Polycentric Law Versus Monopolized Law: Implications from International Trade for the Potential Success of Emerging Markets

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The emergence of market economies in parts of Eastern Europe, Asia, and elsewhere clearly is not occurring as rapidly as many domestic politicians and foreign observers would like. While Aexperts@ point to many factors, a growing number of political, economic, and legal consultants and academics recognize that the slow pace of development is a function of the institutional environment. In particular, the legal systems in these countries often do not effectively support private property rights or enforce contracts. Thus, many of these consultants and academics contend that states must step up their efforts to establish commercial law. In writing about law in the newly independent countries of the former Soviet Union, for instance, Ioffe (1996) maintains that Alegislative activities in the realm of civil law must now be comprehensive. Such a necessity results not only from the emergence of gaps in the law, but also from the restructuring of the former Soviet economy which requires new legal regulation,@ and later that AThe codification which will be implemented in the independent states must lead to the development of two codesCcivil and commercial. ...But the commercial code, not taken literally, must encompass all forms of economic activity, both in production and trade.@ Arguments such as these reflect the widespread belief that law must be monopolized in order to create a single centralized legal system within a large geographic jurisdiction. Landes and Posner (1979) put the case as clearly as any: Athere would appear to be tremendous economies of standardization in [law], akin to those that have given us standard dimensions for electrical sockets and railroad gauges. While many industries have achieved standardization without monopoly, it is unclear how the requisite standardization of commonality could be achieved in the [law] without a single source for [law]Cwithout, that is

to say, a monopoly.@ While there seems to be widespread agreement that law must be monopolized by the state, however, there is less consensus regarding the actual form and scope of such law. Proposals range from legislation of all-encompassing commercial codes (Ioffe), perhaps by copying the codes that exist elsewhere (Izdebski, 1996), to focusing on the Acore tasks of liberal governance@ such as protection of property rights along with clarification and uniform application of contract law (Dempsey and Lukas, 1998), to explicit state recognition and enforcement of existing international commercial norms (Boguslavskii, 1996). Recognition of the important role of international commercial norms suggests an alternative to reliance on the state, however. In reality, less state involvement in commercial law is called for at this stage of market development, not more (Rudden, 1996; McMillan and Woodruff, 1998; Pejovich, 1995, 1997; Benson 1998b, 1999), and this can be seen by considering the sources and institutions of the law of international commerce. Section II explains that the law that dominates international trade is a polycentric system of customary law that tends to minimize the role of state-made rules and state-backed institutions. In order to understand why, Section III explores some of the desirable characteristics of customary law while Section IV explains why international traders resist monopolized law. Section V turns to the question of how commercial law should emerge in emerging market economies in light of the points made in sections II through IV.

The polycentric customary law of international trade

Most international trade contracts have clauses that refer any dispute that cannot be resolved through negotiation (perhaps with the aid of a mediator) to arbitration (Berman and Dasser, 1990). Around eighty percent of these contracts had arbitration clauses at the time of Lew=s (1978) study, for example, and he suggests that over time, Amore and more [international traders]... turn to arbitration,.@ Lew=s prediction is correct, as several recent studies [e.g., Casella (1992)] find that more than 90 percent of all international trade contracts contained arbitration clauses in the early

1990s.[1] International arbitration is attractive for a number of procedural reasons,[2] but arbitration is also attractive because it provides a means of supporting the contracting party=s choice of legal jurisdiction. Böckstiegal (1984) points out that:

[1]Indeed, even though some state-owned enterprises are prevented by various state laws from accepting arbitration, most are forced by trading partners to agree to private arbitration if they want to enter into international contracts (Böckstiegal, 1984: 17-19). This was even true of enterprises from the countries of Eastern Europe under communism, for whom arbitration was the Aexclusive method of dispute settlement in business relations with other socialist countries and also the standard method in contracts with business partners in non-socialist countries@ (Böckstiegal, 1984: 15).

[2]Specialization by arbiters selected for their expertise and reputation (Ashenfelter 1987) means that arbitration typically is a faster, less formal, and less expensive procedure than litigation, in part because the parties do not have to provide as much information to the arbitrator to avoid an error in judgement as they would to a non-specialized judge or jury (Benson 1989, 1999a). Another benefit arises when court time is allocated by waiting, since delay often can be devastating to a business and arbitration services can be purchased in a market or provided by a trade association without such delay (Benson, 1989, 1995). Other potentially important procedural benefits include the facts that, if desired, privacy can be maintained (Bernstein, 1992), and that arbitration is generally less Aadversarial@ than litigation, si it is more likely to allow continuation of mutually-beneficial repeated-dealing relationships (Benson, 1989, 1995).

