offs

to such investments are delayed and very uncertain, incentives to make them tend to be relatively weak, and the emergence of commerce based on such sources of recourse also can be quite slow. Much of this uncertainty is due to the state, however. As Pejovich notes, 'The arbitrary state undermines the stability and credibility of institutions, reduces their ability to predict the behaviour of interacting individuals, raises the cost of activities that have long-run consequences, and creates conflicts with the prevailing informal rules ... [M]ost countries in Eastern Europe [and many other parts of the world] are arbitrary states.'⁶ When property rights are insecure due to potential arbitrary and/or opportunistic behaviour by government (for instance, changes in tax policy to capture the quasi-rents that arise with investments in reputation), incentives to invest in reputation or to count on future dealings are weak and the kinds of private sanctions discussed here are likely to be relatively weak. But that also means that the state cannot be relied upon to provide consistently effective recourse, as traders clearly recognise (even if policy 'experts' do not). McMillan and Woodruff's interviews of entrepreneurs in Vietnam show that despite their frequent reliance on informal sanctions (tit-for-tat, exit, spreading information about non-cooperative behaviour), these entrepreneurs do not want the state to get involved in contract enforcement because they do not trust the state either.⁷

Formalising spontaneous sanctions: recourse through trading organisations

Both commitments and threats can be made more credible, and some uncertainty can be eliminated, if individuals with mutual interests in long-term interactions form 'contractual' groups or organisations rather than waiting for trust or reputation institutions to evolve more slowly. Potential contractual arrangements are numerous, including the implicit contracts of family bonds and ethnic networks, indirect equity ties through pyramidal ownership structures, direct equity ties and interlocking directorates. As Khanna and Rivkin explain, such business groups are actually 'ubiquitous in emerging economies' (as evidence, they cite a large number of studies about groups such as *grupos* in Latin America, business houses in India and *chaebol* in Korea).⁸ In addition to creating strong bonds that facilitate interaction, an affiliation with such a group can be information generating in that it can imply a bond or assurance (a credible signal of reputable behaviour) so

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potential transactors can circumvent the slow process of building reputations in order to create trust.

A business organisation such as a trade association can also form through contract and substitute for family, ethnic, ownership or directorate linkages. These organisations can provide a formal mechanism to overcome frictions in communication, ensuring that information about any individual's non-cooperative behaviour will be transmitted to others in the relevant business community. Then group membership can include a contractual obligation to boycott anyone who fails to live up to a contractual obligation: specifically, any non-cooperative party will be *automatically* expelled from the organisation. Such automatic ostracism penalties make the reputation threat much more credible.⁹ These groups can also lower transactions costs by establishing their own unbiased dispute resolution arrangements. After all, allegations of non-cooperative behaviour are not necessarily true, so they may have to be verified. Furthermore, if a contract does not clearly address some unanticipated occurrence, a dispute can arise over how to treat the new situation.

A group of traders can institute mediation or arbitration alternatives (or both, as illustrated by Bernstein's study of New York diamond traders¹⁰). These services can be produced internally, perhaps by elected members of the organisation (as in the diamond traders' organisation), or by mediation and/or arbitration specialists, or they can be obtained externally by employing arbitrators from organisations like the International Chamber of Commerce, the American Arbitration Association, or any number of other private dispute resolution providers. Mediation and arbitration selection mechanisms actually vary widely, but in general they guarantee that a choice is made without requiring explicit agreement by the two parties while still allowing for prescreening, and possibly more than one level of screening.¹¹ Biased rulings are not likely in a competitive environment where potential adjudicators are chosen beforehand by the trading community or where both parties have the power to reject adjudicators proposed by the other.

