



The Theory of Market Modernization of Law

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Glendower: "I can call spirits from the vast deep."

Hotspur: "But will they come when you do call for them?"

—Shakespeare, *Henry IV*

Many people believe that modernizing the law in developing countries requires comprehensive reform directed by state officials. This paper discusses an alternative, called "market modernization," in which the state repeals laws creating obstacles to markets and selectively enforces norms that evolve in institutions located between individuals and the state. I develop a theory of the evolution of norms and apply it to developing countries.

Many people believe that modernizing the law in developing countries requires comprehensive reform directed by politicians and state officials.¹ For example, labor law must restructure employment relations to protect jobs,² land reform must reorganize agriculture by redistributing rural property,³ antitrust law must suppress monopolies that obstruct development,⁴ and safety regulation must protect consumers and workers against defective products.⁵ Priorities vary, but reformers agree that political leaders and state officials must take the initiative to replace outdated laws with comprehensive statutes.

This article concerns an alternative approach to modernizing the law.⁶ Economic competition changes products and techniques, which in turn creates new problems of coordination and cooperation. Communities of people solve these problems by developing norms of behavior. Social norms impose obligations and coordinate expectations. The state raises some social norms to the level of law. To illustrate, consider safety on the steps of a family's house. Custom determines a standard of safety in maintaining steps. If someone is injured on the steps and sues the homeowner, the court in a common law country will use the customary standard to determine whether or not the homeowner was negligent in maintaining the steps. Similarly, the American Bar Association imposes a code of ethical responsibility on lawyers, and courts hold lawyers liable

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for some types of harm resulting from their unethical conduct. In general, intermediate institutions located in-between individuals and the state, such as the American Bar Association, make private rules for their members that provide a guide when courts assign liability.

Comprehensive reform and piecemeal evolution are two alternatives for modernizing law. When politics leads and the economy follows, I describe the process as “political modernization.” Politics leads when state officials plan the law by a relatively centralized process. Comprehensive reform is a form of political modernization. Alternatively, when the economy leads and politics follows, I describe the process as “market modernization.”⁷ The economy leads when intermediate institutions develop new norms and the state subsequently recognizes them as legal obligations. Under market modernization, the law evolves by a relatively decentralized process. Piecemeal evolution is usually a form of market modernization.

Market modernization assigns the state the modest task of creating the conditions for economic competition and selectively enforcing norms that evolve as the economy develops. Creating the conditions for economic competition requires such measures as protecting property rights, repealing regulations that inhibit competition, and protecting freedom of association. Selectively enforcing norms involves identifying the business practices that are fair and efficient, and, under certain conditions, enforcing them with the power of the state, such as enforcing business promises and imposing liability on the parties who cause accidents.

Most countries combine both political modernization and market modernization, but their roles are not equally appreciated. Political modernization proceeds through changes in statutes and executive orders, which politicians trumpet to their constituents and government offices publish. Market modernization, in contrast, proceeds through changes in customs and intermediate institutions. Overlooking these develops is easy because discovering them requires research. Thus the importance of political modernization is easily overestimated and the importance of market modernization is easily underestimated.

Political modernization runs the risk that the state’s ambition will outrun its capacities. Like Glendower in Shakespeare’s *Henry IV*, officials issue orders easily and extract obedience with difficulty. Politicians lack the information and motivation to make efficient laws. I will argue that efficiency requires market modernization of law, much like efficiency requires allowing development of markets for commodities.

Douglass North recently wrote, “We need to know much more about culturally derived norms of behavior and how they interact with formal rules to get better answers to such issues [as the role of the state in economic development].”⁸ This paper addresses that problem. I will sketch the history of legal modernization, develop a theory of market modernization, and apply the theory to developing countries.

I. Legal Modernization in the West

In continental Europe, the phrase “economic law” refers to laws that apply to the economy, notably the laws of property, contracts, corporations, torts, and industrial regulation, as well as various specialized bodies of law such as securities, payments, bankruptcy, trusts, the environment, and labor relations. In modern economics, complex organizations apply science to the production of specialized goods and compete with each other to sell them in impersonal markets. Modern economic law is law adapted to the conditions of a market economy. If economic law is poorly adapted to

the economy, expectations conflict, cooperating is difficult, and disputes consume resources. Conversely, if economic law is adapted to the economy, people cooperate with each other, harmonize their expectations, and use resources efficiently and creatively. The topic of this paper is acquiring modern economic law.

A conventional starting date for modern history in northern Europe is the 18th century, when developments in science and industry greatly increased the pace of social change. These changes in society provoked rapid changes in law. The law had to discover the corporate form of organization, clarify the meaning of "property" for industrial organizations, extend contractual obligations to new financial instruments, extend accident law to the dangers posed by industrial products, allocate losses from bankruptcies in new types of organizations, and develop regulations to protect the environment from new pollutants. Furthermore, legal scholars had to organize the profusion of new laws, thus lowering the costs of understanding and conforming to them.

Each part of modern economic law has a different history in each country. I cannot possibly review all of them. Instead of discussing substantive law, I will focus upon process. I will first describe some of the processes by which legal modernization occurred in western countries.

Common Law

Comparative lawyers often divide legal systems with western origins into two fundamental types: common law and civil law.⁹ I will discuss each of them in turn. The common law of England has a continuous history reaching back to the medieval period. Throughout most of its history, English common law developed through a close-knit community of professional lawyers and judges solving cases. According to the legal historian Brian Simpson, the common law has been an institution more than a collection of rules.¹⁰ Not until the 18th century did Blackstone first organize the leading cases of the common law into modern legal categories. In the 18th century, the common law had to evolve quickly to keep pace with changes in business.

An often-cited example of modernization by the common law process concerns financial instruments. Notes and bills of exchange, which circulated among 18th century merchants as means of payment and credit, raised difficult questions of risk allocation. To illustrate, suppose that A delivers goods to B. Upon receipt of the goods, B gives a note to A promising to pay a certain sum of money on a future date. A sells B's note to C. In the meantime, B discovers a defect in the goods that he purchased from A. Now B holds defective goods and C holds B's promise to pay A for them. Can B refuse to pay C on the grounds that A delivered defective goods? Or, alternatively, must B pay C and then sue A for breach of contract?¹¹

Such legal questions became acute with the rapid expansion of commerce in the 18th century. Judge Mansfield is usually credited with supplying most of the answers. Mansfield knew that he did not understand fully how businesses use financial instruments. Consequently, he did not try to invent better rules than the ones in practice. Rather, he carefully scrutinized business and tried to identify and enforce the best practices.¹² His elegant solutions were taught in courses on commercial law long after the relevant financial instruments ceased circulating.

I used commercial law to illustrate legal modernization by the common law process. To appreciate other innovations, consider four fundamental legal contributions to modern economies. First, the resources used by complex organizations come from

various sources. The owners of resources assume risk by advancing them for use by others. Contract law and corporate law keep risk low enough so that people willingly supply resources to each other. Second, an efficient organization needs to extract effort and creativity from its workers. Contract law and labor law help organizations to create incentives that motivate workers. Third, without competition, large organizations lapse into bureaucratic lethargy. Property law and antitrust law provide a framework for sustained competition among large organizations. Finally, as goods become more complex, the process of exchanging them uses more resources. Resources used in exchanging goods are called transaction costs. Contract law and commercial law lower the transaction costs of impersonal exchange.

All of these areas of law had to evolve rapidly in the 18th century to produce modern common law. In common law systems, intensive litigation alerts judges to the need to change the law.¹³ Empirical evidence indicates an intensification of litigation around the time that judges adopt a new precedent.¹⁴ Judges respond to a proliferation of novel disputes by making new law.¹⁵ Thus the priorities for legal development in a common law system are determined by litigation rates.

When judges make common law, they cannot do as they please.¹⁶ According to an old principle in jurisprudence, judges cannot make law except when they find a social norm worthy of enforcement by the state. This principle is embodied in the saying, "Judges must *find* common law."¹⁷ Thus Judge Mansfield examined the commercial practices of his day to *find* the foundations of modern commercial law.

Since the 18th century, common law countries have developed new institutions to aid the law's evolution. Organizations conduct studies to scrutinize current law and issue reports recommending changes in it. In Britain, the law commissions perform these tasks,¹⁸ and in America these tasks belong to the American Laws Institute (ALI) and the National Commission on Uniform State Laws (NUCSL).¹⁹ To illustrate the work of these bodies, the American Laws Institute periodically creates *ad hoc* committees of scholars and lawyers to restate the best practices of courts in particular areas of law, such as the *Restatement of Torts* (1977) or the *Restatement of Contracts* (2nd ed., 1979). Restatements serve as references for judges, thus increasing uniformity across jurisdictions and probably increasing the pace of legal change. As products and technology change, business communities continually generate new social norms, which I call the "new law merchant." Organizations like ALI and NUCSL try to keep law current with normative developments in business communities.

Codes

Already in the 18th century, a debate was joined in England over whether the common law was efficient or an archaic residue of obsolete practices.²⁰ The reforming spirit prevailed in continental Europe, where common law was identified with the losing side in the revolutions that brought Napoleon and his followers to power. The victorious revolutionaries, who regarded judges with suspicion for upholding the old regime, wanted to root up "medieval" practices and replaced them with "rational" ones.²¹ The revolutionaries proclaimed that law derives its authority from the popular will as expressed through legislators, not from social norms as found by judges. The popular will was identified with rationality, whereas social norms were identified with habits. Commissions were appointed to draft codes to supersede the common law. Scholars on the commissions examined prerevolutionary law with a critical eye and retained some parts of it, rejecting the rest. Legislators enacted the codes into law.