> When, in relation to arbitration, judges, arbitrators or authors speak of the >applicable law= they do not always mean the same thing. The term is sometimes used rather indifferently with regard to three separate questions: What is the applicable procedural law? What are the applicable conflict of law rules? What is the applicable substantive law? All three of these questions have their definitive relevance in any kind of international commercial arbitration.@

The choice of an arbitration institution involves a choice of procedural rules (Böckstiegal). A large number of international trade associations have their own conflict resolution procedures, using arbitrators with special expertise in trade matters of concern to association members [over three decades ago, for example, Lazarus, et al. (1965) discussed more than 120 such tribunals], but other sources of arbitration are also available. The International Chamber of Commerce=s (ICC) arbitration institution provides a substantial list of arbitrators with expertise in international commerce, for instance, as do nation-specific organizations around the world [e.g., The American Arbitration Association (AAA), the Hungarian Chamber of Commerce] which are eager to provide arbitrators for international trade disputes. *Ad hoc* arbitration is also widely used (Böckstiegal), and in this regard, there is a rapidly growing market in private dispute resolution services provided by for-profit firms, at least in the United States (Benson, 1990, 1998). Procedural rules vary across these institutions, some of which offer different procedures depending upon the wishes of the disputing parties.

A contract can also specify the substantive law and conflict-of-law rules under which any dispute should be resolved, perhaps by designating the contract law of the seat of arbitration or of some other national legal system. The Ausual way@ of determining the relevant substantive law for international commercial arbitration, however, is to decide cases Aexclusively on the interpretation of contracts and the relevance of trade usages so that very little depends on the question of the applicable [national] law@ (Böckstiegal). Lew=s detailed analysis of available records [also see Trakman (1983)

and Draetta, et al. (1992)] reveals that in principle, AThe answer to every dispute is to be found *prima facie* in the contract itself. What did the parties intend, what did they agree and what did they expect?@ When an arbitrator cannot discover the parties= intent in the contract, however, the focus turns to consideration of what the parties expected or should have expected, and in this regard, international arbitrators generally intentionally Adenationalize@ their awards, making them acceptable by showing their consistency with accepted traditional practices and usage (customary rules) of the relevant business community (Lew). Contracts might explicitly state that the practices and usages of a particular commercial community (e.g., a trade association, an informal group of traders who deal in the same products) should be applied, or this may simply be understood. Business custom provides the default rule, at any rate, as arbitrators apply the customary rules which are commonly recognized within the Aprivate international law systems from which the parties come@ (Lew), unless a particular nation=s substantive law has been specified in the contract.

Arbitration selection mechanisms actually vary widely, but they all are designed to guarantee the selection of an unbiased arbitrator or arbitration tribunal that will apply the law that the contracting parties have explicitly or implicitly (be default) chosen. For example, within some organizations a single arbitrator or panel is chosen for a set period to arbitrate all disputes between members. Thus, prescreening occurs as these arbitrators are chosen from a competitive pool by the association through its membership-approved selection process. For instance, in the diamond industry, arbitrators are elected from the organization=s membership (Bernstein, 1992). Those selected are likely to have considerable standing (reputation) within the community, and they have strong incentives to maintain their own reputation for fairness, so they are not likely to be biased or corruptible. Another selection alternative involves a preapproved list of professional arbitrators determined by the contracting parties or their trade organization, so if a dispute arises, an arbitrator is chosen from the list by some preset mechanism (e.g., random selection, rotating selection, selection by a third party

such as a governing board of the association). Empirical evidence indicates that selection of the preapproved list is based on the reputation of the arbitrators for impartiality and expertise in contractual matters that might arise (Ashenfelter, 1987; Bloom & Cavanagh, 1986). Another common selection system gives the parties to a dispute the resumes of an odd numbered list of arbitrators from a larger preselected group (e.g., preselected by a trade association, or provided by an organization like the ICC or the AAA), with each party having the power to successively veto names until one remains. Thus, a second level of screening is added to the time of the dispute, contributing Ato the legitimacy of the arbitrator and his award in the eyes of the parties@ (Bloom & Cavanagh, 1986). Since the parties are given the arbitrator=s resumes, they have information about experience, training, the nature of awards given in the past, and so on. A similar practice provides the parties with a list and resumes of an odd number of potential arbitrators from a preapproved list, with each disputant having the power to veto one less than half and rank the others, and the arbitrator who is not vetoed by either party and has the highest combined rank is chosen. Both sides of the dispute may also provide a list of a fixed number of arbitrators with each being able to veto any or all of the names on the other party=s list; if all names are vetoed, each provides another list and the process is repeated (clearly, this procedure requires that both parties want to arbitrate, so they do not continue to provide unacceptable names). All such systems are intended to guarantee the appointment of an arbitrator without requiring explicit agreement by the two parties while still allowing for prescreening, and possibly more than one level of screening, of the potential arbitrators. Biased rulings are not likely in such a competitive environment where potential arbitrators are chosen beforehand by the trading community (e.g., as in the diamond traders associations) or where both parties have the power to reject judges proposed by the other party. Furthermore, successful arbitrators will be those who consistently apply the customary rules that members of the relevant business community expect to be applied.

