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The Unseen Elephant: What Blocks Judicial System Improvement?

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Abstract

The contribution of judicial system performance to economic development has been actively probed in recent years. Yet efforts to improve judicial systems have faltered. This paper offers an explanation. It proposes that transacting within social networks has provided a seemingly workable substitute for reliance on judicial systems in Brazil and many countries. This prompts public indifference to judicial system improvement. At the same time, where social network transacting is widespread and dominant, it presents numerous obstacles to economic development. Transactions costs economics provides tools for better understanding the characteristics, costs and extent of social network transacting. Relatively low costs are found for intra-network transacting, but trans-network transacting suffers. Constraints inherent in both social network transacting and in judicial dysfunction are reviewed for their negative impacts on both domestic activity and regional integration. Selected transactions costs economics literature is reviewed for a closer look at firm size and corporate governance in the context of countries like Brazil where judicial system dysfunction is found and where social network transacting is prominent. A recently completed project inside the 400 state courthouses of the São Paulo regional tribunal is reported. It shows how close attention to administrative details can significantly improve judicial system performance. The paper mixes real world observation with theoretical insights. It suggests that current explanations for sluggish economic development would be better served by increased awareness of social network transacting. It suggests that research within courthouses at a deeper level of detail will advance understanding of the negative consequences of judicial system dysfunction on specific aspects of economic development.

The Unseen Elephant: What Blocks Judicial System Improvement?

Robert M. Sherwood*

While judicial systems are visibly present in most countries, those that work reasonably well are found in relatively few. The social and economic development consequences thought to stem from good judicial system performance have received considerable thought and attention over recent decades. Rule of Law advocates have predicted development benefits will be gained from upgrading legal and judicial systems in developing and transition countries.¹ Certainly, considerable effort has been put into judicial system improvement since the 1980s when the World Bank and Inter-American Development Bank took first steps in this direction. Yet progress has been distinctly limited. Their efforts, and those of many others, to upgrade judicial system performance in numerous countries have encountered significant difficulty.

This paper identifies and delineates a major cause of that difficulty. It examines a widespread institution that has existed since pre-history in most societies. This is the informal, yet sophisticated institution that substitutes for a well-functioning judicial system. It is the intricate activity of creating and maintaining social networks of many kinds and then transacting within them, relying on social pressure instead of judicial discipline to protect individual interests willingly put at risk within this setting. For convenience, the term social network transacting (SNT) is adopted here to identify this institution.²

In many countries, the institution of social network transacting has served reasonably well as a judicial system substitute. Transacting of many kinds is conducted at relatively low cost. However, this institution appears to have two substantial negative effects. First, precisely because it seems to work well, it renders people largely indifferent to judicial system improvement. Second, this judicial system substitute constrains economic development in numerous ways, many of them little recognized in these societies.

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¹ Carothers, Thomas, 2006, *Promoting the Rule of Law Abroad*, Carnegie Endowment for International Peace, Washington, D.C. Although Carothers is himself skeptical, his book reports representative views from the rule of law community. See also Voigt (2007).

² For background, see Cao (2006 and 1998). In both he shows awareness of transacting within social networks, noting that they exist, but without explaining why or considering their economic and judicial system consequences. Shor (2006) recognizes impediments to implementing “rule of law” but directs attention to political causes.

The new institutional economics is widely applauded for its focus on the ways transacting is done and on their attendant costs. Thus far, its promise for unlocking the gates to improved economic performance in developing and transition countries has been only partially fulfilled. This paper seeks to advance toward that promise by, first, considering the characteristics and extent of social network transacting, and then by enumerating the many constraints imposed on economic activity by SNT. Next, the paper examines more deeply several of these constraints through a literature review of transactions costs analysis. The closing section reports recent research within the judicial system of the state Regional Tribunal of São Paulo, Brazil, to illustrate some of the opportunities and difficulties encountered by judicial system reform efforts.

Transacting Without Effective Judicial Systems: The Characteristics and Extent of Social Network Transacting

Earth's earliest people lived in small, scattered clusters, perhaps in a valley or on a large hill, usually near a source of water. Some lived in relative peace, while many resorted to violence. Some migrated with the seasons, while others held fixed habitations. These early people had no formal judicial system. Still, they learned to conduct some limited, rudimentary business and settle disputes among themselves. They would do little beyond what they could arrange within their tiny social settings.

Transacting probably expanded as social networks grew larger. Several villages in the same valley formed a social network, perhaps through marriages or through a common endeavor, such as building a bridge or fighting intruders. The risk of doing business outside the social network was still too great to consider, however, and commerce did not flourish. In fact, throughout history most communities have found ways to do business and settle disputes, but largely by confining transactions within their social group or network.

Over time, as sophistication increased, two characteristics became central to transacting within social groupings or networks. One is the distinction between "friend" and "stranger". The other is the importance of rough social equality among those known to each other. The first distinction is captured in the Brazilian saying:

"for my friends, anything;
for strangers, nothing;
for my enemies, the law".

The widespread aversion to entering the courts, tersely sketched in this pithy saying, is deeply embedded in public discourse. Jokes and numerous horror stories about unimaginable delays and erratic outcomes repeatedly affirm the common perception that staying out of the courts is vital to economic and social wellbeing.

The term "friend" needs interpretation for those living in countries where the judicial system functions well. In SNT-based societies, "friend" does not necessarily mean a close personal acquaintance, someone whom we enjoy, someone with whom we want to spend time. Rather, it means someone who is known to a set of people who also know me. Under this view, a "stranger" is one who will not be subject to the discipline

inherent in a social network membership. Such a person may even be known to me but is nonetheless ineligible as a candidate for transacting.

Because social networks are so important, people work hard to develop such ties and maintain themselves in good standing. Social networks can be based on such things as blood relationship or relationship through marriage, ethnic identity, proximate land holding, old school ties, long-term residence in a neighborhood or village, professional collegiality, clubs of various kinds, secret societies, the local pub, sports teams, craft guilds, and so forth. Often several of these ties will interweave to form the fabric for transacting. Although many of these types of networks are present in most societies, they take on a significant added utility in those countries where judicial systems function badly. They provide the primary infrastructure for a good deal of transacting.

Rough social equality within any given social network emerges as the other important characteristic for transacting within social networks. It would be unwise to transact within a social network where some members have social power (a fuzzy, but discernable notion) significantly superior to others in the network.³ Otherwise, if a dispute erupts, the pressure to “work things out” will not be evenly applied and such “justice” as is found within an SNT system will not be available. Thus, people are wary of transacting within networks lacking in rough social equality. In fact, they will tend to shun such networks in the first place. It may be that the cast system in India provides an ancient, ossified example of this.

The ingredient that permits transacting without effective judicial system discipline is not trust. Rather, it is the equivalent of trust. Nor is transacting within social networks a matter of reputation, at least not *ex ante*. Roughly speaking, willingness to transact springs from awareness that failure to work out a business disagreement with another member of one’s social network risks ostracism from that group. This threat of ostracism is so severe that people avoid even approaching open disagreement. There is a strong incentive to “work things out” before a deal breaking dispute can arise. Although this concept of socially imposed discipline is variable at the edges, it nonetheless produces sufficient “lubricant” so that in numerous countries and societies many types of transactions can be undertaken notwithstanding the absence of an effective judicial system.⁴

Dispute resolution in the context of social network transacting exhibits several characteristics. Since the penalty for failure to resolve a dispute can be something approaching economic death by social ostracism, people work hard to resolve such disputes as do arise, or to avoid disputes in the first place. If disputes do arise which the

³ Something of this is noted in Kozolchik (2006) at page 5 in his mention of developments in Costa Rica.