When a dispute involves new and unanticipated issues, a mediator or arbitrator may be required to determine what rule should be applied to the situation. In this context, for instance, Lew explains that 'Owing no allegiance to any sovereign State, international commercial arbitration has a special responsibility to develop and apply the law of international trade.'¹² The 'law' that dominates

international trade has evolved through contracting and the use of arbitration. Increasingly referred to as modern *lex mercatoria*, it is a polycentric system of customary law. Lew's detailed analysis of available records on international arbitration reveals that, in principle, 'The answer to every dispute is to be found *prima facie* in the contract itself. What did the parties intend, what did they agree and what did they expect?'¹³ When arbitrators cannot discover the parties' intent in the contract, they must decide what the parties expected or should have expected, and in this regard, international arbitrators 'denationalise' their awards and attempt to make them acceptable by showing their consistency with accepted 'practices and usage' (customary rules) of the relevant business community.¹⁴ The same is often true within domestic commerce as trade association mediators or arbitrators apply the associations' own rules rather than those of the government of the territory within which the commercial transactions take place. Indeed, historically, as trade evolved beyond small close-knit groups formed on the basis of trust and reputation, 'legal systems' arise as a substitute for more informal arrangements, but these legal systems generally are not the product of nation-states.¹⁵

Customary commercial law

A system of behavioural rules backed by institutions to induce recognition, resolve disputes and facilitate change, also is a substitute for knowledge (as well as for trust relationships, and reputation backed by spontaneous ostracism). After all, as Hayek explains, rational individuals are not able to use conscious reason to evaluate *every* option, because there are significant limits on abilities to reason and to absorb knowledge.¹⁶ This means, among other things, that rational individuals will often find it beneficial to voluntarily develop and conform to rules to guide their actions. In this context, 'rules' should be seen as behavioural patterns that other individuals expect a person to adopt and follow in the context of various interdependent activities and actions – that is, rules specify obligations. The rules one individual is expected to follow influence the choices made by other individuals: like prices rules co-ordinate and motivate interdependent behaviour.

The most visible types of rules are the 'laws' designed and imposed by those with authority in nation-states, but there are other rules (such as habits, conventions, norms, customs, traditions or standard practices) that are actually much more important determinants of behaviour in many aspects of human

activity, including commerce. A key distinguishing characteristic of such rules is that they are initiated by an individual's decision to behave in particular ways under particular circumstances. As Hayek emphasises, adopting a behavioural pattern creates expectations for others who observe it and this creates an obligation to live up to those expectations.¹⁷ Furthermore, as Mises explains, when individuals who interact with one another observe each others' behavioural patterns they often emulate those that appear desirable so such behaviour and accompanying obligations spread.¹⁸ In other words, these rules evolve spontaneously from the bottom up rather than being intentionally designed by a legislator, and they are voluntarily accepted rather than being imposed. For an obligation to achieve the status of a 'customary law' it must be recognised and accepted by the individuals in the affected group.

Customary law tends to be quite conservative in the sense that it guards against mistakes. Nonetheless, flexibility and change often characterise customary law systems.¹⁹ For instance, if conditions change and a set of individuals decide that, for their purposes, behaviour that was attractive in the past has ceased to be useful, they can voluntarily devise a new contract stipulating a new behavioural rule. Thus, existing custom can be quickly replaced by a new rule of obligation towards certain other individuals without prior consent of or simultaneous recognition by everyone in the group. Individuals entering into contracts with these parties learn about the contractual innovation, however, and/or others outside the contract observe its results, so if it provides a more desirable behaviour rule than older custom, it can be rapidly emulated. Contracting may actually be the most important source of new rules in a dynamic system of customary law,²⁰ and many innovations in commercial law have been initiated in contracts and dispersed quickly through the relevant business community.²¹

Alternatively, as conditions change, the inadequacy of existing customary rules can be revealed when a dispute arises. Negotiation is probably the primary means of dispute resolution for members of a close-knit customary law community, however, reinforcing the contention that contracting is a primary mechanism for initiating rapid change in customary law. If direct negotiation (perhaps facilitated by a mediator) fails, however, the parties to a dispute often turn to an arbitrator. Since a dispute suggests that existing rules are unclear or insufficient, new customary rules can be and often are initiated

through third-party dispute resolution.²² Unlike public court precedent, such a decision only applies to the parties in the dispute, but if it effectively facilitates desirable interactions the implied behaviour can spread rapidly through the community, becoming a new rule.

Recourse through the state: more powerful sanctions and more rapid rule creation?