Judges allegedly make law in civil systems by interpreting codes, not finding social norms. Compared to common law countries, the codifiers in civil law countries apparently have more influence and the judges allegedly have less influence. Interpreting some codes, however, looks a lot like finding social norms. Comparative lawyers, consequently, debate whether the apparent differences in the two systems are real or illusory.²²

To illustrate, consider a code that I alluded to earlier. I already discussed the fact that the ALI and the NCUSL create committees to restate the common law in the United States. In addition, these bodies create committees to draft model codes. The most successful example is the Uniform Commercial Code (UCC), which applies to contracts among merchants, financial instruments, and bankruptcy. Its drafting was directed by a famous professor of law, Karl Llewellyn, who tried to identify and articulate the best commercial practices in contemporary business communities, much like Lord Mansfield when he modernized British commercial law.²³ After Llewellyn's committees completed their work, the UCC was presented to the legislatures of the American states, which enacted it into law.

When legislation and common law apply to the same case, legislation prevails, so the UCC displaced much of the common law for commercial transactions. Judges continue to make commercial law in the United States by interpreting the UCC. Furthermore, many provisions of UCC are based upon the insight of the drafters into the best commercial practices. Consequently, making law by interpretation of the UCC closely resembles the process by which common law evolves.

Both common law and civil codes rely heavily upon broad principles that apply in many different circumstances. These principles ideally abstract from particular practices, and the practices give specific content to the principles. To illustrate by an earlier example, the common law of torts typically holds injurers liable for accidents caused by their negligence, and this general principle receives specific content from the actual standards by which particular communities evaluate accidents. When judges apply the negligence principle, they often find the specific standard applicable to the case by identifying the best practices in the relevant community. Civil law judges can proceed on similar lines when interpreting general principles in a code. For example, "negligence" in civil law can receive specific content by reference to community practices. By relying on judges to use specific practices to interpret general principles, both systems of law empower judges to make law from community norms.

Regulations

In the 20th century, a massive growth of new law in the industrial countries of Europe and America created the regulatory state. The regulatory state replaced some old laws with new regulations, such as replacing the common law of crimes with criminal codes, and the regulatory state also created entirely new bodies of law, such as administrative law. As before, I focus on the process of making regulations, not upon the substance.

As explained, a community of scholars, lawyers, and judges typically produces the common law and much of the civil law. In contrast, politicians and bureaucrats have more influence upon regulations. Regulations can come from the legislature, the executive, or the bureaucracy. Legislatures produce regulations by familiar processes: committee hearings, debates, bargaining, and majority voting. Executives promulgate rules directly by issuing executive orders or indirectly by having ministries issue regulations. Ministries usually follow procedures prescribed in legislation for making regu-

lations, which differ from one agency to another and from one country to another.²⁴ Thus when U.S. agencies create new regulations, they must follow procedures stipulated in the legislation conveying authority upon them, or, in the absence of such stipulations, they must follow procedures prescribed in the Administrative Procedures Act. To illustrate, the U.S. Environmental Protection Agency must follow procedures specified in the Environmental Protection Act when making regulations, or, in the absence of specific legislative instructions, it must follow the Administrative Procedures Act.

In addition to the differences in process, regulations tend to be drafted differently from the common law or codes. As explained, the common law and codes rely heavily upon general principles whose specific content comes from community practices. In so far as regulations are imposed from the top, they lack a foundation in community practices. Without such a foundation, the regulators would create uncertainty by promulgating *general* principles. Instead of promulgating general principles, regulations rely more heavily upon detailed instructions. For example, instead of requiring the rungs of ladders to be “reasonably strong” or “strong enough for their intended purposes,” a regulation might specify exactly how many kilograms of vertical weight a rung must be capable of supporting.

Regulations crowd out private law. For example, extensive regulation of the employment contract prevents the employer and employee from stipulating the terms of work that both of them prefer. To illustrate, U.S. workers typically work 40 hours per week. Working more than 40 hours per week is “overtime work.” Federal law requires workers to receive 150% for “overtime work.” Such a law increases the cost of working 50 hours and 30 hours in consecutive weeks, as compared to working 40 hours in both weeks. As illustrated by this example, when public law crowds out private law, the state takes control of resource allocation. In resource allocation by the state, the politics of redistribution often dominates the economics of production.

Communism

The most complete legal reforms in the 20th century were carried out by communist revolutionaries, who swept away the law, politics, and economics of the old regimes even more thoroughly than the 18th century revolutionaries, and replaced it with central planning. Under central planning, government officials formulate the state’s goals for the production of commodities, embody the goals in production targets, and order people to meet them. Orders move along a one-way street from top to bottom. To implement production targets, officials need the power to allocate resources. To possess this power, the orders issued by officials must trump the private rights of citizens.

In communist countries, the state repealed or emasculated private law in employment relations, land ownership, antitrust, consumer products liability, and worker safety. Once the legal impediments were removed, officials ruled by decree. So, central planning is a way of making law as well as commodities. Central planning produced remarkably similar results in vastly different countries, such as Poland, Vietnam, and Cuba. Specifically, central planning emphasized economic growth through forced savings and expansion of the capital stock in heavy industry. Everywhere, central planning failed to produce consumer goods in abundant quantity or high quality.

Communism combined socialism and dictatorship, whereas some non-communist countries combined socialism and democracy. Socialism produces some different results when combined with democracy rather than dictatorship. To illustrate, socialist dictatorship in eastern Europe produced inefficiently large organizations (giganticism),

which simplified commands. In contrast, socialist democracy in India produced inefficiently small organizations (minimalism), to distribute investments among the regions represented in the ruling coalition.²⁵ Whether in democracy or dictatorship, however, public law must crowd out private law to implement centralized planning.

Some formerly communist countries are trying to recover legal traditions that were lost in revolutions. National and foreign scholars are drafting new laws for the formerly communist countries, with funding and prodding from international agencies. It seems that each Eastern European country will build private law from their prerevolutionary codes and the law of the country supplying funding for legal reform.²⁶ In western Europe, unification under the European Union has induced another recovery effort. Before the Napoleonic revolutions, continental Europe possessed a kind of common law called the *ius commune*. Scholars and judges developed the *ius commune* by elaborating Roman law in light of local traditions and ongoing realities. Some European legal scholars hope to unify European private law by building upon the *ius commune*.²⁷ An important debate is now occurring within the European Union concerning the roles of centralized and decentralized lawmaking in a united Europe.²⁸

I have briefly described four sources of economic law in the west: common law, civil law, the regulatory state, and communism. The common law process exemplifies the decentralized, evolutionary approach that I call market modernization. The regulatory state exemplifies the centralized, planned approach that I call political modernization. Communism takes central planning to its logical extreme. The civil law process can go in either direction, depending upon whether the codes enforce social norms or invent new regulations.

The New Law Merchant and Structural Adjudication

A community of people is a social network whose members develop relationships with each other through repeated interactions. The modern economy creates many specialized business communities. These communities may form around a technology such as computer software, a body of knowledge such as accounting, or a particular product such as credit cards. Wherever there are communities, norms arise to coordinate the interaction of people.²⁹ The formality of the norms varies from one business to another. Self-regulating professions, like law and accounting, and formal networks like Visa promulgate their own rules. Voluntary associations, like the Association of Home Appliance Manufacturers, issue guidelines.³⁰ Informal networks, such as the computer software manufacturers, have inchoate ethical standards.

Following private international law,³¹ I refer to all such norms of business communities as the "new law merchant."³² The new law merchant arises outside of the state's apparatus for making law. However, lawmakers are pulled into the affairs of business communities by insiders who look to the state to resolve their disputes, and lawmakers are pushed into the affairs of business communities by outside critics of private wealth and power.

As explained, many legal reformers such as the English utilitarians and the French exegetic school have sought to replace custom with systematic statutes. Underpinning these reform proposals is a theory of regressive customs and progressive statutes. Hart distinguishes laws into rules controlling people ("primary rules") and rules controlling rules ("secondary rules"). Rules of the first kind guide the behavior of citizens in a state as they go about their daily lives. For example, motorists are forbidden to exceed 65 miles per hour on most American roads. Rules of the second kind guide the

behavior of officials of the state as they make, revise, repeal, or apply the rules of the first kind. For example, a bill becomes federal law in America when enacted by both houses of congress and signed by the president. According to Hart's theory, the union of primary and secondary rules defines law.³³ Unlike law, custom lacks secondary rules. Custom does not prescribe procedures for making, revising, or repealing itself. Custom has no constitution or judges. A person who wants to change custom must use whatever means are at hand to convince others to follow different norms.

To illustrate, the Tolai in Papua New Guinea formerly recognized the power of the "big man" in the village to allocate land. Once a market for land developed, this norm exposed villagers to the risk that the big man would sell land to outsiders for personal gain. So the Tolai stopped recognizing such power in the big man. The big man lost the power to sell land as soon as the Tolai no longer recognized it. Instead of the old norm, the Tolai recognized the new norm that everyone in the village must agree to the sale of its land. This change in customary law was endorsed by the land courts.³⁴

Customs arise, whereas laws are made.³⁵ Hart concluded that custom tends to be inflexible because it is not under anyone's rational control. The development of the regulatory state impressed some scholars so much that they detect movement in modern history towards centralized law. Salmond asserted that customary law is important in the early stages of legal development, but gradually cedes its place to statutes when "the state has grown to its full strength."³⁶ In a recent article, Ott and Schafer point out that modern German law has moved away from customary law and towards statute as the basis of business law.³⁷ Many intellectuals believe that centralized law is inevitable, just as they once believed that socialism is inevitable.