⁴ Nor is social network transacting the same as Hernando DeSoto’s “informal sector”, although the two concepts overlap somewhat. DeSoto (1989) has famously urged creation of legal rights of various kinds, but without addressing the issue of whether there is in place a judicial system capable of supporting those rights. See Kozolchik (2006).

parties themselves are unable to resolve, a wise elder or prominent member of that particular social network may be invited to assist in fashioning a resolution. It may be relevant to note that reference to customary law has been a motif in the legal systems of many countries with weak judicial system performance. This may have been, at least in part, an effort to recognize practices, conventions and habits that have guided social network transacting.

Recent research in Brazil identified extensive reliance on social network transacting in leasing rural land.⁵ In many instances, formal documents were prepared but then not recorded. Instead, they were “put in the drawer” for possible later use but only if other means for contract enforcement by either party failed. This research showed transactions were entered on the strength of a handshake in the context of a social network.

The extent to which social network transacting pervades an economy appears difficult to measure, given a paucity of data for direct measurement.⁶ In the case of rural land leasing, for example, little data is generated by handshakes. Still it can be presumed that in countries where the judicial system functions poorly, all people, whatever their social position, will resort to transacting as much as possible within a social network appropriate to their position and to the nature of the intended transaction. This not a game played only by powerful elite groups. Where the courts work badly, they work badly for everyone, so everyone must rely on some sort of social network if they are to transact.

To estimate the extent of social network transacting in an economy, certain transactions would be subtracted from the total economy. Spot transactions, “capture” deals (pay the phone company or get disconnected), credit card purchases, and similar types of dealing are not induced by the availability of a well-functioning judicial system. Still, the influence of social network transacting within an economy is probably significant and might approach half of a nation’s economic activity where courts are dysfunctional.

Transactions Costs *within* Social Networks

If transactions costs analysis were comprehensively applied to social network transacting, the costs of transacting would, at first glance, no doubt be found low. Lawyers are not involved, either in pre-deal negotiation and contract drafting or in litigation when disputes arise. The legal costs of corporate law and securities law compliance are largely absent. Employment arrangements tend to be done off the record through social connections to bypass labor law complications. Business managers are spared the considerable time that judicial issues can consume.

⁵ Zylbersztajn, Decio, University of São Paulo, forthcoming.

⁶ A previous exploration of this question reached no conclusion. See, Sherwood 2004.

However, there is an offsetting and little noticed cost. It centers on the time and expense that must be devoted to entering and maintaining participation in social networks. This includes business managers who act on behalf of their companies. People tend to actively participate in at least a few networks, ranging from extended family relationships to business groups, clubs and other types of relations. For some people, their economic aspirations may dictate expanding the number of social networks in which they become active. All this takes time and, for some types of networks, more than a little money. Social events with little apparent intrinsic value can, in fact, take on considerable importance. Social networking strongly conditions the culture of many countries. Visitors may misconstrue things like strong family ties and large convivial groups in restaurants as merely charming virtues, whereas they are also part of the infrastructure needed for social network transacting.

On balance, social network transacting can be said to work. However, from the perspective of economic development, there is a good deal more to be said. Economic development is significantly hindered by constraints inherent in social network transacting where SNT dominates an economy. To the extent people believe that social network transacting makes sense and works reasonably well, they tend to be indifferent to how well the judicial system performs. Resulting judicial system dysfunction then adds a further series of constraints to economic development.

COSTS TO DEVELOPMENT

A. Constraints Inherent in Social Network Transacting

In an economy that is highly dependant on transacting within social networks, *intra*-network transacting works reasonably well while *trans*-network transacting does not. A fragmented economy is the result. More precisely, there are numerous islands of economic activity within the country as between which intermediation remains difficult. This undoubtedly constitutes a significant constraint on development. There are numerous others. Barriers to entry proliferate. Resource allocation is skewed. Specialization is scarce. Choice is diminished. Better-qualified actors are excluded. Competition is restrained. Product quality suffers. Social stratification hardens. Export performance suffers. Equity or loan capital sufficient for large projects may not be available from within a particular social network.

Social network transacting is not risk free. Depending on the nature of a social network, asymmetrical social bargaining power may tilt intra-SNT dispute resolution enough to threaten skewed outcomes. As a result, higher than “normal” rates of return are commonly sought to offset social asymmetry risks. Those with lesser social bargaining power refrain from some transacting or from participating in a given network. Thus, transactions common under well-functioning judicial systems may not be undertaken or will be undertaken only at exceptional rates of return.⁷

⁷ I am indebted to Adrian Guissarri for these observations.

For many social network transactions, people consider it pointless to lay down paper trails since they intend never to go to court, as in the case of rural land leasing in Brazil. Thus, data normally relied on to gauge economic activity may be deficient and misleading, making policy analysis inaccurate.⁸

This quick sketch of inherent constraints illustrates several ways SNT can substantially impair development. It is meant to be suggestive, not comprehensive. Some of these constraints are elaborated below.

B. Constraints Inherent In SNT-Induced Judicial System Dysfunction

Beyond these constraints, social network transacting induces negative secondary economic (and social) consequences because of its corrosive impact on judicial system performance. From their sense that SNT works reasonably well, people adopt a basic attitude of indifference to judicial system performance. Social network transacting is deeply ingrained. It is commonly viewed as “the way life is”. Since it facilitates avoidance of the courts, it is the smart thing to do. Judicial system performance thus usually suffers from a lack of public concern, notwithstanding occasional public rhetoric to the contrary.

It should be noted that this attitude of indifference is changing in Brazil. Research conducted in Brazil by Armando Castelar and Bolivar Lamounier produced a report published in 2000.⁹ They found that as a result of judicial system dysfunction, the growth of the national economy is impeded by about 20% each year. This report, part of a program of research in seven countries,¹⁰ has become fairly well known in Brazil. This has altered public discussion of judicial system performance, placing it into an economic development context.¹¹ This research did not, however, identify what specific aspects of judicial dysfunction produce this economic loss.

Implications of judicial system dysfunction for economic development are surveyed next, looking first at domestic activity, then at regional integration.

(i) Implications for Domestic Economic Activity

For analysis, we consider eight arenas within which dysfunctional judicial system performance influences economic life. How a judicial system performs will affect not only parties to a particular dispute but also others considering or already engaged in

⁸ The widely read *La Porta* (1998) may be an example.

⁹ See, Castelar (2000).

¹⁰ Sherwood (2004).

¹¹ The Hon. Peter Messitte, a U.S. District Court judge and keen observer of the Brazilian judicial system, has noted that a good deal of progress in judicial system improvement has been made over the last several decades in Brazil. Public perceptions of system performance, however, continue to be fairly negative.

comparable activity. A single court decision can shift activity patterns of considerable magnitude.