The high likelihood of unbiased dispute resolution creates strong incentives to accept arbitration under customary law for parties who want to maintain the benefits of group membership. In addition to such positive incentives, refusal to accept arbitration under customary rules results in automatic ostracism. Of course, for some individuals, long-run benefits and ostracism threats may not be sufficient. Thus, a stronger sanction might be desirable, and nation-states with coercive power certainly can provide strong threats. Furthermore, a state's legal system can provide recourse for traders who are not members of informal or formal trading communities. And while customary law can evolve quite rapidly under some circumstances, it does tend to be conservative, so perhaps the state, through legislation, can create beneficial new laws even more rapidly. Perhaps commercial law for emerging markets should be produced by governments? Actually, despite such potential (although certainly not guaranteed) benefits, there are a number of reasons for avoiding substitution of the state's legal system for alternative (although always imperfect) solutions to the assurance problem. One is simply that governments of the nations where markets are attempting to emerge face a tremendous knowledge problem which means that they are not capable of doing the things that various commentators suggest that they should do. For instance, legislators, bureaucrats and judges in places like Russia, Poland, Vietnam, China and Brazil, are even less likely to understand the important underpinnings of a successful market system well enough to provide effective support for one than the Western European and North American judges, bureaucrats and politicians who frequently seem to make decisions that undermine rather than support market processes.²³

There is another problem with state-made commercial law. The wide variety of activities and relationships that exist in commerce mean that many rules that are effective for one type of transaction or one group may not be effective for another. The diamond traders discussed by Bernstein may prefer a

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very different set of rules and institutions from those adopted by the oil traders discussed by Trakman, for instance.²⁴ The products being traded are very different, of course, suggesting that very different contractual issues are likely to be relevant, but the trading communities are also very different. Diamond merchants share common ethnic and religious backgrounds, creating an environment of mutual understanding (for example, of common trade practices and usage) and trust, thus reducing the need for highly technical and specific contracts, while oil traders display much greater ethnic and religious diversity as well as differences in motivations (a number of oil-producing states have nationalised production, for instance, so political considerations can have major impacts on decision-making), so the level of common understanding is low, trust relationships are weak, and much more specific and complex contracts are required. Imposition of a homogeneous set of rules on these two groups would lead to higher transactions costs for at least one set of these traders, if not both. Yet, national legal systems tend to produce a homogenised although very complex law that limits the potential for specialisation but, as Cooter explains, more decentralised law-making is desirable in increasingly complex economic systems.²⁵

There is another problem that arises with state-made law. Any legal system that is larger than what would spontaneously evolve through individual interaction will, by definition, require some concentration of coercive power. While such power might be used simply to extend the scope of basic customary rules, this is unlikely because, in addition to a knowledge problem there is also an interest problem. Coercively imposed rules can internalise externalities and facilitate voluntary interaction, but they also determine the distribution of wealth, and these distributional consequences create incentives to use coercive law to transfer wealth. Indeed, an understanding of state-made law requires recognition of the resulting conflict between incentives to pursue wealth through both productive and transfer processes.²⁶ The use of law to transfer wealth actually reduces wealth for at least five reasons. *First*, comparative static analysis of a transfer points to a deadweight loss. *Second*, as Tullock explains, the resources consumed in the rent-seeking competition for such transfers also have opportunity costs: they could be used to produce new wealth.²⁷ *Third*, potential victims of the transfer process have incentives to resist, of course, so rent-avoidance

costs also arise through investments in political information and influence. Exit is another option, however, whether by moving to an alternative political jurisdiction, or by hiding economic activity and wealth (for example, moving transactions ‘underground’). Therefore, in order to induce compliance with discriminatory transfer rules, the rule-makers will generally have to rely on an enforcement bureaucracy, both to limit exit and to execute the rules. These high enforcement costs are a *fourth* source of opportunity costs that accompany a wealth transfer process. The *fifth* consequence is likely to be even more significant than the other four, however. Faced with the probability of involuntary transfers, productive individuals’ property rights to their resources, wealth and income flow are perceived to be relatively insecure, so their incentives to invest in maintenance of and improvements to their assets, and their incentives to earn income and produce new wealth that might be appropriated, are weak. If transfers are expected to be large, frequent and arbitrary, production will be low and wealth expansion (economic growth) will be very slow if it occurs at all.