In fact, centralized law, like socialism, is not even plausible for a technologically advanced society. The forces that reversed the trend towards socialism and destroyed central planning are also undermining legal centrism. An advanced economy involves the production of too many commodities for anyone to manage or regulate. As the economy develops, the information and incentive constraints tighten upon public policy. These facts suggest that efficiency requires decentralized law to become more important, not less important, as economies become more complex. Specifically, efficiency requires the enforcement of customs in business communities to become more important relative to the regulation of business.

To stand Hart's conclusion on its head, note that custom arises from consensus, not politics. A consensus can change without going through costly procedures that are vulnerable to special interests. Thus a custom can disappear without being repealed, or change without being amended. To illustrate, the Tolai did not have to launch a lobbying campaign or overcome political contributions by the big men in order to change their customs regulating the sale of land. From this perspective, customs should be more flexible than statutes.

Structural Adjudication

Hart's critique of custom resembles a socialist's critique of markets. Socialists observe that prices arise, whereas plans are made, and conclude that markets must be inefficient because prices are not determined by deliberation and reasoning. The basic confusion concerns the difference between individual rationality and social efficiency. Individual rationality generally requires deliberation and planning, but social efficiency does not. Research in industrial organization shows that the efficiency or inefficiency of markets is often determined by their structure.³⁸ Similarly, the efficiency or inefficiency of

custom often depends upon the incentive structure producing it. In the language of game theory, the payoff matrix determines the possible equilibria.

These facts suggest how lawmakers, especially courts, should respond to the new law merchant. I propose that modern lawmakers should respond to the new law merchant much like the alleged response of English judges to the old law merchant. However, modern lawmakers should take explicit account of insights from modern economics. First, the lawmakers should identify actual norms that have arisen in specialized business communities. Second, the lawmakers should identify the incentive structure that produced the norms. Third, the efficiency of the incentive structure should be evaluated using analytical tools from economics. Those norms should be enforced that arise from an efficient incentive structure, as ascertained by tests that economists apply to games. I call this procedure the "structural approach" to adjudicating social norms.

The structural approach conflicts with much writing in the economic analysis of law in two respects. First, lawmakers following the structural approach infer the efficiency or inefficiency of a norm, rather than measuring it directly. In contrast, much of the economic analysis of law commends the evaluation of legal rules by cost benefit techniques. For example, at the end of his classic article entitled "The Problem of Social Cost,"³⁹ Ronald Coase recommends that judges choose among alternative liability rules by comparing their costs and benefits.⁴⁰

Second, the structural approach that I develop applies to norms, not regularities. To illustrate the difference, men take off their hats when they enter a furnace room or a church.⁴¹ Taking off your hat to escape the heat is different from taking off your hat to satisfy an obligation. The former is a regularity and the latter is a norm. A regularity results from an inclination, whereas a norm imposes an obligation.

Using "norm" to refer to obligations is standard usage among philosophers,⁴² and some game theorists also use the term this way. In contrast, social scientists sometimes use "norm" differently, to refer to average behavior. For example, sociologists sometimes use "norm" to mean what people normally do, as opposed to what deviants do. Similarly, statisticians talk about the "normal distribution." On average, people take off their hats in a boiler room, so this behavior is normal, but it is not a "norm" as I use the term in this paper.

What difference does this distinction make? Economic models seldom distinguish between inclinations and obligations. For purpose of most studies of markets, the difference can be ignored. I will argue, however, that the difference cannot be ignored in studying behavior relevant to law. Without explaining the sense of obligation, a theory cannot explain the law. Norms arise in a game when it creates, or evokes, a sense of obligation in the players concerning the strategies that they follow. I develop a predictive theory of "normative equilibria" in Part II by adapting some philosophical concepts to evolutionary game theory. Part III uses the theory of normative equilibria to characterize the conditions under which fair and efficient norms will evolve, and then shows how judges can use this information in adjudication.

II. Games and Norms

Social norms can be regarded as a "public good" subject to the usual corrosive logic of the prisoner's dilemma. Members of a community collectively gain if they all adhere to the norms, and members individually gain if they violate them, so the norms tend to unravel.⁴³ Reality, however, does not conform to this pessimistic prediction. In fact, many social norms arise and persist without enforcement by the state. I try to explain these facts in this section of the paper.

Agency Game

I develop the “agency game” depicted in the Figure 1 as the paradigm for cooperation in business. In the agency game, the first player to move, who is called the principal, decides whether or not to make an investment of 1. If no investment is made, the game ends and the players receive nothing. If an investment is made, the second player, who is called the agent, decides whether to cooperate or appropriate. Appropriation is merely redistributive: The agent appropriates the principal’s investment of 1. Consequently, the sum of the payoffs in northeast cell of Figure 1 equals 0. Cooperation by both players is productive: The invest of 1 grows to 2. Consequently, the sum of the payoffs in northwest cell of Figure 1 equals 1. When the agent cooperates, the principal recovers his investment and the players split the product (each player receives .5).

The parties in a business network often communicate with each other and cooperate together to make a product. Cooperation involves relying upon each other, and reliance creates the possibility for opportunism. by “opportunism” I mean an act in which someone destroys part of the cooperative surplus to secure a larger share of it. The agency game embodies these facts in a simple payoff matrix. If the agency game is played only once, the agent’s best move is to appropriate. Knowing this, the principal’s best move is not to invest. The one-shot game of investment has a unique solution, which is unproductive.

An enforceable contract can overcome this inefficiency by changing the agent’s incentives. For example, costless recovery of expectation damages gives the principal an incentive to invest regardless of the probability of breach by the agent. Similarly, the costless collection of expectation damages from the agent gives him a strong incentive to perform. Enforcement of contracts, however, typically requires coercion by a third party such as the state.

At this point, I want to analyze cooperation without state protection, so I turn to solutions to the agency problem that do not require enforcement by a third party. Instead of one-shot transactions, investment in a business network often occurs among people with enduring relationships. To capture this possibility, assume that the agency game depicted in Figure 1 is repeated indefinitely often, thus transforming a one-shot game into a super game. In any round of the super game in which the principal invests, the agent enjoys an immediate advantage from appropriating. A successful strategy for preventing such opportunistic behavior, called “tit-for-tat,”⁴⁴ is for the principal to

		Agent	
		cooperate	appropriate
Principal	invest	.50	1.00
	don’t invest	.50	-1.00
		0	0
		0	0

FIG. 1. Agency game.

respond in the next round by refusing to invest, and to begin investing again in a subsequent round. The experience of immediate punishment usually suffices to stop opportunistic behavior by the agent and restore cooperation. Experimental evidence indicates that tit-for-tat comes very close to maximizing a player's payoff in a variety of circumstances. These empirical findings are generally supported by theory, although some mysteries persist.⁴⁵

The problem of cooperation is solvable in many repeated games when players commit to an enduring relationship, provided that they can observe each others' moves and they do not discount the future too heavily.⁴⁶ (The exceptions to this generalization need not concern us here.⁴⁷) Enduring relationships can be based upon kinship, friendship, ethnicity, or religion, to name a few forms of commitment. For example, the theory of cross-cutting ties of kinship, developed in anthropology by Levi-Strauss and others, can be interpreted as using the ideology of kinship to extend biologically based enduring relationships.⁴⁸ Relationships substitute for state-enforced law in tribes, among criminals, in much international trade, under communism, and in informal business networks. Instead of analyzing the anthropology of business, however, I turn to the tentative relationships that form the fabric of most modern business transactions.

Many relationships in a business network dissolve and reform easily. To model tentative relationships, assume as before that the agency game is repeated indefinitely often. However, change the assumption that there are only two players. Instead, assume that there are indefinitely many players, who form into pairs to play each round of the game. At the end of each round, some of these partnerships continue in the next round and others dissolve. When a partnership dissolves, the players must find new partners for the next round of the agency game by a random draw from the pool of available players.

Partnerships dissolve in two ways. First, the principal exits after an agent appropriates. Second, an unpredictable change in business conditions makes the relationship unproductive, so both partners agree to end it. Thus a partnership can end unilaterally or mutually. If neither party ends the partnership, it continues into the next round of the game.

The equilibrium concept for this kind of game draws upon evolutionary theory.⁴⁹ Think of the "players" as hosts for competing behaviors and ask which of these behaviors will survive in competition with the others. Selection favors the behavior that enjoys a higher return. To model this fact, assume that the proportion of players using a particular strategy increases as long as it enjoys an above-average return. Conversely, the proportion of players using a particular strategy decreases as long as it suffers below-average returns. Competition tends to eliminate all below-average strategies, so that every strategy surviving in equilibrium earns the same rate of return.

When a payoff matrix like the one depicted above is embedded in an evolutionary model, a familiar result to theorists is a mixed equilibrium in which most agents cooperate and some agents appropriate.⁵⁰ To see why this result occurs, consider the fact that cooperators form stable relationships, whereas noncooperating agents only play once with any particular principal. Consequently, the agent who follows the pure strategy of cooperation expects to enjoy a modest payoff in a high proportion of rounds, whereas the agent who follows the pure strategy of noncooperation expects to enjoy a high payoff in a low proportion of rounds. In a mixed equilibrium, these two strategies have the same expected value.

I have discussed how to solve the problem of cooperation by committed and tentative relationships. Committed relationships rely upon tit-for-tat, and tentative relationships

rely upon exit. Neither solution requires enforcement by a third party. In contrast, the agency game can also be solved by contracts, provided a third party can enforce them. Thus contracts and relationships are substitutes that solve the problem of cooperation by different means.

Internalizing a Norm

I have shown that relationships can solve the agency game through tit-for-tat or exit. In communities of people, however, such games usually generate norms. Norms are practical in the sense that they direct behavior. To direct behavior effectively, a speaker ought to say who must do what and when. A complete norm provides these instructions explicitly. Thus the canonical form of a norm, according to one formulation,⁵¹ states that each member of a certain class of people (norm's subjects) has an obligation (norm's character) to do something (norm's act) in certain circumstances (norm's conditions), subject to a penalty for noncompliance (norm's sanction). For example, drivers ought to remain within the posted speed limit in all circumstances or pay a fine.