[1] Dysfunctional **contract dispute** resolution broadcasts a wide influence. Chronically delayed dispute resolution tends to subdue business activity. Where certain litigants routinely succeed as a result of judicial dysfunction, competent actors will refrain from activity, retreating to the relative safety of social network transacting. It is in relation to contract dispute resolution that SNT finds utility.

[2] The value of **property rights** oscillates with judicial outcomes over time. Where land tenure is not well supported judicially, those who own land are less willing to make improvements or lease the land, and may be less able to secure financing for land-based activities. In general, property rights are defended only by the power of the state, not the good will of friends. Defense of property rights by SNT is awkward and limited.

[3] Failure to **discipline government officials** who abuse their discretionary authority has broad economic influence. Where bribe taking or favoritism by officials goes undisciplined, competence is displaced as the indicator of who will provide services and goods to serve the public. SNT is not likely to discipline abusive exercise of executive power and may incline officials toward unjustified favoritism.

[4] The manner in which a judicial system oversees the **quality of legislation** has less obvious, but quite possibly profound impact on economic activity. When legislation is tangled, unclear, or conflicting, economic actors may be forced to expend extra effort in planning and assume greater risk in acting¹² or may refrain from transacting. SNT offers no means to discipline legislative quality.

[5] Brunetti (1992) suggests that the **credibility of public policy** may be more important than its correctness. Public conviction that a policy will be durable rather than capriciously altered assures more stable planning horizons. Here, the role of judicial systems is to assure that after a policy has been established, it will not be altered by illegal means.¹³ Again, SNT has little ability to enhance policy credibility.

[6] Judicial systems **support institutions**. Adjustment of rate structures for utility companies privatized in Latin America a decade ago is giving rise to difficult cases. As public service commissions assess rate change proposals, they must apply rather imprecise formulas. Judicial resolution of the inevitable ensuing litigation will radiate widespread economic influence. New bankruptcy laws, now being enacted in many countries, will succeed or fail depending on judicial response. Efforts to train judges are underway, but this may accomplish less than expected where the judicial system itself is dysfunctional. There are many further examples. SNT has little ability to support public

¹² In many instances, statutes and even constitutions reflect political issues that the body politic has failed to resolve. Judges often face unwarranted criticism when they deal with such issues.

¹³ The cited work reports initial research by scholars at the University of Basel. Later research, supported by the World Bank, is also relevant. Brunetti and his colleagues underrate the role of judicial systems as a foundation for credibility.

institutions. Thus, SNT-based economies will face continuing development obstacles. Research in this arena can examine the multiple ways judicial dysfunction undermines public institutions. Cross-country comparisons would be valuable.

[7] Judicial systems help manage **informality and** suppress **criminal behavior**. Although estimates range widely, in some countries informality¹⁴ constitutes a significant segment of the national economy. Often dubbed the “underground economy”, it has been viewed both positively and negatively. Some observers suggest that shifting informal activity into the formal economy would produce more positive economic results.¹⁵ Without a well-functioning judicial system, this seems problematic. Crime suppression is another role for judicial systems. Obviously, rampant crime imposes severe costs on a society and SNT is hardly a corrective.

[8] Judicial dysfunction weakens protection for **intellectual property**. Thus, various kinds of useful knowledge tend to be partitioned within social networks rather than fungible. Many firms in Brazil, for example, protect whatever technology they invent by confining direct knowledge of it to family members. This works in situations where reverse engineering does not reveal the invention, but it also hinders further invention that requires technical knowledge beyond the education of family members. Firms that depend on R & D face competitive disadvantages relative to firms in countries with stronger judicial systems. Indeed, in Brazil, as elsewhere, firms conduct very limited in-house research because results cannot be well protected. Research joint ventures and technology licenses based on “friendship” are perilous without adequate intellectual property protection.

The economic impact of judicial system dysfunction probably cannot be measured for each of these eight arenas. Nor is it suggested that, if each were quantified, they would provide a credible aggregate loss for the national economy. Still, it is useful to consider in which of these arenas the greatest economic loss is probably suffered. This could help prioritize reform efforts. Deeper research can help determine issues such as: What losses can be reversed most easily, most quickly, with least expense through judicial system reforms? What improvements will take longer, encounter more difficulty, yet produce large gains? If nothing else, examining the eight arenas helps to emphasize that feeble judicial system performance influences economic activity in multiple ways.

(ii) **Implications for Regional Integration**

Weak judicial system performance negatively impacts regional integration in three arenas. **Trade in goods** involves numerous activities that can lead to disputes with customers, other businesses, and government regulatory agencies regarding

¹⁴ The term “informal sector” is frequently used to imply activity found in the poor part of town with the formal sector located elsewhere. Often, however, formal and informal activity coexists, even within the same firm. While a high proportion of informality is SNT-based, much formal activity is also SNT-based.

¹⁵ See, for example, de Soto (1989).

transportation, credit, product standards, marketing, distribution arrangements, warranty terms, product return policies, pricing, and safety regulations. **Trade in services** involves many of these factors and others, such as licensing, performance standards, taxation issues, and reporting requirements. Again, disputes are likely to arise with various actors, gatekeepers and referees. Again, poor judicial system performance is likely to cloud planning, increase costs, and retard the velocity and extent of activity. **Investment** across national boundaries also involves a host of judicially conditioned factors. The return to an investment depends to some degree on judicial system performance in the place of investment. For example, few investors will place capital for construction of apartment buildings where the courts are slow or unable to evict non-paying tenants. Judicial system performance influences the cost of capital. In Argentina, interest rates have been found to vary from one province to others depending on local judicial system performance.

Beyond this, to the extent that SNT dependence and corresponding poor judicial system performance limit the national growth momentum of one country, those from other integration-partner countries will face reduced opportunities there, and they will encounter the difficulties faced by local citizens who are not members of prominent social networks. The thought processes, reflexes and business instincts of citizens in states with poor judicial system performance and dominant SNT will differ from those of citizens of states with good judicial system performance and limited SNT. This alone imposes a subtle trade barrier. A strong SNT preference will probably deny the judicial system the opportunity to develop competence for dealing with many issues relevant to regional integration. Local lawyers, accountants, bankers and other advisors will have difficulty offering foreigners reliable guidance for business planning and operations.

The *quality* of judicial system performance probably matters more to deep regional integration than do specific differences among the judicial systems as such.¹⁶ Thus, harmonizing procedural codes or judicial qualifications may be less important than improving overall judicial system performance, something SNT is likely to impair.

It is difficult to detect any aspects of domestic economic activity or regional integration that social network dealing handles better than, or even nearly as well as a well-performing judicial system.

A CLOSER LOOK AT SOCIAL NETWORK TRANSACTING

**Is Social Network Transacting *seen* by Transactions Costs Economics?
If so, what does it see?**

The foregoing catalogue of inherent constraints provides a survey from which to approach a deeper examination of several types of typical transactions in the context of robust social network transacting and judicial system dysfunction. Firm size and three

¹⁶ This would seem to be an issue for the European Union as new states gain membership, particularly since many appear highly dependant on SNT.

aspects of corporate governance have been selected, quite arbitrarily, for this examination.

Judicial system dysfunction is widespread in developing and transition countries. As a high-level concept, many observers assert that a well-functioning judicial system is an important underpinning to economic growth.¹⁷ Transaction costs economics is providing tools for understanding more precisely why this is so, but a comprehensive portrait of the linkage is yet to emerge.¹⁸ Such a portrait will be well served by moving to a level of greater detail in regard to both the component parts of a judicial system and the impacts of those components on specific patterns of economic and social behavior. From this, a better sense of priorities for judicial system reform may emerge.