Conclusions

If we look to Western Europe and North America for models of how market economies emerge, we find that markets were well established and governed by customary law long before states became involved in the making and enforcing rules of commerce and, that even when the states did so, they generally started by recognising established custom.²⁸ Furthermore, after state intervention previously established institutions of trust, informal recourse (for example, spontaneous ostracism), commercial groups, and customary law survived as an ongoing source of competition for the state, helping to constrain its activities. As Feldbrugge observes, of course, ‘the construction of a totalitarian system entailed the systematic destruction of the civil society and the free market system,²⁹ so the emerging markets of formerly communist Eastern Europe and still-communist Asia are not able to start with the types of private commercial institutions that have provided the foundation for trust and recourse in the West. The West did not have them either, however, until they became desirable.³⁰ The evolution of the private institutions of commercial law and of market institutions themselves has always been simultaneous rather than sequential.³¹ And in this regard, it is not surprising to find that repeated dealings and

reputation effects are being used to support trade. Informal and formal groups of trading partners are developing quite rapidly in many countries.³² During the early stages of group formation arbitration arrangements may not arise as members rely instead on negotiation and threatened sanctions to resolve disputes,³³ but arbitration is also developing in some emerging economies.³⁴ While these developments are often quite slow, that is generally because the threats of an arbitrary state stand in their way. Even if that is not the case, however, reliance on the state for rules and/or legal sanctions at this early stage is likely to mean that the future evolution of commercial law will be along a very different path from the one taken in the economies of Western Europe and North America, where the state did not claim jurisdiction until long after the evolutionary process was under way. The withdrawal of the state from any efforts to influence commerce will do more to stimulate commercial activity than any proactive efforts by the state to speed up the process, since such efforts will inevitably be undermined by the problems of knowledge and interest.

¹ The paper draws on B. Benson (1998) 'Evolution of Commercial Law,' in P. Newman (ed.) *The New Palgrave Dictionary of Economics and the Law*, Vol. II, London: Macmillan, pp. 89–92; B. Benson (1998) 'Law Merchant,' in P. Newman (ed.) *The New Palgrave Dictionary of Economics and the Law*, Vol. II, London: Macmillan, pp. 500–508; B. Benson (1998) 'Arbitration in the Shadow of the Law,' in P. Newman (ed.) *The New Palgrave Dictionary of Economics and the Law*, Vol. I, London: Macmillan Reference Limited, pp. 93–98; B. Benson (1999) 'To Arbitrate or to Litigate: That is the Question,' *European Journal of Law and Economics*, 8, 91–151; B. Benson (1999) 'Polycentric Law Versus Monopolized Law: Implications from International Trade for the Potential Success of Emerging Markets,' *Journal of Private Enterprise*, 15, 36–66; B. Benson (2000) 'Jurisdictional Choice in International Trade: Implications for Lex Cybernetoria,' *Journal des Economistes et des Etudes Humaines*, 10, 3–31; B. Benson (2000) 'Arbitration,' in B. Bouckaert and G. De Geest (eds.) *Encyclopedia of Law and Economics*, Vol. 5, Cheltenham, UK: Edward Elgar, pp. 159–193; B. Benson (2000) 'Interjurisdictional Competition Through Alternative Dispute Resolution,' a Commentary in *What Price Civil Justice?*, by B. Main and A. Peacock, London: Institute of Economic Affairs, Hobart Paper 139, pp. 69–96; and B. Benson (2000) 'Law and Economics,' in W. Shughart II and L. Razzolini (eds.) *The Elgar Companion to Public Choice*, London: Edward Elgar, forthcoming.

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¹¹ For discussion of such procedures, see references in note 1.

¹² J. Lew (1978) *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Dobbs Ferry, NY: Oceana Publications, p. 589.

¹³ *Ibid.*, p. 581.

¹⁴ *Ibid.*, pp. 582–585.

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³⁰ Benson (1989) op. cit.

³¹ *Ibid.*

³² Pejovich (1995) op. cit.; McMillan and Woodruff (1998) op. cit.; Khanna and Rivkin (2000) op. cit.

³³ McMillan and Woodruff, *Ibid.*

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