The fact that a law was enacted provides a reason for citizens to do what it requires. Similarly, the fact that a norm was internalized provides a reason for the decision maker to do what it requires. To illustrate, suppose that I initially regard the decision to smoke as a purely personal preference, in which the individual should weigh immediate pleasure against future harm to his health. Someone subsequently convinces me, contrary to my previous beliefs, that smoking is morally wrong. ("God forbids us to harm ourselves for pleasure's sake," "You risk orphaning your child," etc.). After my conversion, I have an additional reason for not smoking, specifically the fact that smoking violates a moral rule that I now hold.

Psychologists have extensively researched the internalization of norms. Stages in the development of moral reasoning among children have been studied, notably by Piaget and Kohlberg.⁵² According to their theories, a child perfects the ability to internalize norms as it acquires a capacity for general reasoning. Their research, like my characterization of internalization as accepting a new reason for acting, makes the process sound cool and rational. In contrast, "depth psychology" often traces the internalization of morality to irrational processes that are hot and inchoate. According to these theories, internalization of morality ingrains new impulses in a child through emotional experiences. An example is Freud's theory that morality is the "ghost in the nursery," meaning the repressed memory of parental punishments. Repression transmutes fear into guilt, which changes behavior.⁵³

Both types of internalization—accepting a new reason and ingraining a new impulse—create a new motive, which can tip the individual's motivational balance. Economic models often view motivation as a calculus of psychological benefits and costs.⁵⁴ From this perspective, internalization attaches a "guilt penalty" to violating a norm, which can change the sign of the net psychological benefits.⁵⁵ To illustrate, consider how the payoffs in Figure 1 might change if the agent internalizes a norm forbidding the appropriation of the principal's investment. In Figure 2, the agent enjoys a payoff of 1 from appropriating. After internalizing the norm, however, the agent might experience a cost of .7 from violating it. After internalization, the net payoff from appropriating now equals .3, as depicted in Figure 2. Cooperation is the dominant strategy for both players in Figure 2.

Figure 2 depicts how internalization can tip the motivational balance of a decision maker who maximizes his net benefits. Some moral theorists, especially those in the

		Agent	
		cooperate	appropriate
Principal	invest	.50	.30
	don't invest	.50	-1.00
		0	0
		0	0

FIG. 2. Internalization and agency game.

tradition of Kant, object to this characterization of motivation. The precise account of how internalization can tip the motivational balance, however, does not matter for purposes of this paper.

How can an observer tell whether a norm or law exists in a community of people? According to the positive theory of law,⁵⁶ a norm or law exists in a community when it achieves a minimum level of effectiveness in directing behavior. Otherwise, the community does not have the norm or law in question. This conclusion, which is the core of provides a building block in the theory of norms and games. (The many refinements and criticisms of the positivist theory of norms need not concern us.⁵⁷)

The requirements for the effectiveness of social norms involve its internalization. As explained, someone who has internalized a norm feels guilt from violating it and pride from obeying it.⁵⁸ Consequently, internalization may tip the balance for a decision maker in favor of obeying a norm. In addition, norms are necessarily general in their application. Consequently, someone who has internalized a norm feels that others ought to obey it as well. A person who feels that others ought to obey a norm tends to criticize or punish people who violate it. The threat of criticism and punishment deters some people from violating a norm. Consequently, when a significant proportion of people in a community internalize a norm, it becomes effective in directing behavior. Thus a social norm exists in a community when enough people internalize it to make it effective.

According to sociologists, an important connection exists between morality and business. Max Weber argued that the emergence of capitalism depended upon an ethic, first perfected among Protestant Christians,⁵⁹ in which the individual internalized an occupational role. "Internalization" here means accepting the norms of an occupation so intimately that they become part of the individual's self-conception, thus altering his perceived self-interest. Internalization of an occupational role, according to Weber, increases the dedication and creativity with which individuals pursue business goals.

Similarly, Durkheim asked how a modern society can divide labor so finely and still hold itself together.⁶⁰ He found the answer in the internalization of occupational roles. Occupational roles combine technical skill and social norms. Complimentary roles allow the development of specialized skills that result in a high level of efficiency, according to Durkheim, and also secure cooperation among strangers.

By dispensing with the need for state enforcement, internalization of norms is the ultimate decentralization of law. Consequently, the internalization of occupational roles

is critical to decentralizing economic law. This view has been revived by Casson in a recent book applying game theory to business practice.⁶¹

In addition to serving valuable social objectives, internalization of norms contributes to solving a technical problem in game theory. When theorists model games, a persistent problem is that games of strategy have too many equilibria. Instead of making testable predictions, models with multiple equilibria can rationalize almost any outcome.⁶² Part of the solution is to substitute evolutionary equilibria for rational expectations.⁶³ Another part of the solution is to supplement the theory of games with the theory of norms. If only some equilibria can become norms, the theory of norms can reduce the problem of multiple equilibria in the game. Later I discuss cases in which only some equilibria can become norms.

Emergence

Having discussed how individuals internalize norms, I turn to the question of how norms arise in a business community. Recall the agency game in which a partnership can end unilaterally or mutually. When a partnership ends, the two players must draw new partners at random from the available pool. The expected payoff to a player who draws a new partner at random increases with the proportion of cooperators in the pool of eligible partners. This is true regardless of whether the player making the draw is a cooperator or an appropriator. All players enjoy a positive externality when other players cooperate rather than appropriate, and all players suffer a negative externality when other players appropriate.

The players in games often provide signals concerning the strategies that they follow. In the agency game, every agent has an incentive to provide signals that induce principals to invest. The principal will invest if he thinks that his agent is a cooperator, whereas he will not invest if he thinks that his agent is an appropriator. Thus every agent will signal "cooperation," regardless of whether his real strategy is cooperation or appropriation.

I have explained that every player in the investment game has an incentive to "signal cooperation," and that cooperation has positive externalities. These two conditions are often sufficient for a custom to arise. Customs arise among people in a community through discussions of morality. Alert people recognize when a practice has positive externalities. If everyone has an incentive to signal conformity with the practice, no one will argue publicly against it. Consequently, a consensus will arise in the community that its members ought to conform to the practice. Such talk will convince some members of the community to internalize the norm and to ingrain it in the young. Thus a new norm will emerge in the community.⁶⁴

I have explained that a custom will emerge when external effects align with incentives for signaling.⁶⁵

Marginal Cooperator

If a business community develops cooperative norms, will the equilibrium level of investment and production increase? I will demonstrate that individuals typically change the evolutionary equilibrium by punishing violators of the norm, but not by obeying it themselves.

In the agency game, people who internalize the norm will cooperate, not appropriate, even if the objective payoff for cooperating is slightly lower than for appropriating.

I call this behavior "principled" conformity to the norm. In contrast, people who do not internalize the norm will cooperate only if the objective payoff for cooperation is at least as high as for appropriation. I call this "adventitious" conformity to the norm.

When the objective payoff for cooperation is at least as high as for appropriation, there is no "strain of commitment" to the norm.⁶⁶ When there is no strain of commitment, an outside observer cannot tell whether someone's cooperation is principled or adventitious. In contrast, there is a strain of commitment when the objective payoff is higher for appropriation than for cooperation. When there is a strain of commitment, everyone who conforms to the norm is principled.

In a mixed equilibrium, some players pursue the strategy of cooperation and others pursue the strategy of appropriation. In an evolutionary equilibrium, all strategies that persist yield the same objective payoff. Consequently, there is no strain of commitment in a mixed evolutionary equilibrium. When there is no strain of commitment, some people conform to the norm adventitiously. Equilibrium is reached by adjusting the number of people who conform adventitiously to the norm. Consequently, the presence of people who conform from principle does not affect the equilibrium.

For example, assume the rate of return for players in the agency game equalizes when 80 players cooperate and 20 players appropriate. Furthermore, assume that 60 players cooperate from principle and 20 players cooperate adventitiously. Now assume that one of the appropriators is convinced to change his evil ways and start cooperating. The change in his behavior causes a disequilibrium in which 81 players cooperate and 19 players appropriate. Equilibrium will be restored by one of the adventitious cooperators changing his strategy from cooperation to appropriation. Thus the internalization of the norm by one more player changes the identity of the cooperators, but not their number.

Marginal players change their strategy when objective payoffs change by a small amount, whereas infra-marginal players persist in their current strategy when objective payoffs change by a small amount. The argument in this section can be summarized by saying that adventitious conformity is marginal and principled conformity is inframarginal in a mixed evolutionary equilibrium. A change in the number of infra-marginal players does not change the equilibrium, which is determined by marginal players.

Cheap Pain

Now I will explain why internalizing a norm changes the evolutionary equilibrium. Informal sanctions like gossip and ostracism are cheap pain.⁶⁷ A person who internalizes a norm may be willing to devote modest amounts of his resources to enforcing it for the benefit of others. Enforcement for the benefit of others is principled, whereas enforcement for the benefit of oneself is adventitious. With enforcement as opposed to conformity, an increase in principled behavior does not cause an offsetting decrease in adventitious behavior. In other words, the people who internalize norms are marginal with respect to enforcement efforts. Consequently, an increase in principled enforcement causes an increase in aggregate enforcement, which shifts the equilibrium towards more conformity.