Two bodies of literature supply the point of departure for this section. One deals with social network transacting, the other with the influence of judicial system performance on economic development.

Social network transacting has been much discussed. The literature is replete with a rich array of descriptive terms and categories such as good agent character, relational contracting, embeddedness, ethnically homogeneous middleman groups, non-legal norms, fairness norms, reputation effects, trust, reciprocity, and internalized group standards. They all point to a kind of “lubricant” that facilitates transacting without recourse to a judicial system. Various additional mechanisms facilitate non-judicially based transacting, but SNT appears to be the most ancient and probably the most widespread mechanism.¹⁹

In his widely cited paper, Granovetter (1985) observed that “classical and neoclassical economics, assumes rational, self-interested behavior affected minimally by social relations“, while many sociologists, political scientists, historians and others have stressed an opposite view, namely that behavior and institutions are deeply influenced by surrounding social conditions. Having elaborated this polarity, he delves into a middle position he dubs “embeddedness” where something of both subsists. Tracking Williamson’s market and hierarchies views, he asks which transactions in a modern capitalistic economy are conducted best in the market and which take place within hierarchically organized firms.

In the context of judicial system dysfunction, his question seems misdirected. Without apparently giving the issue much thought, he seems to implicitly assume that all modern capitalist societies have judicial systems that function equally well. The early British economists held this view and it was a reasonably accurate reflection of their time and place. Indeed, this assumption has pervaded much economic thought for several

¹⁷ Voigt (2007) finds data from appeals to the Privy Council strongly affirm this view.

¹⁸ Goodenough (2006) provides useful insights as to the difficulty of “seeing” SNT.

¹⁹ For extended discussion of social networks in relation to judicial system performance, see Sherwood, 2005. See also Ohnesorge (2006) which implies a significant role for social network transacting w

centuries. But where judicial dysfunction prevails, social network transacting in its various forms subsists as a widespread and widely influential institution and therefore as an important subject for examination.

It has surely been helpful to appreciate that in seeking personal economic benefit people act opportunistically (Williamson, 1975). Such behavior occurs before, during and after transactions are agreed. This behavior is held in check to some degree in countries with well-functioning judicial systems, perhaps sufficiently to minimize economists' concern for opportunism. In countries lacking this constraint, Granovetter's embeddedness deserves to be refocused.

Granovetter (1985) asserts that opportunism abounds, but institutions mitigate its proliferation. He correctly points out that trust is not the result. Instead, social institutions substitute for trust. He goes beyond, to note that social relationships serve primarily as a source of reliable, pre-transaction information concerning the probable behavior of an actor. He reaches the view that "embeddedness" is a less sweeping but more useful explanation for economic behavior than either of the over- or under-socialized concepts from which his analysis starts. He offers only modest claims for the "embeddedness" view because malfeasance obviously persists. Still, he favors its ability to provide more nuanced understandings of a range of transactions at the micro-level.

Whereas he began with a broad conceptualization of social networks, he later describes embeddedness as consisting primarily of close personal relations. This weakens the power of his thesis. It would gain more force if his understanding of social networks remained more firmly open to inclusion of people connected socially yet little known, if at all, to each other. Awareness of the pressures arising from judicial system dysfunction would also strengthen his thesis.

Granovetter asserts that social connections permit more transacting outside of hierarchies than Williamson's theory would contemplate. Unequal power among actors also strains use of overly simple categories, and Granovetter pays respect to this as he argues that social embeddedness best explains how transacting is facilitated. In the context of this paper, his caution helps to explain why social networks tend to foster social stratification (barriers to entry).

Although Granovetter criticizes Williamson, in effect he affirms the importance of Williamson's focus on transaction costs. He stresses the importance of observing the role social networks of all kinds play in facilitating transactions. Only rarely does he suggest that social network transacting carries inherent growth constraints. Although he occasionally mentions the background role of judicial systems, he takes no account of poor judicial system performance as a determinant of social network extent or influence.

Much of the literature creates an impression that in any given country, a few social groups exist within which its members advantageously transact business. Landa (1981) exemplifies this with her useful depiction of Chinese middleman groups in Southeast Asia. Other writers make general statements that SNT exists, but without

quantification. It is reasonable to assume, however, that in countries with judicial system dysfunction, everyone knows the courts work poorly and everyone undertakes to conduct their affairs without ever needing to enter the courts. This means that everyone, from wealthy elite groups to the poorest citizens, resort to transacting within the best available means, usually their social networks.²⁰ Dysfunctional courts prompt social network transacting, with the need to do so evenly distributed across society.

Although the literature amply describes why and how SNT works, and although SNT consequences for economic activity at the micro-level are sometimes described, there does not appear to be much quantification of its aggregate impact on a national economy. Does SNT account for a small corner of economic activity, or might it undergird something like half of the economy?

This question is closely related to the parallel uncertainty as to the degree to which judicial system dysfunction impairs national growth momentum. Studies of this question through surveys of business manager perceptions in seven countries have provided rough order of magnitude answers.²¹ The damage appears to be significant. These same surveys revealed a surprising degree of confidence among business managers in their ability to conduct business successfully in spite of judicial dysfunction. This finding spurred investigation of the SNT phenomenon and the extent of its use.

From the growing literature that delves into the influence of judicial system performance on economic development,²² this paper picks two of them to set a context. Davis (2004) provides a critical literature survey. Cadwell (2004) is a commissioned survey of six developing countries that examines for the tools presumably needed to spur their growth momentum.

Davis (2004) describes the history of law and economics thinking in relation to development. For over a century, observers have held divided views regarding the importance of rule of law to economic development. Optimism in the 1960s and early 1970s faded into disillusionment. Then it revived in the mid-1990s as the Cold War ended. Attention today focuses on how to make capital-driven systems work in developing countries.

Development economists generally recognize the relevance of the rule of law to this project. Many commentators have noted the importance of well-functioning judicial systems as an underpinning for this role. Still, according to Davis, whether rule of law is vital to development or not remains unsettled, and he proceeds to critique various datasets recently used to measure the rule of law variable, finding them weak or flawed. He shows, for example, how a crime rate does not necessarily reveal reliable information about rule of law or judicial system quality. Public perception of the judicial system may

²⁰ The author has found support for this supposition from anecdotal evidence gained through business and consulting experience in some twenty countries over forty years.

²¹ These studies are summarized in Sherwood (2004).

²² The bibliography for this paper lists many of them.

simply reflect aggressive journalism. He keeps asking whether the data are useful in determining what specific legal (judicial) reforms are most worth making in relation to enhancing development.

He criticizes the concept of Contract-Intensive Money (CIM) introduced by Clague et al (1999), saying that it mixes two distinct legal concepts, property rights security and contract enforceability, and is therefore weak in predicting legal reform priorities. Beyond this, and relevant to this paper, he notes that CIM fails to tell us whether the legal system is effective or whether perhaps social network transacting might contribute to the stock of CIM. He does not elaborate the point.²³

An unpublished survey (Cadwell, 2004) provides another point of reference for the present paper. A team organized by the IRIS Center of the University of Maryland, under contract to the European Commission, examined selected laws of six countries – Algeria, Egypt, Jordan, Lebanon, Morocco, and Tunisia to determine their degree of readiness for investment and trade agreements with the EU. The study is particularly valuable because of the methodology used to establish protocols for calibrating and applying an array of benchmarks in each of six domains: corporate governance, insolvency, secured lending, enforcement of agreements, intellectual property protection, and constraints on state action. Judicial system performance was addressed specifically in some of these domains.