Customary law

A Acustomary law@ is an obligation that is widely recognized and accepted by the individuals in the affected group. The original source of widely accepted customs are often not known, but in all likelihood, they started as a convention or a contractual promise for some individual and then spread through the relevant community. Indeed, a key distinguishing characteristic or a customary rule is that it is initiated by an individual=s decision to behave in particular ways under particular circumstances. Adopting a behavioral pattern creates expectations on the part of others and accompanying obligations (Hayek, 1973). Then, as numerous individuals who interact with one another observe each others= behavioral patterns emulating those that appear desirable, such behavior and obligations spread (Mises, 1957). In other words, customary rules evolve spontaneously from the bottom up rather than being intentionally designed by a legislator, and they are voluntarily accepted rather than being imposed, even though no explicit statement declares their relevance. The result is analogous to a unanimity (or consensus) rule for collective decision-making. If some individuals choose not to adopt all of the rules, they will not be members of that customary community.

A unanimity requirement implies that a rule of obligation is not going to be adopted if some individuals expect that the rule will be biased against them, that it will fail to support decisions that enhance their chances for wealth production, or that generate greater personal costs than personal benefits. Indeed, customary law tends to be quite conservative in the sense that it guards against mistakes. Of course, unanimity could also mean that many unbiased rules that could generate positive net benefits are not adopted. The view that custom is static, or at least very slow to change, is widely held [e.g., see Landes & Posner (1979)]. It implies that customary law is an Ainefficient@ process for developing new rules in a dynamic environment. The fact is, however, that flexibility and change often characterize customary law systems (Trakman, 1983; Berman, 1983; Benson, 1988b, 1998c, 1998d). The mistaken perception that customary law is slow to change may arise from the belief that there is only one mechanism for initiating change: an individual must begin behaving in a particular way under certain circumstances, others must observe the behavior, come to expect it, and then adopt similar

behavior under similar circumstances, ultimately creating similar obligations for everyone in the community. Certainly, this process can be a very important mechanism for creating new custom [it has characterized the transmission of commercial customs among expanding networks of traders, for instance (Trakman, 1983; Bewes, 1923; Benson, 1989, 1998c, 1998d)]. However, there also are faster mechanisms for initiating change in customary law.

If conditions change and a set of individuals decide that, for their purposes, behavior that was attractive in the past has ceased to be useful, they can voluntarily devise a new contract stipulating any behavior that they wish. Through negotiation and contracting, existing custom can be quickly replaced by a new rule of obligation toward certain other individuals without prior consent of or simultaneous recognition by everyone in the group. Individuals entering into contracts with these parties are informed of the contractual innovation, and/or others outside the contract observe the results of a new contractual stipulation, so if it provides a more desirable behavior rule than other customs, it can be rapidly emulated. Many contracts spread quickly as Astandard forms@ throughout the relevant community (Rubin, 1995). Contracting may actually be the most important source of new rules in a dynamic system of customary law (Fuller, 1981), and many innovations in commercial law have been initiated in contracts before quickly spreading through the relevant merchant community [e.g., see Berman (1983), Benson, (1989, 1998c, 1998d), Draetta, et al. (1992)].

Alternatively, as conditions change, the inadequacy of existing customary rules can be revealed when a dispute arises. Negotiation is probably the primary means of dispute resolution for members of a close-knit customary law community, reinforcing the contention that contracting is a primary mechanism for initiating rapid change in customary law. If direct negotiation (perhaps facilitated by a mediator) fails, however, the parties to a dispute within a customary enterprise of law often turn to a third party for arbitration. This is clearly the case within modern international commercial communities, as noted above, but it is also true for primitive societies (Benson, 1988b, 1991), and for many domestic commercial communities (Bernstein, 1992; Benson, 1995). Since a dispute

suggests that existing rules are unclear or insufficient, new customary rules can be, and often are, initiated as arbitrators resolve the disputes (Fuller, 1981; Lew, 1978; Benson, 1988b, 1989, 1998c, 1998d). Unlike public court precedent, such dispute resolutions only apply to the parties in the dispute, of course, but if the resolution suggests a rule that appears to be more effective at facilitating interactions than previously existing customary rules have been, the rule can spread rapidly through the community. In fact, as Lew (1978) observes, AOwing no allegiance to any sovereign State, international commercial arbitration has a special responsibility to develop and apply the law of international trade.@