I will illustrate these points by the agency game. In the agency game, the victim of appropriation can punish the wrongdoer by exit. Immediate self-interest, narrowly defined, provides sufficient reason for victims to exit from relations with wrongdoers. However, enforcement often goes beyond the narrow self-interest of the enforcer, in which case it is principled rather than adventitious. The possibility of principled en-

forcement can be captured in the agency game by introducing reputation, which supplements repetition in promoting cooperation.

To add reputation to the model, assume that partnership is selective, not random, and selection is based upon the reputation of a potential partner. Someone's reputation consists of information about his past behavior that disseminates among other players. Accurate information about someone increases the expected value of the game to all of his potential partners. Everyone is a potential partner to everyone else in the agency game. Thus the benefits of accurate reputation diffuse among all the players of the game.

While benefits diffuse, the costs of disseminating information about the reputation of others fall upon the disseminator. People who have internalized the norm are prepared to bear modest costs of enforcing it for the benefit of others. Consequently, the internalization of norms promotes the sanctioning of wrongdoers by disseminating information about their past acts.

How much informal enforcement of norms is possible in fact? Anthropological evidence shows enforcement of norms without the support of the state, or even with its opposition. For example, squatters who occupy land illegally in Papua New Guinea sometimes hire lawyers to draft real estate "contracts" for buying and selling land that actually belongs to someone else.⁶⁸ The existence of such contracts provides facts to sway public opinion within close ethnic groups.

Dynamics

I have explained that people who internalize a norm increase the equilibrium level of cooperation by punishing appropriators. I will develop this argument in a dynamic setting, which explains many peculiar features of norms.

People who externalize a norm will not use their own resources to enforce it for the benefit of others. In contrast, people who internalize a norm will, presumably, pay something to enforce it. As the cost of enforcing the norm increases, however, fewer people are willing to pay the higher costs. This situation is depicted in Figure 3. According to Figure 3, 80% of the population has internalized the norm and 20% have externalized it. As depicted in Figure 3, the proportion of the population who exter-

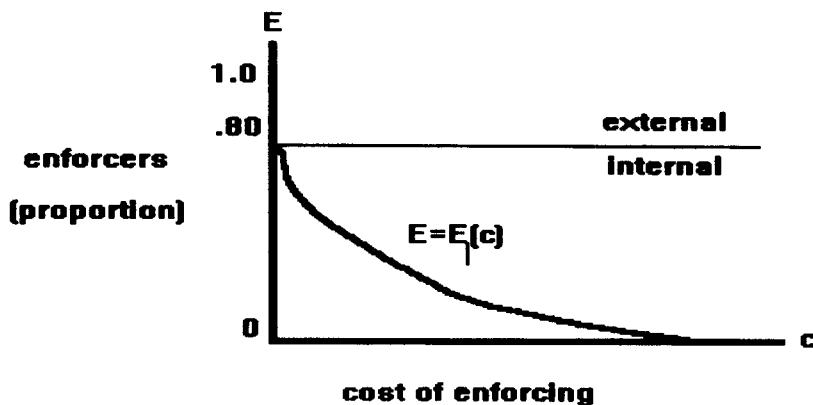


FIG. 3. Proportion of enforcers.

nalize the norm will pay nothing to enforce it, whereas the 80% who have internalized it will pay something to enforce it. Many people will pay a little to enforce the norm, and some people will pay a lot. This fact is indicated by the function $E(c)$, which slopes down to indicate the decline in enforcers E as the cost of enforcing c increases.⁶⁹

Figure 3 depicts how much individuals are willing to pay to enforce a norm. Now I consider the amount that enforcement actually costs. The informal punishments that people use to enforce norms include criticism, shunning, and force. To illustrate, people who break rules of social etiquette may experience gossip, ostracism, and vandalism. Similarly, people who break the norms of a professional may suffer loss of reputation, expulsion, or predatory competition. The person who spontaneously punishes someone in these ways usually runs some risk of confrontation or revenge, as well as any direct monetary costs. The risk of confrontation and revenge, however, tends to fall as the proportion of people willing to act as punishers increases. In other words, the enforcer's cost of punishing decreases as the proportion of enforcers increases. Thus informal enforcement, like state enforcement, enjoys increasing returns to scale.

These facts are depicted in Figure 4, which graphs the relationship between the cost of punishing someone who breaks a social norm and the proportion of people willing to bear that cost. As the proportion of enforcers E rises towards the maximum possible value 1.00, the cost of enforcement falls to its minimum value c . Conversely, as the proportion of enforcers E falls towards 0, the cost of enforcement rises to its maximum level \bar{c} .

Now let us compare the two preceding figures. Figure 3 takes the cost of enforcement as given and depicts how many people actually enforce the norm. Figure 4 depicts how many enforcers are required to sustain a given cost of enforcement. If the actual number of enforcers equals the number required to sustain the current cost of enforcement, then the cost of enforcement remains constant. In other words, an intersection of the curves graphed in Figures 3 and 4 indicates an equilibrium in the number of enforcers and the cost of enforcement.⁷⁰

Graphing several different equilibria helps to explain some actual cases observed in

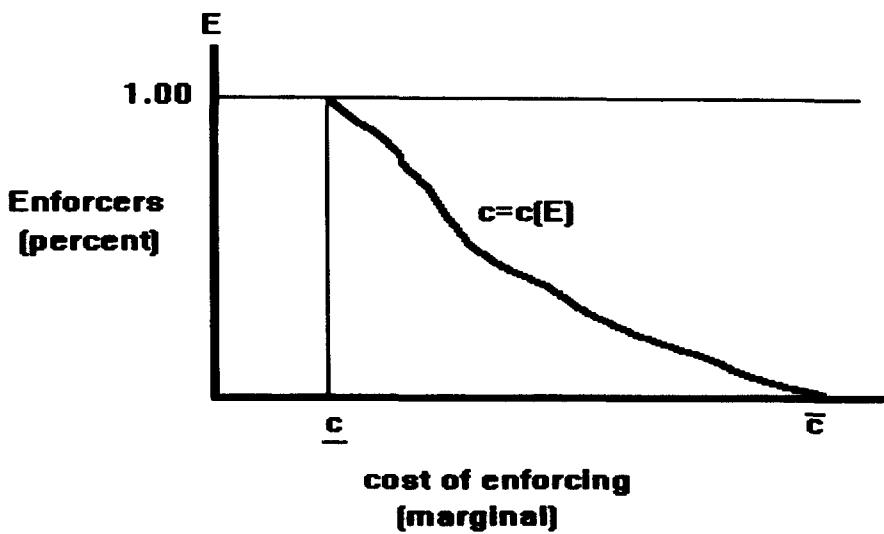


FIG. 4. Enforcement costs.

social life. I begin with the common situation discussed in preceding sections, where some proportion of the people who internalize the norm enforce it on others. In Figure 5, an equilibrium occurs where the two curves intersect at (E^*, c^*) . The dynamic behavior of the system is easily explained. If the actual number of enforcers exceeds the number required to sustain the current cost of enforcement, then the cost of enforcement will fall. This situation occurs in Figure 5 for values of the variables less than (E^*, c^*) . The directional arrow in Figure 5 indicates the direction of change. Conversely, if the actual number of enforcers falls short of the number required to sustain the current cost of enforcement, then the cost of enforcement will rise. This situation occurs in Figure 5 for values of the variables greater than (E^*, c^*) , as indicated by the directional arrow. Notice that the directional arrows in Figure 5 point toward the intersection of the two curves at (E^*, c^*) , indicating that this equilibrium is stable.⁷¹

Now I turn to another case with two extreme possibilities: Either everyone who internalizes the norm enforces it, or else no one enforces it.⁷² This situation occurs in an unstable internal equilibrium as depicted in Figure 6. In Figure 6, for values of the variables exceeding (E^*, c^*) , the actual number of enforcers exceeds the number required to sustain the current cost of enforcement, so the cost of enforcement falls, as indicated by the directional arrow pointing away from (E^*, c^*) . Similarly, for values of the variables falling short of (E^*, c^*) , the actual number of enforcers falls short of the number required to sustain the current cost of enforcement, so the cost of enforcement rises. The directional arrow pointing away from (E^*, c^*) indicates this fact. According to the directional arrows in Figure 6, any slight movement away from the unstable equilibrium at (E^*, c^*) will send the system to the upper corner, denoted $(.80, c)$, or to the lower corner, denoted $(0, c^-)$. In the upper corner, everyone who internalizes the norm enforces it, and in the lower corner no one enforces the norm.

Figure 6 depicts a social norm that can only exist at a high level of enforcement. (E^*, c^*) is the tipping point. If the system begins above the tipping point, it "tips in" to a high level of enforcement of the norm. Conversely, if the system begins below the tipping point, it "tips out" and the norm disappears. Many variations of this theme are possible by modifying the shapes of the curves. For example, in Figure 7 most people enforce the norm, unless enforcement falls below the tipping value, in which case few

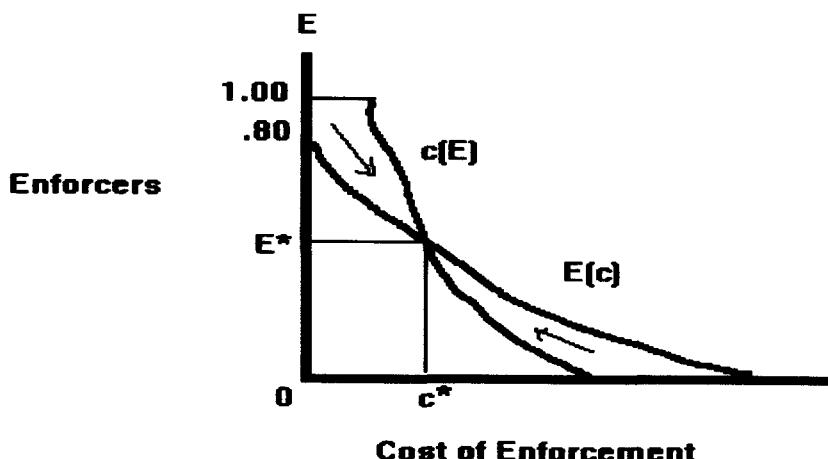


FIG. 5. Stable equilibrium.