A particular gift of this study is the establishment of a basket of instruments and institutions that facilitate what is called “constraints on state action”. Weaknesses found in these constraints were identified as posing a major impediment to business activity. The study chose to focus on topics likely to cast direct light onto judicial system contributions to growth momentum. It traced specific activities, rather than broad legal categories and it chose things that can realistically be fixed. Still, the survey makes no claim to prove the economic impacts of any particular legal system characteristic although it discusses the desirability of identifying which legal activities have high positive impacts on economic and social activity.

Although not an academic endeavor, the IRIS study provides useful discussion of the need for greater specificity in identifying institutions that foster economic growth. Numerous authors have linked rule of law with economic development, but have provided little advice to judicial system reformers regarding which elements of a judicial system deserve priority attention. More precisely, the IRIS authors argue the need to identify the specific elements in the “bundle” of rights needed to produce beneficial effects in an economy.

Referencing the “credibility” survey work of Brunetti, Kisunko and Weder (1997), the IRIS study found that unpredictability of judicial system performance ranked highest among the impediments to business activity evaluated in three of the examined

²³ Macher and Richman (2006) usefully evaluate a wider body of TCE studies, reaching a kinder evaluation of Williamson.

countries. The IRIS team also identified institutional sources of impediments, with courts named most frequently as culprit.²⁴ The IRIS analysis concludes that an economy functions at a lower equilibrium in the presence of judicial dysfunction, although no order of magnitude is offered on the point.

Many of the laws in the six countries were found similar in large part to laws in economically advanced countries. However, disturbing gaps were detected, particularly in the domain of “constraints on state action”. Lack of judicial independence surfaced as among the most troublesome gaps.

The IRIS study methodology served well to reveal specific flaws in the legal and institutional infrastructure of these six countries. It provided reformers with a fairly precise list of things to fix that offer a high expectation of improved economic results. Unfortunately, benchmarks for judicial system performance are lacking, even though enforcement is repeatedly cited as critically important to economic development.

The Davis and Cadwell (IRIS) studies are used here for context because they spotlight a vital role for judicial system performance in fostering economic development. Yet both come well short of suggesting how that role might be examined more thoroughly other than to call for more detailed research. These two studies²⁵ reflect, as it were, much of the current state of the art regarding our understanding of the impact of judicial system dysfunction on economic development.

Transactions Costs Economics

The tools of transactions costs economics (TCE) have considerable potential to deepen our examination of SNT in relation to economic development and judicial dysfunction. Looking at transactions costs and the choices available for reducing them in the presence of judicial dysfunction would presumably precipitate discussion of SNT. For the most part, however, literature that might be expected to “see” this phenomenon does not.²⁶ Mention of SNT under any of its various labels relative to judicial dysfunction seems sparse and tends to be fairly casual. To explore this void more deeply, two fields are arbitrarily selected: firm size and corporate governance.

Firm Size

Granovetter (1985) suggests that the disproportionately large number of small firms in “periphery” countries is explained by “dense” social networks.²⁷ Density obviates the need to merge or combine for greater efficiency. While his observation

²⁴ For comparison, Godoy (2006) finds legal institutions have made a significant difference to the economic development of transition countries since about 1990.

²⁵ Together with Macher and Richman (2006).

²⁶ The widely mentioned 1998 “Law and Finance” article by La Porta, Lopez-de-Silanes, Schleifer and Vishny, for example, is weakened for not seeing this.

²⁷ Page 28.

deserves elaboration, it provides a threshold for looking at the missing middle issue and for consideration of the costs of acquiring information (see below).

Rajan and Zingales (1996) show that firms in need of external finance grow disproportionately faster in countries with more developed financial sectors. Kumar *et al* (2001) find that larger firms are better able to access external finance than smaller firms. They also find that large firm size correlates strongly with judicial efficiency (page 3) and recommend further study of this. We can wonder whether there is some reason to think small and medium enterprises do not benefit from judicial efficiency, or perhaps they do so well relying on SNT that they care little about judicial system efficiency.²⁸

In countries where SNT plays a significant role in economic activity, corporations tend to be aggregates of members of a particular social network.²⁹ Typically, companies are launched when a few individuals invite their “friends” or extended family members to become shareholders. In some cases, shares are granted more as an eventual reward than as an initial source of investment. It can be a way to provide for family members. In other cases, the objective indeed is to raise funds to launch the company or to expand it, particularly where sources of external financing may be difficult to tap.

In countries where SNT is a preferred mode of dealing, firm size is likely to be constrained by network size since each firm tends to be embedded in a single network. This observation is not found where it might be expected in the literature.³⁰ Network size tends to be limited by time and space. That is, news must travel fairly rapidly to all or most members of the network for it to impose effective social discipline on member behavior.³¹ Even the largest networks will not come close to equaling the size of the economically active population and most are a good deal smaller.

Where firm size is conditioned by social network size, another factor probably further constrains firm size. The higher the cohesion (density) of a social network, the higher the risks individuals will be willing to assume relative to each other as firm members (shareholders). Since unacceptable risk levels set in as shareholding extends to the periphery of a social network or where the network is perceived as insufficiently cohesive relative to the risks involved, firm size will be even more limited than would be indicated by the prevalence of SNT in general. This may help to explain why medium sized firms are missing in many developing and transition countries.

²⁸ See Sherwood (2005). In countries with judicial dysfunction, much credit may be extended to small firms by “family banks” in reliance on social network discipline.

²⁹ In such countries, only a handful of publicly-trade companies with numerous shareholders will typically be found, often the result of privatization of former state enterprises. In Brazil, shares of less than a dozen companies comprise a substantial proportion of trading on the leading stock exchange.

³⁰ I hazard this view without conducting a truly exhaustive literature search.

³¹ We can speculate that the Internet and cell phones may be expanding nominal network size currently, but still there will be finite limits to network size.

Social networks are exclusionary. People are willing to deal with “friends” but not strangers. In this sense, relational dealing trumps judicial dysfunction. Transacting takes place, and with fair efficiency. As noted, there may be some cost to entering and maintaining acceptance in a social network. People attend countless birthday parties for little reason other than to burnish their social network credentials. However, relative to the costs of full-blown litigation, the cost of having someone expelled from a social network for unacceptable behavior is quite small.

The inherent downside to this, of course, is that firms seeking investors in the face of judicial dysfunction avoid strangers. More precisely, strangers avoid them. The loss to capital formation and therefore to economic development is probably fairly severe.

Corporate Governance

It is central to Transaction Cost Economics (TCE) that governance choice is largely conditioned by the costs of transacting relative to any particular economic activity. In the literature, however, costs of many types are commonly itemized but not quantified or even approximated. For example, things like incentives, monitoring, opportunism, information seeking and enforcement are often included in lists of transaction costs, but the magnitude of such costs is not determined or even suggested. Cost savings are similarly enumerated but without their magnitude being specified. Nonetheless, for the most part those doing real-world transacting have some awareness of the magnitude of their real and potential costs. Thus, it is not surprising that Macher (2006) finds “a remarkable convergence between the theoretical predictions of TCE and the results of empirical applications within [...] many social science arenas.”