A potential contradiction to the contentions that contrasts and/or arbitration can be a source of new substantive rules is the frequently made claim that in order to induce compliance with arbitration clauses in contracts and/or acceptance of arbitration rulings by the loser the other party must be willing and able to seek enforcement by some coercive power. For example, Lazarus, et al. (1965), Landes & Posner (1979), and Shavell (1995) are among many who suggest that domestic arbitration in the United States must be backed by a threat to litigate. If litigation provides the relevant threat then, the potential for creating new rules through contract and/or arbitration, and indeed, arbitration=s potential as a jurisdictional choice, may be undermined even if judges never directly interpret most of the rules that are applied. After all, a credible threat to litigate requires that contractual clauses and arbitration rulings will be acceptable to judges, and therefore, they will have to correspond, at least to a degree, with expectations about how they will be viewed under judicial review. A similar claim is made by some who see sanctions under the 1958 New York Convention on the Recognition and Enforcement of Arbitral Awards and other similar international agreements between states to recognize and enforce arbitration rulings (e.g., the 1961 European Convention on International Commercial Arbitration) as the major reason for widespread acceptance of arbitration [e.g., Butler (1996)]. These claims are not correct, however, because Anonlegal sanction@ (Charny, 1990) can induce the members of a Acommunity of transactors@ to live up to contractual obligations and accept arbitration.

Repeated dealings create an environment conducive to the development of trust, for instance, and incentives to employ cooperative strategies. In addition, each individual enters into several different dealings with different trading partners, so refusal to live up to an obligation or to arbitrate within one transaction can affect the person=s reputation and limit his ability to enter into other transactions. Essentially, anyone who chooses a non-cooperative strategy in one transaction will have difficulty finding a partner for any future transactions (Tullock, 1985). Therefore, in order to maintain a reputation for dealing under recognized rules of behavior (i.e., for fair and ethical dealings, including amicable acceptance of Afair@ non-violent dispute resolution), each transactor=s dominant strategy is likely to be to cooperate in each transaction, whether it is a repeated or a one-shot deal.

Both commitments and reputation threats can also be made more credible, in many instances, if a group of individuals with mutual interests in long-term interaction form a Acontractual@ organization such as trade association. Such a group can provide a formal mechanism to overcome frictions in communication, insuring that information about any individual=s non-cooperative behavior will be transmitted to others in the relevant business community (Rubin, 1994). Then group membership can include a promise to arbitrate or accept an arbitration ruling: specifically any noncooperative party will be automatically expelled from the organization (Rubin, 1994). Such automatic ostracism penalties make the reputation threat much more credible (Williamson, 1991). These groups can also lower the transactions costs by establishing their own unbiased arbitration arrangements (Bernstein, 1992; Benson, 1995, 1998a).

Now return to the issue of economies of standardization raised by Landes & Posner (1979). Perhaps a customary legal system will be too small to achieve the optimal size and scope for a particular set of rules. Thus, a state or group of states may be desirable to expand the legal system. Many observers consider the polycentric system of international commercial law with it reliance on custom rather than legislation to be troubling. Drobnig (1996) finds it

Aamazing,@ for instance, that Athe EEC Treaty did not, and does not, envisage any positive action with a view to unify or at least harmonize commercial law.@ In this regard, note first that any legal system that is larger than that which would spontaneously evolve through individual interaction will, by definition, require some concentration of coercive power in a centralized authority (customary law may require institutions to impose sanctions, too, as noted above but they do not have to be applied by a centralized authority with coercive power). Such power might be used to simply extend the scope of basic customary rules, perhaps by unconditionally enforcing arbitration agreements (but as explained below, it is also likely to be used to alter at least some of those rules to produce wealth transfers, thereby offsetting many if not all of the gains from an expanded legal system). In fact, however, it took privately produced and adjudicated customary commercial law to overcome the limitations of political boundaries and localized protectionism during the medieval period, thus paving the way for the commercial revolution and development of international trade (Benson, 1989, 1998d). In other words, where the Atremendous economies of standardization in law@ that Landes and Posner allude to exist, a customary system is likely to be better able to take advantage of them. Territorial governments typically cannot because of the artificial constraints of geographic boundaries (a customary legal system=s jurisdiction may reflect a functionally defined Acommunity@ rather than a geographically defined one, after all). Indeed, there is absolutely no reason to believe that any particular national government is of the ideal size to take full advantage of the economies of standardization in law. However, since customary law can be geographically extensive and functionally decentralized (i.e., specialized), in contrast to the law of geographically defined states which tends to be functionally centralized and geographically constrained, customary law can have different sized jurisdictions for different functions. In some areas of law, economies of standardization may be considerably more limited than any state, so existing political entities are too large geographically [e.g., this applies for many aspects of criminal law (Benson, 1998e) or functionally [e.g., many aspects of domestic commerce may be most effectively governed by diverse trade associations rather than by the state]. In