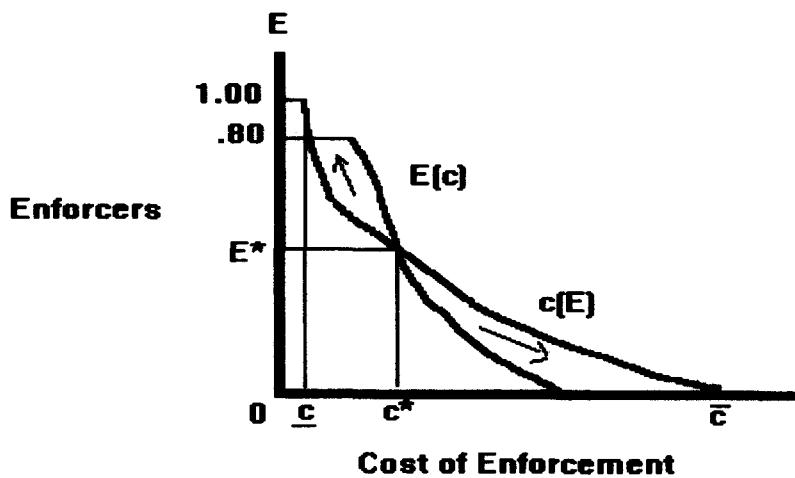


FIG. 6. Unstable equilibrium.

people enforce it. The instability occurs when (i) a small increase in the number of enforcers causes a large decrease in the cost of enforcement, and (ii) a small decrease in the price of enforcement causes a large increase in the number of enforcers.

If the system has "tipped out," a policy that causes the system to "tip in" can dramatically increase conformity to the norm. This fact can provide a justification for Durkheim's expressive theory of the state.⁷³ This theory asserts that the state should express the commitment of society to fundamental values by recognizing them in law and punishing violators. State enactment, without formal enforcement, can sometimes tip the social system into conformity to the law, by causing citizens to believe correctly that more of them will enforce the norm on others.

To illustrate such a self-fulfilling prophecy, many states have enacted ordinances prohibiting smoking in public buildings such as airports. Officials almost never enforce these rules. However, the posting of the ordinances apparently causes citizens to en-

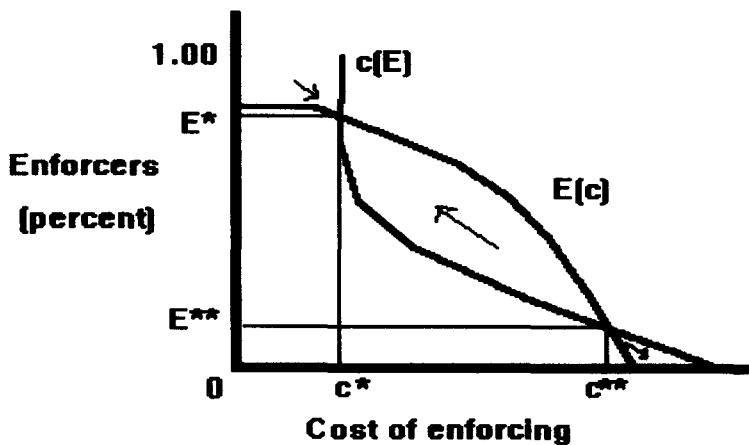


FIG. 7. Most conform or few conform.

force the rules against violators. Knowing this, most smokers conform to the rules. In terms of the preceding figures, enactment of the antismoking ordinance lowered the perceived cost of confrontation in complaining to smokers, which shifted $c(E)$ down and caused the system to tip into a new equilibrium with a high level of conformity.⁷⁴

A personal anecdote provides another example. The city of Berkeley, California, recently enacted an ordinance requiring owners to clean up after their dogs ("pooper-scooper" law). Enactment of the law clarified vague social norms concerning courtesy. After the law's passage, people became more aggressive about enforcing what common courtesy demands. Apparently it is easier to say "Obey the law" than to say "Don't be so rude." The ordinance tipped the balance in favor of private enforcement of the norm and changed the behavior of the owners of dogs.

In these two examples, the law solves the problem it addresses without formal enforcement. In other cases, however, state enforcement may be required to tip the balance towards conforming to a social norm. The possibility of state enforcement provides a credible threat to citizens who complain about the violation of social norms. The threat is credible in so far as the state will enforce its laws against violators of them.

Intermediate Institutions

I have developed a theory of the spontaneous evolution of norms. In reality, however, many norms are made by intermediate institutions. Organizations makes rules for members typically by following a legislative process such as majority vote. The forms of representation are quite distinct from one organization to another. To illustrate, the Visa Corporation is a for-profit, nonstock company in which the member banks vote in proportion to their billings through the system. In contrast, the American Economics Association governs itself by a board of directors elected by members from slates proposed by the current board of directors. A theory of intermediate institutions would have to characterize different types of organizations and then predict how different governance structures will perform. While I cannot develop a detailed theory here, I will offer a few generalizations.

Theories of collective choice, which have progressed in describing how states govern, provide the basic tools for analyzing intermediate institutions.⁷⁵ These theories assume that people exercise political power in their own interests. Voting averages the interests of the electorate, giving more weight to those who control the agenda or invest resources in influencing elections. Governance of intermediate organizations give them direction and purpose. Disagreements persist about the goals pursued by intermediate institutions. On the one hand, intermediate institutions can be viewed as providing detail and meaning to broad principles of property and contract law, as in the preceding discussions of the new law merchant. On the other hand, intermediate institutions can be viewed as creating local monopolies to inhibit competition. To illustrate the latter view, Mancur Olson asserts that as a society ages, organization of intermediate institutions deepens, and the society pursues political rents with increasing effectiveness, until "sclerosis" clogs the arteries of economic competition.⁷⁶

In reality, organizations that seek to maximize the wealth of members will pursue efficiency and monopoly. The organization will seek to create monopoly power for members in dealing with nonmembers. Monopoly power is achieved by the standard devices of a cartel—price fixing, exclusive territories, and withholding information from the public. The organization will also seek to minimize agency costs that members incur in dealing with each other. To minimize agency costs, the organization must create

efficient property rights and contracts among members. Thus a general principle of motivation for intermediate organization can be stated: *efficiency for interests encompassed by the organization, monopoly for outsiders*. In an ideal situation, competition deprives an organization of monopoly power over outsiders, thus limiting the organization to the goal of efficiency among members. In the worst situation, organization form tight cartels to control local markets.

III. Market Modernization as Policy

I have explained that centralized law comes from officials who impose their decrees upon people, whereas decentralized law comes from a community of judges and scholars who find the best social norms and make them into state law. In developing countries, these alternatives present themselves as a choice between political modernization and market modernization. I will explain briefly some programmatic differences between them.

Repealing and Transplanting Regulations

Business norms evolve quickly when vigorous competition causes products and techniques to change rapidly. Repealing laws that inhibit competition increases the pace of change. Many laws that inhibit competition are regulations created for the benefit of politically powerful groups. Indeed, one school of thought holds that companies in regulated industries typically "capture" their regulator and use its powers to restrict competition.⁷⁷ Whereas political modernization expands the scope of public law, market modernization repeals anticompetitive regulations and thus reduces the scope of public law.

Import duties, trade restrictions, and restrictions on foreign investment close an economy to world competition. Opening the economy to world competition stimulates economic and legal change. Foreign investment rapidly transfers new techniques to the host country. The new techniques create new problems of coordination and cooperation. To solve these problems, new social norms and laws must develop. To speed the process, the importer of technology may also want to import foreign laws. Fitting imported laws into the domestic legal system is called "transplanting."⁷⁸ Foreign investment creates a demand from business for legal transplants. To hasten modernization of law in developing countries, the state should dismantle laws that insulate domestic producers from international competition and respond to the demand of business for legal transplants.

Monopolies and Free Trade

Markets in many developing nations are small enough so that restricting imports conveys market power on some domestic producers. Monopolies can arise from industrial structure (increasing returns to scale, barriers to entry, product differentiation, etc.) or from anticompetitive practices (price collusion, common sales agency, agreements not to compete, etc.). Developing nations, however, have small economies relative to the world market, so opening the economy to international competition eliminates many domestic monopolies. Potential competition from foreign producers undermines many anticompetitive practices and exposes others to public scrutiny. The pressure of international competition is more reliable and relentlessly procompetitive than the activities

of antitrust officials. Developing nations can accomplish many goals of antitrust policy through free trade without the state creating an enforcement bureaucracy. An antitrust bureaucracy may even diminish competition in the pursuit of its own interests.⁷⁹ Free trade is, consequently, the best antitrust policy.

Labor Law

As an economy develops, large firms, which pay higher wages than the traditional sector, employ more workers. The gap in wages between the modern sector and the traditional sector is so large that economists sometimes speak of a “dual economy.” Economists have tried to explain why this wage gap persists by referring to “efficiency wages”⁸⁰ and rigidities in capital-labor ratios for imported equipment.⁸¹ Politicians often aggravate the dual labor market and create an underground economy by loading the employment contract with compulsory benefits, such as health care, higher wages for working overtime, and generous severance pay for dismissed workers. Loading the labor contract with compulsory benefits can buy industrial peace at the price of aggravating the gap between industrial workers and the traditional sector or the unemployed. Furthermore, loading the labor contract with compulsory benefits creates incentives to evade or avoid the law. For example, some companies in the United States have found ways to obtain labor while legally eliminating *all* employees.⁸²

Market modernization, in contrast, assumes that labor contracts should be negotiated locally, not prescribed centrally. Most people know best how to structure their own employment contracts. In large organizations, labor organizations should bargain with employers to improve the structure of employment contracts. Courts should enforce the contracts that people actually make.