What follows is an effort to sketch the mechanisms of corporate governance in settings where judicial system dysfunction causes people to transact as much as possible within social networks. The sketch is drawn largely from extensive business experience in many developing countries, and is done largely without benefit of data, since SNT leaves few direct footprints.

The field of corporate governance employs two languages. Legal minds speak of minority shareholder rights, super-majority voting, director responsibilities, and compensation packages. Economists and others talk about firm size, suppressing opportunistic behavior, internalizing firm norms, the cost of information seeking, asset specific investments, tacit knowledge and similar concepts.

At a first impression, the language of SNT translates poorly into the legal concepts of governance. TCE terminology seems to fit somewhat better with SNT conditions. Both languages offer help in framing deeper examination of corporate governance in an SNT-oriented economy, that is, in a country with feeble judicial system performance. This examination reveals specific benefits (efficiencies) of SNT but also helps expose the growth constraining limitations inherent in SNT.

Three features of corporate governance are examined: minority shareholder rights, board member responsibilities, and information seeking costs.

Minority Shareholder Rights: SNT provides no minority shareholder rights in the ordinary legal sense. At first glance, this would seem to be a major deficit for development. However, SNT can impose fairly severe discipline to deter abuse of minority shareholder interests. These shareholders picture themselves primarily as members of that social network and secondarily, if at all, as shareholders with investor rights.

Shareholder protection in an SNT environment is derived from the social pressures that can be brought to bear on members who offend other members. As noted, these pressures range from ugly gossip to ostracism or exclusion from the network, and can be highly adverse to the offender's future economic and social interests. Exclusion from the network can be tantamount to an economic death, a penalty so severe that any activity undertaken by any network member that will harm another member will be launched only after careful consideration of its possible consequences. This tilts business decision-making toward conventional, familiar, readily tolerated activity and away from unusual, creative, unfamiliar or opportunistic actions. Broader economic consequences at the macro-level are probably significant but yet to be traced or measured.

Under conditions of a well-functioning judicial system, the threat or actual commencement of litigation can bring pressure to resolve a dispute. Indeed, the Australian Law Reform Commission has found that a high proportion of cases entering the Federal Civil Courts in Australia are settled by the parties without a final court decision.³² Various reasons for this finding are proposed, and occasional press articles offer insights, but systematic data are not generated by these private decisions.

By way of contrast, where the existing judicial system is feeble, the locus of settlement pressure will lie within the relevant social network. Because the penalty from an adverse social network decision can be severe (expulsion), the pressure to settle is often greater than it would be in a court. Members of the social network act as *de facto* judge and jury. They try the case, as it were, without settled rules and possibly relying on poor information. The possibility of erratic, biased outcomes is well understood and this enhances the pressure to settle disputes. In fact, the "case" rarely gets as far as the social network "jury" given the blunt severity of a negative verdict. People find ways to settle their differences. In some instances they may request the advice of another member of the network. Only in rare circumstances will they ultimately go to court, a choice which of itself may invoke a harsh social penalty. The more nuanced outcomes possible in a well-functioning judicial system provide interesting contrast for comparison with the mechanisms of social network dispute resolution.

It would, of course, be useful to have data to verify and quantify these observations. However, by its very nature, the frequency of disputes and of dispute

³² Australian Law Reform Commission, (2000).

settlement in a SNT context is not recorded. Unlike a judicial system, no statistical public record is generated. The best information is derived from interviews and conversations with those who function within an SNT setting.

Board Member Responsibilities: In countries with feeble judicial systems, where corporations tend to be collections of “friends”, the concept of a board as having legal obligations to look out for the interests of the shareholders is close to ephemeral. Board members are often chosen to give assurance of the social network *bona vides* of the firm. Board members serve the interests of their friends, not as directors, but as members in that social network.³³

This is a normative view of governance in SNT-dependent countries. Obviously there is considerable variation and nuance from city to city, industry to industry, and most particularly from one social network to others. Nonetheless, there tends to be a bias against any adventure in the business that might strain the perceptions of the particular social network involved. Social networks tend to be conservative in the sense that it takes time and effort for a network to shift consensus about how things are to be done.

It is useful to illustrate how a typical board decision might be made under SNT circumstances. Suppose the company needs added financing. A decision to sell shares to other individuals will dilute the earnings of existing shareholders. Rather than debate the issue at a meeting of the board, board members will discuss the proposal with other members of the social network (whether shareholders or not) perhaps at the “club” or wherever network members gather. If this goes well, the board will then ratify the consensus developed within the network. This approach minimizes friction and forestalls disputes.

From a TCE perspective, costs are low. However, there may be a partially hidden cost to development in that business adventure beyond the nominal consensus of the network will be impeded. While this restraint will affect all companies in that country equally, it may take the edge off their global competitiveness. There is a more obvious cost to development in that financing for firm expansion through sale of added shares will generally be confined to the universe of the underlying social network. That may well not provide adequate scope for growing the firm, particularly when constraints on credit financing under SNT conditions, such as weak financial intermediation, are factored in.³⁴

Information Seeking Costs: In the late 1990s, “crony capitalism” was identified as a culprit, hindering development. As a cure, the World Bank provided funds to Mexico on condition that bank lending to relatives of bank officers and bank owners would be prohibited. The supposition was that “favoritism” toward family members led to bad loans and squeezed out worthier borrowers. However, as a consequence of imposing this

³³ The author’s numerous conversations with people in a number of developing countries found the foregoing description widely acknowledged.

³⁴ Some years ago, Robert T. Aubey identified the stultifying constraints on development derived from weak financial intermediation in Mexico.

condition, bank lending decreased slightly rather than increasing as expected. The role of social network transacting in relation to credit access had been overlooked.

Where transacting is conducted to a significant degree within social networks, many kinds of information are readily available at relatively low cost. Reputation is part of this basket of information, but more important is awareness of the degree of cohesion of any specific network and the resulting constraints and facilitation to behavior of many kinds. The relative strength of these built-in social constraints is vital to credit, investing, hiring, purchasing, and other transaction decisions. For example, many of the officers and employees of a company are likely to be members of the underlying social network. They are favored, not because of nepotism or cronyism, but because their abilities and character are known, and they are subject to SNT discipline. This lowers the odds of a labor dispute and reduces the risks implicit in litigation in the labor tribunals.

If, as seems probable, the degree of risk assumed when making deals correlates directly with network cohesion, then the contribution of SNT to high-quality information acquisition at low cost is counter-balanced by the outer boundaries of the networks themselves. Thus, for example, another cost to development is likely to be the limits on tacit knowledge, since employees and managers from the ranks of the social network may not possess optimum knowledge for conduct of an advancing technology business or expanding sales to new territory or for export. It has been observed that many Brazilian exporters feel hesitant to sell abroad because their social network does not extend there. Only a few have learned that transacting with agents (strangers) in countries with well-functioning judicial systems can be done successfully with acceptable risk.