other areas of law, such as international commerce, some of these economies appear to be greater in geographic scope than any existing nation can encompass, although many also are narrower in functional scope, as international trade associations may be the most efficient source of rules and governance for many groups of traders. A customary system of polycentric law would appear to be much more likely to generate efficient-sized Ageographic market areas@ (jurisdictions) for the various functionally defined legal communities involvedCperhaps many smaller than most nations, with others encompassing many of today=s political jurisdictions (e.g., as international commercial law does today). The existence of economies of standardization really provides an argument against state provision of adjudication and law then, in order to break away from the inefficient artificial political restrictions that exist. Furthermore, the relatively limited jurisdictions of some customary communities are not as constraining as they might appear to be. Individuals often are members of several different communities, so being outside one community does not preclude dealing with people in it on some dimensions. A person may belong to a trade association, a homeowners association, a religious group, a fraternal organization, and so on, for instance, each with its own rules and governance institutions. The membership of all of these communities can differ, although considerable overlap may also occur, so individuals may deal with other individuals on some dimensions but not on all dimensions.

Why is Monopolized law undesirable?

If the problems associated with limited political jurisdictions could be overcome, perhaps with large nations like the United States or with the creation of regional (e.g., the European Union) or worldwide (e.g., the World Trade Organization) cartels of states, then a monocentric legal system might appear to be desirable. After all, rules could be Aharmonized@ and Aunified@ (Drobnig) and duplication of services (e.g., courts) might be reduced. There are at least three reasons for merchant resistance to such monopolized law, however. First, the wide variety of activities and relationships that exist in a modern world mean that many rules that are effective for

one type of transaction or one group may not be effective for another. Consider the diamond traders discussed by Bernstein and the oil traders discussed by Trakman, for instance. The products being traded within these commercial communities are very different, suggesting that very different contractual issues are likely to be relevant, but the trading communities are also very different. Diamond merchants share common ethnic and religious backgrounds, creating an environment of mutual understanding (e.g., of common trade practices and usage) and trust, for instance, thus reducing the need for highly technical and specific contracts, while oil traders display much greater ethnic and religious diversity as well as differences in motivations (a number of oil states have nationalized production so political considerations can have major impacts of decision-making), possibly reducing the level of common understanding and undermining trust relationships, thus dictating much more specific and complex contracts. These two commercial groups are likely to share many of the same rules but there are also likely to be some important differences in traditions and practices. Indeed, imposition of the diamond merchants= contractual rules and governance institutions on the oil traders would probably lead to higher transactions costs for these traders, including more contract disputes, while imposition of the oil traders on the diamond merchants probably would add unnecessary complexity and costs to their contracting process. Combining all of the rules from each group under a monopolized legal system would create unnecessary complexity for both communities of traders. Nationalized legal systems tend to produce homogenized although very complex law that limits the potential for specialization, and the development of international economic and political Ablocks@ made up of several nations implies an increasing likelihood of even more centralized and homogenized state-backed commercial law. But as Cooter (1994) explains, more decentralized lawmaking is actually desirable in the increasingly complex international economy. In other words, one reason for avoiding monopolization of law is that economies of standardization are not nearly as significant as some contend, and they are probably shrinking, while the benefits of specialization are relatively large and growing.

A second but closely related point is that a monopoly in law will have undesirable results in a dynamic uncertain world. For instance, given the potential for Abad@ rules (e.g., biased or transactions-cost-increasing rules) to be produced and maintained no matter what size the legal system is, the effects of such laws are less severe in a decentralized or polycentric system of legal jurisdictions. As Osterfield notes (1989), in the case of a Agood@ rule, it often does not matter how extensive the legal system is, as good rules tend to be emulated, especially if there is competition for members and freedom to choose among jurisdictions. In the case of a bad rule, however, the extent of the legal system clearly matters, particularly if there are institutional factors that make elimination of such rules difficult. Furthermore, in the absence of alternatives, it may not be possible to evaluate the Agoodness@ or Abadness@ of a rule. A rule imposed in an over-arching legal system may produce undesirable, unintended consequences that another rule would not produce, but this may not be recognized. On the other hand, as individuals in parallel legal systems experiment with alternatives, the relative impacts of different rules can be observed and more effectively evaluated. Judges in the common law system, with its numerous jurisdictions (e.g., 49 of the 50 U.S. statesCLouisiana has a civil law systemCplus the federal common law, along with the jurisdictions of Great Britain, Canada, Australia and other former British Colonies) have clearly looked to evolving rules in other jurisdictions, for example, and many rules have spread from jurisdiction to jurisdiction while others that are tried in some jurisdictions are rejected by others. Centralization of law, perhaps through legislation or a single hierarchical court system, eliminates the benefits that arise from such experimentation, and in this regard, customary law can be a very important source of the rules adopted by national legal systems. Indeed, much of the commercial law that has been codified or recognized as precedent in national legal systems actually derives from custom (Bewes; Berman, 1983; Benson, 1998c). Today, however, traders generally assume that national courts will not enforce obligations derived solely from contracts and custom (Chen, 1992), choosing instead to apply the nation=s politically-motivated statute or precedent law where a conflict with custom arises.