Contracts

The contracts that people make inevitably contain gaps, especially for low-probability events. Gaps save the cost of negotiating and drafting explicit terms. Although gaps reduce transaction costs, gaps also increase the risk of a dispute over an unresolved contingency. These factors—negotiating costs and the costs of resolving disputes—must be balanced. Rational parties leave gaps when the cost of negotiating and drafting explicit terms exceeds the cost of the risk of a dispute. When contracts contain gaps, law fills them by supplying the missing terms. Gap-filling rules are also called “default rules,” because they apply in the absence of explicit terms to the contrary. When an explicit term is present, it overrides any applicable default rules. Efficient default rules lower the transaction costs of contracting by lowering the risk created by gaps.

In some situations, the law may go beyond default rules and *regulate* the terms of the contract. A regulation applies in spite of an explicit term to the contrary. For example, a fraudulent contract is unenforceable. Regulations can contribute to the efficiency of contracting in the presence of market failures. Political modernization implicitly assumes that market failures occur frequently, and that officials can perceive the failures and correct them with regulations. Market modernization implicitly assumes that market failures occur seldom, and that social norms will identify the failures, so officials should selectively enforce social norms. For example, business morality will condemn fraud, and so should the law.

New organizational forms emerge as an economy develops.⁸³ Business communities that develop new forms of organization also develop new forms of contracts, which

contain new kinds of gaps. Filling the gaps requires developing specialized business law. To illustrate, the proliferation of franchising has required courts to fill previously unknown gaps in contracts between franchiser and franchisee.

Business Organization

Modern industries sometimes form around a network with a central switch, such as the computer for making payments in Visa's credit card system. Teubner argues that the business network is a fundamentally new form of organization characterizing post-industrial economies, as distinct from more familiar forms such as corporations, partnerships, cooperatives, clubs, and unions.⁸⁴ In any case, competing firms have developed new forms of cooperative organization to share ownership of the central switch.

Earlier I discussed the development of commercial law in the 18th century by Judge Mansfield. Common law judges like Mansfield preside in courts of general jurisdiction, which hear many different types of cases. In contrast, some countries create specialized courts to enable judges to acquire knowledge of particular business practices. For example, Germany has specialized courts for business and labor disputes. The United States has also developed a specialized court for business law by an indirect route. American corporations can obtain a charter from any of the 50 states, and many of the largest corporations prefer to obtain their charter in Delaware, where the courts have developed a special expertise in business law.

Just as free trade produces a surplus, people who freely join an organization usually produce more by cooperating together than they can produce on their own. No one can predict in advance the form of organization that will be most efficient in supplying a new good or service. Organizations such as partnerships, corporations, cooperatives, and associations compete for members and money. To insure success of the most efficient organizations, law must provide a neutral framework for competition among organizational forms. Neutrality requires the law to protect the right of people to associate freely with each other, which many constitution's guarantee. Neutrality also requires the law to treat different kinds of organizations as possessing the same powers to contract, sue, and be sued. Finally, pair competition among organizations precludes extending tax and regulatory advantages to politically favored forms.

Corporations and labor unions sometimes engage in anticompetitive practices to create cartels and restrain trade. Legal protection for these practices sometimes comes from the principles of free contract and freedom of association. Free contract and freedom of association are justified economically by the surplus that they normally create. This justification does not extend to anticompetitive practices, which destroy surplus and create inefficiencies. Earlier I argued that free trade is the best antitrust policy for industrial structure. Free trade, however, may not be enough to destabilize cartels created by overt agreements. Courts should not enforce such agreements and the antitrust authorities should undermine them.

Rural Land Law

As the rural economy develops and population expands, peasants may subdivide their modest holdings among many heirs whose plots are too small for using modern equipment. Alternatively, a feudal tradition may concentrate ownership of land in the hands of a few families. Political modernization demands land reform to consolidate frag-

mented holdings of land or to break up concentrated holdings, distribute it to landless families, or otherwise reorganize agriculture. In contrast, market modernization assumes that the best pattern of rural ownership results from free movement among country people, freedom of association, and a free market in rural land. To modernize rural organizations, the state should protect the right of country people to organize as they prefer and to relocate freely. To modernize land holdings, the courts should protect ownership rights and minimize the legal costs of real estate transactions. Given freedom of association and free markets, competition will drive land ownership and rural organization towards efficiency.

Accident Law

Economic development introduces new hazards in the form of defective products and dangerous equipment. Consumers and workers require protection from these hazards. Political modernization favors protecting consumers and workers by enacting safety regulations. By prohibiting dangerous products and techniques, safety regulations prevent accidents before they occur. In contrast, market modernization favors protecting consumers and workers by the extension of liability law. The anticipation of liability induces injurers to avoid accidents before they occur, and the award of damages compensates the victims of accidents after they occur.

To apply liability law, officials must determine who caused the accident and the extent of the harm to victims. Causation determines liability and harm determines damages. Injurers who bear the cost of the risk that they impose on others have incentives to take efficient precaution. Consequently, officials do not need extensive knowledge about the technology for avoiding accidents. For example, applying a rule of strict liability does not require officials to measure the marginal cost of precaution.⁸⁵ In contrast, enacting efficient safety regulations requires officials to compare the cost of harm and its avoidance. Computing the cost of avoiding accidents requires extensive knowledge about safety technology.

Deterring accidents by liability law requires victims to have access to reliable courts. The accessibility of poor people to courts partly depends upon the organization of the bar. Capital market imperfections often prevent poor plaintiffs from borrowing funds to pursue a valuable claim. Contingent fees can overcome this imperfection in capital markets. However, the bar in many countries prohibits lawyers from accepting contingent fees, thus preventing poor plaintiffs from initiating suits.

Besides accessibility to courts, deterring accidents by liability law requires honest judges with the power to enforce their judgments. Liability law cannot deter accidents if injurers can bribe courts to escape liability or avoid a court's judgment through bankruptcy or chicanery.

IV. Conclusion

As an economy develops, specialization steadily increases the information deficit of central officials. To overcome this deficit, law and economics must decentralize. "Market modernization" is my name for decentralized development of business law. The ultimate decentralization of law consists in the evolution of norms in communities and their internalization by its members. This paper develops a theory of the evolution and internalization of norms. According to my theory, norms arise when each individual benefits from representing himself as conforming to a practice that benefits other

people. In other words, norms arise when everyone's self-interest is served by signaling that he will supply a local public good.

Sustaining a social norms requires its spontaneous enforcement by individuals. I show that increasing returns to the scale of enforcement can create an instability in the cost of enforcement. Given such an instability, the community may "tip in" to a high level of enforcement, or "tip out" to no enforcement. State intervention can cause a community which "tipped out" of a norm to "tip in." Thus the spontaneous enforcement of norms falls often falls short of optimal enforcement.

Business norms tend to be efficient within the community in which they arise, although they are underenforced. Enforcement of a social norm by the state can increase efficiency, provided that the norm does not have harmful spillovers to communities other than the one in which it evolved. The active aspect of market modernization involves the state removing impediments to competition, which is the engine driving the evolution of business norms, and the responsive aspect of market modernization involves the state selectively enforcing the norms that arise in business communities.

Notes

1. Developing country governments seeking industrialization of their economies have often resorted to large-scale, centralized legal reforms to modernize relations between worker and manager, peasant and landlord, consumer and supplier, competing firms, and between producers or consumers and the environment. Perhaps the leading scholar who advocates centralized legal reform in developing countries is R.B. Seidman [see Seidman (1978)]. Seidman's central theme is that the state reflects conflict and in the third world, where the parties are unequal, the state should side with the weaker party. For his wholesale attack on the application of the modern economic analysis of law to developing countries, see Makgetla and Seidman (1989). See also the discussion in Marsinghe (1984).
2. The "first law and economic development movement" also held that reforms to modernize the law are a prerequisite to economic development. See Trubek (1972) and Galanter (1974).
3. James (1973); Mattick (1992) Dolinger and Rosen (1992).
4. White (1975).
5. *Consumer Protection in Brazil* (Pinheiro Neto, Advogados, Sao Paulo, 1990); Brazil, *Codigo do consumidor* (Grafica Auriverde, Rio de Janeiro, 1992); The Indian Law Institute, *Consumer Protection Law in India* (N.M. Tripathi Pvt. Ltd., Bombay, 1991).
6. The most forceful advocate of decentralized lawmaking, who writes out of the tradition of Hayek, is Leoni. See Leoni (1991) and Hayek (1976) Ch. 6, pages 72 to 87. More recently, this theme has been taken up by Rubin (1993).
7. As I use these terms, "market modernization" does not refer to the modernization of markets, and "political modernization" does not refer to the modernization of politics. Rather, the terms refer to alternative ways to modernize law.
8. See North (1990), page 140; quoted in Trebilcock (1995), pages 24 to 25.
9. Schlesinger (1959).
10. Simpson (1973, 1975).
11. Here is the common law's answer: A holder in due course takes a promissory note free from the contractual defenses of the maker.
12. The process of assimilating bills of exchange and negotiable instruments into the common law, which occurred in the 18th century, is well documented. The traditional theory is developed in Holden (1900). Holden is criticized in Baker (1979). A revised view, which stresses that Mansfield immersed himself in the minutiae of business practice to extract the best principles from it, is found