Perhaps enough has been noted to indicate that entry barriers to transacting are erected by the SNT environment. Although social networks are themselves permeable and open to new members, including the children of current members, an economy where social network transacting is prominent will suffer from constraints on investing, access to credit, access to technology and build-up of tacit knowledge.

Granovetter (1985) mentions that social networks serve well to mediate information such as employee evaluation, auditing depth, technical information and other valuable knowledge which Williamson claims are provided best or only within hierarchical firms. Internal subversion of organization best practice by cabals of employees undermines Williamson's bright picture of hierarchical intra-firm discipline. Granovetter accuses Williamson of idealizing intra-firm transacting, although his own perception of social networks has traces of idealization as well.

The foregoing look at selected literature regarding firm size and the three arenas of governance reveals limited awareness of the economic influence of judicial system dysfunction and the prominent role played by the institution of social network transacting as a judicial system substitute. These observations will perhaps help to focus more attention on these conditions in many countries.

A Look Inside Dysfunctional Judicial Systems Can they be improved?

Most judicial systems - certainly the one in Brazil - are an accumulation of historical influences ranging across colonial inheritance, various constitutions, legislation inspired by various motives, dictators' whims, the insights of wise statesmen and jurists, courthouse work norms, a jumble of physical assets, and the means by which judges and judiciary employees are selected and trained. In recent times, the work of the judicial system has been burdened by factors such as the eruption of mega-cities from agrarian societies in less than thirty years, bursts of new technology, increasingly global social and economic dynamics, narco-terror, and the increasing disintegration of the historical bases for social networks, particularly in São Paulo.

It has become common in Brazil in recent years, particularly subsequent to the findings of Castelar (2000), to blame the judges for judicial system dysfunction and the ensuing economic loss. However, judges operate within a system not of their making. This criticism of judges assumes that they have authority to modify the judicial system that employs them. For the most part they do not. They do, however, have an exceptional vantage point from which to offer suggestions for improvements.³⁵

Within their existing authority there appears to be much judges can do to improve judicial system performance. Recent research inside the state tribunal of the São Paulo region (some 400 courthouses and over 4,000 judges) was built, in good part, from this insight. Almost 40% of all the cases in Brazil are running in this large state tribunal. For comparison, the absolute number of these cases equals all the cases pending in England, Germany and France at one time. This project was undertaken by Instituto Nacional da Qualidade Judiciária (INQJ) of São Paulo at the invitation of the then newly elected president of the tribunal. Financial support was provided by The Tinker Foundation of New York. The project was designed to improve tribunal administrative performance by applying business management techniques.³⁶

The research started by inviting the leading judges and senior court administrators to identify for deeper review the predominant or most troublesome types of cases that they handle. Though this analysis was not carried to complete refinement, they were able to suggest categories of cases that (a) are most difficult for them to decide, (b) have large amounts at issue, (c) are most repetitive, (d) seem to take a long time, (e) seem to have broad consequences for social and business activity. Several of these categories were then selected for closer examination.

Numerous follow-up questions were not fully pursued, but valuable insights were nonetheless gained. For example, what factors give judges the greatest difficulty in

³⁵ Earlier research developed this insight, Castelar (2003). A broad sample of Brazilian judges offered views as to what might be done to improve judicial system performance.

³⁶ The original research proposal was only partially implemented due to funding constraints.

reaching their decisions? Is legislation badly written? Have crucial public policy issues been papered over by the congress, leaving the judges to struggle with problems the politicians were not willing to resolve? Do production quotas imposed on judges prompt them to postpone consideration of “tough” cases that might take a great deal of time?

Considerable attention was focused on factors that cause undue delay in processing cases to conclusion. Does the physical movement of case files from one building to another cause exceptional delay? Do procedural rules play a negative role in causing excessive delay? Numerous appeals are possible, but in what proportion of cases are repetitive or redundant appeals actually taken? Does the constitution or legislation place unnecessary burdens on judicial system procedures?

After gathering initial impressions, the researchers were given access to the records of the courthouses to determine what data were available to verify the initial impressions. This led to systematic mapping of each step taken, and charting the duration of each step, as cases proceeded through the courts. The resulting “chronograms” provided the basis for detailed analysis. Working at this level of detail, INQJ was able to identify multiple causes of judicial system slowness. This led to over 100 recommendations for streamlining internal processes, most of which were adopted by the judges and are being implemented.³⁷

INQJ interviewed selected judges to discover the biggest difficulties they encounter in their day-to-day work. From their statements and analysis of courthouse data, the researchers determined the main reason for low quality is a lack of sufficient time for analyzing each case, essentially because of the huge number of cases each judge is assigned to handle. On average, in this tribunal, each judge is responsible for more than 10,000 cases at any one time. Moreover, for each case, INQJ identified almost 90 different steps, both procedural and deliberative, that require the personal attention of the judge. As a result, each judge is responsible for almost 90,000 judicial steps, many of them highly repetitive.

INQJ also measured how long, on average, a case takes from beginning to end in the first degree of jurisdiction in the tribunal. They found an average of about three years. In addition, they measured how much time is give to active consideration of each case by a judge or other senior court official and found an average aggregate of six hours during that three year period. Most of the specific actions taken by court officials or judges require about three to five minutes per action. After most of these actions, the case stays inactive on a shelf for weeks or even months.

The research team concluded that to diminish the extensive intervals of inactivity, it would be useful to eliminate some incremental actions. To achieve this, they analyzed

³⁷ These recommendations were adopted under authority of the court officials themselves. Because of funding constraints, the original intention to identify changes that would require authority from beyond that available to the judges, such as new legislation or added resources from the legislative or executive branch, was not pursued.

each of the roughly 90 procedural steps to verify the possibility of its elimination. They combined management techniques with a cursory legal analysis to compile a list of recommendations. Working together with the judges, the researchers did an assessment of probable workforce reaction to each possible change. They found that in some instances, even if the law did not prohibit the elimination of a step, internal workforce sentiment would strongly resist a change, making the recommendation non-viable.

Three examples further illustrate some of the recommendations that were adopted. It was found that three and sometimes four routine judicial orders were needed simply to complete the opening phase of most cases. Brazilian law requires each of these orders be published in the official gazette. Internal court procedures consume about three months to officially publish each order. Thus, a year can pass before the judge is able to consider making a decision. During most of this period, the case is inactive, waiting for these initial orders to appear in the official press.

Rather than eliminate any of these orders, the research team recommended they be aggregated into one order. They developed a standard format by which these orders are consolidated into a single document. The judge is able to officially notify both parties and insert conditional orders, so that the entire set of judicial directives to the litigating parties can be notified in a single published composite order. This format is available in the new software specified for use throughout the tribunal. This tactic alone is expected to shorten the duration of cases by as much as nine months.

In a second example, it was found that delay has also been caused by the procedure used to transmit judicial orders from the desk of the judge to the office of the official gazette. The clerks had been collecting these orders on a CD. Only after the CD was full was it physically transmitted to the official gazette office. This made good sense a few years ago, but the Internet now makes it possible to transmit orders directly on-line without using a CD. It was recommended that a desktop icon be placed on every computer to identify the link for transmissions to the official gazette.