This brings us to the third and probably most significant reason for avoiding monopolization of commercial law. Coase (1960) emphasizes that one motivation for creating rules is to eliminate externalities and facilitate voluntary interaction, but he also explains that rules and institutions determine the distribution of bargaining power and therefore the distribution of wealth. While he did not focus on this issue, these distributional consequences also create incentives to make and alter rules, as emphasized in the rent-seeking literature that has evolved from Tullock=s insights. In fact, the politicized Alaw@ of nation states almost always reflects the conflicting efforts to achieve both objectives (Benson forthcoming 1999a). Unlike voluntary joint production and exchange which tends to increase wealth, involuntary wealth transfers through enforcement of legislated rules within a monopolized legal jurisdiction, whether the rules are established by kings, dictators, Arepresentative@ parliaments, or courts, tend to reduce wealth for at least four reasons. First, transfers (e.g., through a tax and/or subsidy, through trade barriers and other limits on competition such as licenses and exclusive franchises, and through other similar discriminatory Alegal@ actions) produce deadweight losses. Second, while many observers suggest that these deadweight losses are small and that institutions should evolve to minimize them [e.g., Becker (1983)], Tullock explains that the resources consumed in the competition for such transfers also have opportunity costs. Individuals and groups have incentives to invest time and resources in an effort to gain wealth through the political process, and victims of the transfer process have incentives to defend their property rights. Part of these defense costs are rent-avoidance costs arising through investments in political information and influence, but exit is another option. Exit can be achieved by moving to an alternative political jurisdiction, or by hiding economic activity and wealth (e.g., moving transactions Aunderground@ into black markets). Therefore, in order to induce compliance with discriminatory transfer rules, the rule makers will generally have to rely on an enforcement bureaucracy, both to prevent exit (e.g., establish a monopoly in law) and to execute the rules. These enforcement costs are a third source of opportunity costs that accompany a wealth transfer process. Rules that facilitate

voluntary production and exchange (e.g., private property rights) also require some enforcement costs, of course, but the level of these costs increases dramatically when laws are also imposed in order to generate involuntary wealth transfers. The fourth source of costs may be the most significant, however. Faced with the probability of involuntary transfers, productive individuals= property rights to their resources, wealth, and income flow are perceived to be relatively insecure, so their incentives to invest in maintenance of and improvements to their assets, and their incentives to earn income and produce new wealth that might be appropriated, are relatively weak. If transfers are expected to be large, frequent, and arbitrary, most wealth production actually may have to be motivated by threats (e.g., as under slavery or totalitarian socialism), making enforcement costs even higher. Such threats are imperfect, however, so production will be low and wealth expansion will be slow compared to a situation wherein property rights are relatively secure.

Perhaps a monopoly in law will not necessarily produce biased rules for the purpose of transferring wealth, but a necessary prerequisite for such law is strong barriers to exit for those who expect to lose wealth through transfers. Interjurisdictional competition can occur between legal systems attempting to monopolize lawmaking and enforcement, and to the degree that wealth can escape one to move to another, the potential for using law as a transfer mechanism is limited. This is another obvious benefit of interjurisdictional competition, and importantly, there is another source of competition as well: customary law can be produced and supported by institutions which are not attempting to monopolize law, and these legal systems offer an alternative to escape the jurisdictions of those who seek such monopolies.[3] Indeed, resistance

[3]In law, as in markets, competition is an important determinant of the outcome. Indeed, the benefits of competition go beyond the enhanced abilities to evaluate and choose among rules. Competition actually stimulates legal innovation and sophistication, as Berman (1983: 10) explains:

> It is this plurality of jurisdictions and legal systems that makes the supremacy of law both necessary and possible.... The very complexity of a common legal order containing diverse legal systems contributes to legal sophistication. Which court has jurisdiction? Which law is applicable? How are legal differences to be reconciled? Behind the technical questions lay important

to efforts to transfer wealth is likely to be most effective where the benefits generated through voluntary interaction are very large (so the costs of submission are large) and/or the relevant group member=s wealth is mobile so they can interact across the jurisdictions of different authorities and inter-jurisdictional competition to attract that wealth that occurs, and the international merchant communities of modern trade discussed above are examples of such groups. Customary commercial law provides the mechanism for avoiding the politicized law of nation states, and the choice of customary commercial law=s jurisdiction is becoming increasingly important during the twentieth century, in part for the reasons suggested here. As Lew (1978) emphasizes, international businessmen are increasingly uncertain about politicized national courts= impartiality and abilities to appropriately resolve disputes with a domestic trader. Gardner (1958) makes the same point, explaining that international traders avoid nationalized legal systems, in part because these legal systems are frequently less concerned with fairness and justice than with political power. These concerns do not arise with customary law.

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political and economic considerations.... The pluralism of ... law, has been ... a source of development, or growthClegal growth as well as political and economic growth.