- in Rogers (forthcoming). I benefited from discussions on this point with Dan Coquillette, James Gordley, and Jim Rogers.
13. Models of the evolution of the common law towards efficiency are often based upon a bias in litigation favoring more intensive and extensive challenges to inefficient laws. The first paper is Rubin (1977); for a review of proposed mechanisms and their mathematical testing, see Cooter and Kornhauser (1980).
 14. See Priest (1987). Note, however, that the evidence is unclear as to whether intensified litigation precedes a new precedent, follows a new precedent, or both. See Cooter (1987).
 15. Eisenberg (1988).
 16. This is the subject of a famous critique of H.L.A. Hart's theory of positive law by Dworkin. See Hart (1961), and Dworkin (1977), Ch. 2, page 14.
 17. For an exposition of this old view of lawmaking, see Davies (1986). In a recent article, Ed Rubin traces this line of thought to a belief in medieval Europe that law is at once divine and natural (Rubin, 1995). Rubin cites Chodorow (1972), Fichtenau (1991), and Lewis (1954). This older view finds an echo in the jurisprudence of Ronald Dworkin (1977), who asserts that courts should find rights and not make policy.
 18. Ogus (1995).
 19. Schwartz and Scott (1995).
 20. This debate was joined in the famous attacks of Bentham on the common law. For a modern discussion that rehearses this old debate, see Posner (1979).
 21. Dawson (1972).
 22. Cooter and Gordley (1991). The dispute is difficult to resolve because, in reality, neither system exists as a pure type. In common law countries, restatements and codes have legal authority, and judges in civil law countries are influenced by social norms.
 23. Hillinger (1985).
 24. For a study in German and U.S. administrative law, see Rose-Ackerman (1994).
 25. Fikert proves that Indian socialism produced inefficiently small industries to spread factories "fairly" across regions. See Fikert (1995).
 26. A useful review is in Cadwell (1995). Also see Stephan (1995).
 27. The leading proponent is Reinhard Zimmermann. See Zimmermann (1990).
 28. Streit and Mussler (1994). This paper contrasts top-down and bottom-up approaches to integration of European business law and tries to show how they could be reconciled.
 29. For example, see Ullmann-Margalit (1977) and Taylor (1982, 1987). Also see Rubin (1993).
 30. Hemenway (1975).
 31. For discussions of norms in private international law, see Dezelay and Garth (1995) and Schmitthoff (1983).
 32. The term has also been applied more restrictively to norms of international trade invoked in arbitration and mediation ("lex mercatoria"). See Schmitthoff (1983) and De Ly (1992).
 33. Hart (1961).
 34. Cooter (1991), p. 788, discussing *Enos Malakit and Jonah Tourai v. Peter Tobung*, (Papua New Guinea Land Court, 1987).
 35. See Hart (1961), pages 89 to 96.
 36. Salmon (1966), pages 66 to 67. Note also that Peter Stein writes: "Roman law, like most legal systems, begins as a set of orally transmitted traditional norms and written law begins as written custom." See Stein (1995), page 1.
 37. Ott and Schafer (1991). In making these remarks, they are describing history, not passing judgment upon it.
 38. One of the intellectual foundations of American antitrust law is the distinction between industry structure, the conduct of firms, and economic performance. See Bain (1968) and Caves (1967). For applications to mergers, see Fisher and Landes (1983) and Sullivan (1983). This distinction came under attack as game theory was applied to industrial organization. My term "structural approach" refers to the incentive structure of games, not the competitiveness of markets.
 39. Coase (1960).

40. An exception to the enthusiasm for judicial cost-benefit analysis is Richard Epstein's view that judges ought not to have so much discretion. See Epstein (1987).
41. Equivalently, men put on a hat in a snowstorm or a synagogue.
42. I adopt the language and much of the theory of norms developed by the philosopher von Wright (1978).
43. Douglas (1986), Ch. 1 to 3.
44. Axelrod (1984).
45. Fudenberg and Maskin have proved that in any game in which (i) players maximize the discounted sum of single period utilities, (ii) the discount rate is not too high, and (iii) the players can observe the past history of moves in the game, any pair of payoffs which Pareto dominate the minimax can arise as average equilibrium payoffs of the repeated game. Thus repetition of the game makes a Pareto improvement possible. See Fudenberg and Maskin (1986). This theorem, however, still leaves unexplained why the probability of a Pareto efficient solution is as high as empirical studies suggest it to be.
46. Fudenberg and Maskin (1986).
47. See especially the "weakest link in the chain" game, Harrison and Hirshleifer (1989) and Hirshleifer and Coll (1988). See generally, Hirschleifer (1982). See also Anderson and Hill (1975).
48. For an excellent review of these developments, see Bannerjee and Weibull (1993). For a discussion of the relationship between law and evolutionary theory, see Elliott (1985) and Elliott, Ackerman, and Millian (1985). For a pioneering article on evolutionary models of law, see Hirschleifer at note 49, and for a pioneering book on evolutionary models of economics, see Nelson and Winter (1982).
49. Schussler (1993).
50. For this formulation, see Schussler (1993) and Dawes and Orbell (1993).
51. Here I follow the account of the "kernel" of a norm in von Wright (1978).
52. Piaget presented his ideas about stages in mental development in a series of books in French beginning in 1937, including the English translation (Piaget, 1948). Kohlberg also developed his ideas in a series of books and articles over many years; see especially Kohlberg (1981), where the appendix outlines his account of the six stages of moral development. Flaws in Kohlberg's approach have generated much criticism from feminists, notably Gilligan (1982); see also Lyons (1983).
53. In Freud's account, morality is the repressed memory of punishment and threats from a child's father. In technical terms, the superego emerges when a child represses his Oedipal fears and identifies with his father. See Freud (1962). A clear explanation is in Wollheim (1971).
54. Anti-utilitarian philosophers typically reject the theory that conforming to a principle of morality involves weighing alternative reasons and balancing them. For example, see the account of "exclusionary reasons" in Raz (1986) and Kant (1983).
55. For the use of a "guilt penalty" to change payoff matrix in a game, see Casson (1991), page 51.
56. A summary of the positive theory of law is in Dworkin (1977).
57. See Fuller (1958, 1964) and Hart (1958).
58. These feelings manifest themselves in various behaviors that signal to others what the actor did, and change the optimal strategies in games. For example, a person may prefer to cooperate in a game because involuntary emotional responses increase the risk of detection for "cheaters." For an account of emotional responses as signals, see Frank (1988) in Ch. 1 and 3.
59. Weber (1948).
60. Durkheim (1984).
61. Casson (1991), p. 3.
62. Especially problematic is the so-called "Folk Theorem" (Fudenberg and Maskin, 1986).
63. Suppose the multiplicity of equilibria makes it impossible or impractical for the players to form rational expectations in bargaining games. The concept of an evolutionary equilibrium avoids these problems. Instead of characterizing the players as rational maximizers, evolutionary theory characterizes the players as hosts for competing behaviors and asks which behaviors will survive in equilibrium.
64. Arguing along similar lines, Pettit says that norms will be "resilient" when nearly everyone approves of those who benefit others and disapproves of those who harm others (Pettit, 1990).

65. For a similar account of the emergence of norms, expressed in the language of philosophy, see Gibbard (1990).
66. This phrase is from Rawls (1971).
67. In discussing the problem of sanctioning wrongdoers by gossip, Pettit writes: "But people do not have to identify violators intentionally; they just have to be around in sufficient numbers to make it likely that violators will be noticed. And equally, people do not have to discipline violators intentionally, going out of their way for example to rebuke them or report them to others; they just have to disapprove of them—or at least be assumed to disapprove of them—whether that attitude ever issues in intentional activity." See Pettit (1990), page 739.
- Pettit's argument is based on the motivation assumption that people are moved by a concern that others not think badly of them. For a more pessimistic assessment of informal sanction, see Heckathorn (1989). For a discussion of how overenforcement might arise from the interdependence of enforcement actions by private property owners, see de Meza and Gould (1992). For theories of ostracism, see Gruter and Masters (1986).
68. See Cooter, *supra* note 48.
69. Here is a strict definition of terms, using the density function $f(s)$ over willingness-to-pay to enforce the social norm:

$$E = 1 - \int_0^c f(s).$$

70. To be precise, an equilibrium is a pair of values (E^*, c^*) such that $E^* = E(c^*)$ and $c^* = c(E^*)$.
71. The stability conditions are as follows: (i) If $E(c)$ cuts $c(E)$ from below, then the equilibrium is stable; (ii) if $E(c)$ cuts $c(E)$ from above, then the equilibrium is unstable.
72. This possibility is discussed by Taylor (1987), page 145, and Casson (1991), page 83.
73. See Garland (1990).
74. For a fascinating collection of studies on public policy towards smoking, see Rabin and Sugarman (1993).
75. See Mueller (1989).
76. Olson (1993).
77. The "capture thesis." See Stigler (1975) and Kolko (1967).
78. The theory of legal transplants has been developed especially in Italy by the school of Sacco. As an example, see Hansmann and Mattei (1994).
79. See McChesney and Shughart (1995), and Baumol and Ordover (1985).
80. For example, the operator of an expensive machine may be paid more than his replacement cost to give him an incentive to be careful with the equipment. In general, see Akerlof and Yellen (1986).
81. Capital may have rigid labor requirements that were designed for a different wage structure. See the innovation possibility frontier as described in Solow (1969).
82. For example, a legal publisher has converted its editors into subcontractors, and a company that makes recreational vehicles obtains its labor, without having any employees, by contracting with another company that specializes in satisfying the labor laws.
83. Robert Merges provides many interesting examples in the field of intellectual property, such as "patent pools" (Merges, 1995).
84. Cite Teubner.
85. The information requirements of such standards has been discussed extensively. See Cooter (1984) and Shavell (1985).

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