In a third example, it was found that whenever a judge needs to transact with the state attorney, a forensic unit or some other auxiliary agency located outside the courthouse, the entire bundle of papers that comprised the dossier of the case is physically transported to that agency. Thereafter, a paper record of action taken by the outside agency is inserted into the dossier and the bundle of paper transported back to the courthouse. It was recommended that the dossier stay in one location and that the transaction with the outside agency be done via the Internet. A standard format incorporated into new administrative software will be used.

INQJ encountered more than a few judges who resisted adoption of some of the recommended changes, alleging they would compromise their independence. To overcome this objection, the Presidency of the Tribunal decided to buy and install on all tribunal computers a software package recommended by INQJ that was already running in courts in several smaller states. This software provides standardized templates for

numerous routine court procedures including the consolidated initial orders. All judges will be required to use these standard formats.³⁸

These three examples give an idea of the variety of recommendations that were identified and are being implemented. In all, as a result of the many changes adopted, about 30 distinct steps of the previous 90 are being eliminated, many of them the most time consuming. This is expected to shorten the typical three-year duration of a case to perhaps 8 to 12 months.³⁹

As judges find they can devote more time to substantive consideration of cases, an improvement in the quality of decision-making is expected. If this occurs, it will be an extremely significant project outcome. At the same time, the time saving is unlikely to translate into a reduction of court employees, particularly since the number of cases entering the courts may gradually increase as people shift to judicially based transacting as they learn of improved judicial system performance.

In the São Paulo state courts, the cost to the public treasury incurred by processing one case from beginning to end amounts to about US\$500 (somewhat below the national average). By one estimate, the recommended improvements can be expected to substantially lower administration costs by something like \$100 - \$150 per case. Given some fifteen million cases pending in the state of São Paulo, the public saving over time could be substantial.

The research has left a significant residue in the courts. More than 1,000 administrators and 100 judges learned management techniques and statistical evaluation that will aid them in future efforts to improve the performance of their tribunal.

Probably the most significant finding made during the project was that the judicial system in Brazil is managed by amateurs. The president of every tribunal is responsible for budgeting, purchasing, IT, hiring, training, system design, facility maintenance and improvement, and related aspects of system administration. Every president is a judge. Every president appoints other judges to assist with administration. Almost no Brazilian judges have business management experience. Thus, amateurs run the judicial system. Worse yet, every president is elected for a non-renewable two-year term. Thus presidents and their support teams learn by doing, and then are replaced by more amateurs who must repeat the learning process. As a consequence, the judicial system is poorly administered. This is not the fault of the judges. It is a system imposed on them. Clearly few organizations of comparable size, complexity and importance are administered by amateurs. In many other countries, professional managers with long-term appointments

³⁸ The project could have been aborted at the outset had there been a strongly negative reaction by the judges toward its intrusiveness. This risk was handled successfully, with considerable credit going to the President of the Tribunal and his team.

³⁹ This can only be verified after the software is fully installed and has been running for some time.

provide administrative management support and continuity to the judicial system under the supervision of senior judges.

Although the project was confined primarily to internal rules and procedures, the project shows that there is considerable latitude, at least within this particular judicial tribunal, for performance improvement. Once causes of judicial system dysfunction that are rooted in legislation or the constitution can be identified, even greater improvements can be anticipated. This project has demonstrated that analysis from within the courthouses at the INQJ level of detail can produce significant results.

We can only guess how much additional judicial system improvement will be needed before people are inspired to shift from social network transacting to judicially based transacting. In all likelihood, things will change incrementally.⁴⁰

In a Nutshell

In countries where the judicial system is dysfunctional (which is much of the world), people avoid the courts as much as possible. Still, they need to do business somehow. So, they transact within their social networks. Everyone does this. Not just the powerful elites, but everyone. They all have their social networks. These networks provide the institutional setting in which everyone does business.

This works fairly well. It is relatively low cost. Other than spot and capture transactions, it is the primary game in town. Things will be okay if we just stay away from the courts. In fact, we don't really care whether the courts work or not, except for crime, of course.

There are many kinds of social networks, but their common denominator is the ability they provide to transact with the relative comfort of knowing that both you and your "friend" are subject to roughly equal social pressure in the event a dispute arises. You will both be under social pressure to work things out. If you don't work things out, the penalty can be expulsion from that social network, a kind of economic suicide. So you work things out.

"Working things out" in social network settings is an ancient art. This is probably a seedbed for institutional change. In some societies, the understandings that facilitate "working things out" are quite intricate and sophisticated. Gunar Myrdal (1968) and Clifford Geertz (1983) get deeply into this, but they never quite grasp the broad implications for economic development.

Social networks come in many flavors, some more cohesive than others. Some have a core with a periphery. A person may be part of several networks. Marriage may add more. Some are permeable, admitting new entrants, while others are closed. New

⁴⁰From review of the diamond industry, Richman (2007) proposes that some forces of globalization are beginning to breakdown recourse to social networks for transacting.

networks can form quickly. Thousands of networks subsist in a country. Many constitute the primary medium for a great deal of a nation's economic activity.

Each firm is embedded in a social network. Firm size is constrained by the size of its corresponding social network. Social networks in general have size limits.⁴¹ Such limits are not present in judicially well-supported economies. Firms tend to remain small, with growth impeded. Network size is limited by the need for roughly equal social bargaining power and efficient dispersion of information. Size limits are also imposed by time and distance.

Social network transacting – the term embraces relational contracting, trust, collective action, social capital, the natural state, and more - imposes severe constraints on economic growth, notwithstanding low costs for intra-network transacting. Trans-network transacting is not supported by SNT and thus where the judicial system is dysfunctional significant limitations are placed on development.

There are other constraints. Barriers to entry abound. Social stratification gets reinforced, since only fools will transact within the network of a higher social order. Firms that exist within a social network are poor at exporting unless members of that network live in foreign markets.⁴² Resource allocation is far from optimized when dealing tends to be compartmentalized within social networks.

There are still more (hidden or misdiagnosed) costs that SNT imposes in the presence of judicial system dysfunction. Predatory state action cannot normally be constrained by SNT. Corporate governance is provided, not by legal rules, but by that network's members' sense of what is wise and fair in business. Corporate business strategy shelters within the corresponding network's tolerance for adventure and risk, and this is likely to inspire a caution that stunts competitiveness, particularly in global markets.

Transactions costs economics offers excellent tools for looking at these inherent limitations, but what needs examination are not so much transactions themselves, but rather things that do not happen in countries where the judicial system works badly and where people therefore direct their economic activity as much as possible to transacting within social networks.

The perceptions of traditional economic discourse fit poorly into landscapes of judicial system dysfunction. The tools of transactions costs economics offer a means of seeing and examining this landscape. The phenomenon of social network transacting may provide better explanations for the some of the failures of economic development.

Significant improvements in judicial system performance are demonstrably possible, but public demands for improvement, while sometimes fairly strong, have been

⁴¹ See Dixit (2004).

⁴² Kimborough (2006) is interesting in this regard.

too frequently misdirected. Both the mechanisms through which judicial system dysfunction constrains economic development and the corrective action that might be taken to reduce these constraints are too poorly understood. More research at a greater level of detail within the courts and closer attention to linking specific types of judicial dysfunction to specific patterns of economic activity may focus and speed improvements. Success in correcting even a few specific kinds of dysfunction could build stronger public interest in judicial system improvement. The elephant in the judicial system's path may yet be seen and moved.

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