Domestic merchants are also likely to have incentives to choose the jurisdiction of customary law if a nation=s law is expected to be biased or to apply rules that are relatively costly to employ. Thus, arbitration is a major source of dispute resolution within many domestic commerce countries [e.g., see Bernstein; Benson (1995)]. Domestic commercial activities may be less likely to be able to avoid the application of a nation=s law, however. Indeed, the state is frequently called upon to establish and enforce rules having to do with domestic economic activity, and often by the same merchants who are able to enforce their own rules in international trade and within their domestic trade associations. This political influence is not surprising, both because domestic merchants might be targets for wealth transfers that they hope to avoid, and because members of the merchant community also have incentives to seek wealth transfers. Not surprisingly, merchants have actively sought and willingly accepted wealth transfers within political jurisdictions. Domestically, medieval mercantilism was a system dominated by merchants dealing with kings to restrict competition in favor of domestic monopolies and guilds, and that system has a firm hold within many twentieth century economies (de Soto, 1989). After all, political rule makers have strong incentives to create mechanisms through which various business communities= political interests can be determined and facilitated. By granting selected merchants special privileges (i.e., transferring wealth to the merchants) in exchange for their willingness to invest within the political jurisdiction, rents arise as wealth is produced by relatively immobile resources that are inputs to or complements of the merchants= enterprises, and those can be appropriated by the merchants and others who have sufficient political power, including many who are employed within the state=s governing institutions.

Government efforts to influence and control commerce tend to undermine the development or maintenance of customary law institutions. When property rights are insecure due to the potential arbitrary and/or opportunistic behavior by government (e.g., changes in tax policy to capture the quasi-rents that arise with investments in reputation, changes in commercial regulations to favor some groups over others), incentives to invest in reputation or to count on future

dealings are weak and the kinds of private sanctions discussed above are likely to be relatively weak. Thus, the ability to develop and then choose a customary law jurisdiction may be relatively weak [the large Ainformal@ sector that develops in such economies typically establishes and enforces its own rules (de Soto, 1989), but the economic activities within this sector are clearly limited relative to what it would be if the state was not a threat to the wealth that is generated]. As Pejovich (1995) notes, AThe arbitrary state undermines the stability and credibility of institutions, reduces their ability to predict the behavior of interacting individuals, raises the cost of activities that have long-run consequences, and creates conflicts with the prevailing informal [customary] rules... [M]ost countries in Eastern Europe are arbitrary states.@ Such politicization of commercial law can have devastating effects on emerging economies where repeated dealing arrangements and reputations are young and fragile.

Conclusions: emerging law in emerging market economies

Even if the national governments with influence over the Eastern-European, Asian, Latin-American, and African emerging markets were exclusively focused on making and enforcing rules that would facilitate the development of market economies (rather than on wealth transfer issues and rent extraction), it does not follow that they would be the best source of those rules and governance institutions. For one thing, these states are probably not capable of doing the things that various commentators suggest that they should do. After all, legislators, bureaucrats, and judges in places like Russia, Poland, Ukraine, Belarus, Vietnam, China, and so on, are even less likely to understand the important underpinnings of a successful market system well enough to provide effective support for them than Western European and North American judges, bureaucrats, and politicians who frequently seem to make decisions that undermine rather than support market processes (Pejovich ,1997). More fundamentally, as Feldbrugge (1996) notes, the fact is that the beliefs and/or objectives of those in authority in many of these economies are generally not compatible with the kinds of changes that would have to be made in state law to effectively support a strong market

economy. Feldbrugge suggests, for instance, that the Ainstincts of the leaders@ are that they can guide the development of a market economy. Similarly, Simons (1996), in discussing corporate law in Russia, notes that Athe system is changed but state control is not,@ in part because of Athe mere tradition of state control (especially as concerned the foreign, non-state sector in the Soviet Union).@

Similar impediments exist when it comes to emulation of international customary rules. Ginsburgs (1996) points out, for example, that in Russia, Athe will and desire to harmonize international law and national law certainly seemed to be there now, but the blueprints for the machinery to fit the pieces together into a coherent whole continued to languish on a welter of drawing-boards.@ Furthermore, he notes that the selection of international norms that the Russian constitutional Committee is likely to adopt is biased by the persistent beliefs among Russian leaders that the state must be the source of rules that facilitate the transition to a market economy. In this context, that belief results in a focus on those international norms which have been recognized in formal treaties and agreements between states. As Ginsburgs explains: Athe habit evinced in this genre of instructions of zeroing in on the treaties (agreements) to which the Russian Federation is a party has attracted valid criticism on the grounds that it would be more correct here to talk about international law as a whole inasmuch as customary norms, too, might be relevant in this context.@ Similarly, in Russian courts, the Astandard tendency ... to treat international customs as something >tertiary,= to be consulted only where national and international normative acts supply no answer to the question brought up before the court@ (Ginsburgs).

When the state is expected to produce law, of course, the resulting law inevitably has conflicting objectives, as explained above. Certainly, law makers in several Eastern European and Asian countries are under considerable pressure to create an environment conducive to market activity, but they are also under pressure to do many other things. As a consequence, Rudden (1996) sees a Atendency to constitutionalize the civil law, that is to insist that its ordering of private legal relations comply with certain public virtues@ in Russia, for instance, and Hazard (1996) notes that AContinuing debate within

the Congress of Deputies of the Russian Republic suggests that there ... remain ideological restraints in civil law, although it cannot be determined what their origin really isCsocialist or primordial?@ Indeed, a Ajungle of state control@ still exists there, Aparading under the banners of reform or democracy@ (Simons, 1996). Ideology regarding Apublic virtue@ may explain the volution of law in these situations, of course, but most of the issues being debated have to do with the distribution of wealth, and rent seeking to influence that distribution is often motivated by self-interest.[4]

[4]For instance, organized crime in Eastern Europe actually traces back to the communist era when widespread underground markets developed, often to supply government officials with consumer goods and services, since they were among the few who could command the financial resources to purchase such goods. The end of the totalitarian regimes did not bring an end to organized crime, however, or to government ties to it, because of the strong controls that the government attempts to maintain over economic activities. Much of organized crime in Russia and the other newly independent states is not involved in the drug, prostitution, or gambling markets that are the primary focus of such groups in the United States and Western Europe. Instead, many Amafia@ are serving as middlemen to facilitate the illegal sale by bureaucrats of state-owned enterprises and resources, and another major function is to coordinate the payment of bribes by businesses in their efforts to expedite the regulatory process which involves Aa daunting array of license, permit, and fee requirements on normal business activity@ (Dempsey and Lukas, 1998). After all, a vast array of complex rules enforced by bureaucrats with a great deal of discretionary power also creates an environment that can be very lucrative for public officials who are willing to accept bribes (Benson, 1988a, 1990). The still substantial import/export procedures and high taxes also stimulate a tremendous amount of smuggling and black-market trade in all kinds of consumer goods, and bribery of police, customs officials, and probably judges, supports these activities.

Reliance on the state for rules and/or legal sanctions at this early stage also means that the future evolution of commercial law will be along a very different path than the one taken in the economies of Western Europe and North America. After all, if we look to Western Europe and North America for models of how market economies emerge, then we must recognize that markets were well established and governed by customary law long before the states got involved in the making and enforcing of rules of commerce, and that even when the states did become active, they generally started by recognizing established custom (Bewes, 1923; Benson, 1989, 1998d). Furthermore, in many places the institutions of customary law (merchant courts, arbitration) have survived as an ongoing source of competition for the state, helping to constrain its activities. As Feldbrugge (1996) emphasizes, of course, Athe construction of a totalitarian system entailed the systematic destruction of the civil society and the free market system,@ so the emerging markets of formerly-communist Eastern Europe and still-communist Asia are not able to start with the types of trade associations and other private organizations that have provided the foundation for customary commercial law in the U.S. and in much of Western Europe. Western Europe did not have them either, however, until they became desirable (Benson, 1989, 1998d). The evolution of the private institutions of commercial law and of market institutions themselves has always been simultaneous rather than sequential (Benson, 1989). As the conditions of commerce change, customary rules and governance institutions evolve, and this in turn leads to more commercial developments and more legal evolution. And in this regard, it is not surprising to find that informal and even formal groups of trading partners are developing quite rapidly in places like Poland, Hungary, the Czech Republic, and even Vietnam (Pejovich, 1995, McMillan and Woodruff, 1998), much as they did in North America during the colonial period and western expansion when the state was unable to provide protection for property rights and unwilling to enforce contracts (Benson, 1995). Repeated dealings and reputation effects are being used to support trade among the members of these groups, although during the early stages of their formation they may not develop arbitration arrangements, relying instead on negotiation and threatened sanctions

to resolve disputes (McMillan and Woodruff, 1998). Arbitration is also developing in some of these emerging economies, however [e.g., Jankovich (1996)], and the fact is that it takes time for the private institutions to evolve. If viable growing markets are going to be established and sustained in these emerging economies, such developments must be allowed to continue. Thus, the states in these parts of the world simply must shrink as Amany of its functions are to be taken over by persons, human and corporate, of private law, and it will go hard with them if they are not permitted in good faith to set aside the application of the standard legal patterns@ (Rudden, 1994). The withdrawal of the state from any efforts to influence commerce is likely to do more to stimulate commercial activity than any proactive (but inevitably politicized) efforts by the state to speed up the process. Laissez faire appears to be the best policy for emerging economies in the area of arbitration and contract law enforcement as well as in economic policy itself (Benson, 1998b, 1999, forthcoming 1999b).

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