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Contract Enforcement and Investment: A Systematic Review of the Evidence

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Summary. — This "systematic review" focuses on the empirical research that evaluates the causal link between contract enforcement and investment. The evidence available in a variety of academic media, reviewed with established procedures, provides some but weak support for the existence of such link. During 1990–2010 we only found 19 independent studies that empirically test the relationship, and only one that directly examines the effects of an actual institutional reform. Few of the studies test alternative explanations, perform robustness checks, or critically assess the findings. In sum, the broadly accepted hypothesis of direct causation is still awaiting strong empirical backing.
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1. BACKGROUND AND RATIONALE

The key role of capital accumulation in economic development has been almost a truism in economics since the classical economists (Smith, Ricardo, Marx). Investment was one of the obvious ways to promote economic growth in their theories as well as in the "modern" growth models (Barro, 1991; Mankiw, Romer, & Weil, 1992; Solow, 1956), and the specific circumstances of underdeveloped economies in this regard have been extensively explored since development economics became a recognizable sub-discipline (see, e.g., Hirschman, 1958; Rostow, 1960; and various contributions in Meier & Seers, 1984).

In recent years, institutions have become more prominent in the scholarly literature, among the factors that could determine growth and investment performance, (North, 1990; Rodrik, 2000; Shirley, 2008). The literature has identified a host of growth and investment-relevant institutions, and their direct or indirect channels of influence. This has led, among others, to the "business environment" and "investment climate" approaches to institutional reforms for growth and poverty reduction (see, e.g., OECD, 2004). Salient among the key institutions are those that protect investors from expropriation and those that determine how contracts are enforced. Though these two classes of institutions may overlap, they are not conceptually identical, and we will argue (as have done; e.g., Acemoglu & Johnson, 2005) that it is analytically desirable to try to disentangle their specific effects.

This article weighs the empirical evidence on one specific link between institutions and economic performance. In particular, we undertake a *Systematic Review* (SR) on the connection between contract enforcement and investment.

(a) *Contract enforcement*

Various economic historians, including North (1990), have argued that the enforcement of contracts became more involved and consequential with increased specialization, larger numbers of trading partners, and geographic dislocation of transactions. With complex contracts it became necessary to devise some form of third-party enforcement. In fact, in modern societies, the three forms of exchanges and enforcement arrangements (tacit, explicit-informal, and formal) coexist, and even archaic and seemingly dysfunctional informal rules can have major impacts. The different behavioral outcomes in countries with similar legislation are a confirmation that informal rules can be powerful (Berkowitz, Pistor, & Richard, 2003).

These historical and theoretical issues are still debated between those that take the view that formal enforcement mechanisms (and contract law) are essential for development and those that believe that informal enforcement mechanisms (and contract arrangements) could be sufficient (North, 1990; Greif, 2006). In the middle, some advance the idea that different enforcement arrangements can work well at different levels of development and/or for different country contexts. The "varieties of capitalism" literature maintains that liberal economies rely more on standard market relationships and enforceable formal contracts than coordinated market economies, where dense business networks and associations disseminate reputations allowing firms to operate on the basis

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of informal contracts (Hall & Soskice, 2001). In the same vein, communalist societies resort more to intra-group sanctions, meanwhile individualist societies rely more on formal contract enforcement (Greif, 2005, chap. 28). Trebilcock and Leng (2006) favor stages of development argument: for low levels of economic development informal contract enforcement may be a good substitute for formal enforcement, but for higher levels of development formal contract law and enforcement are necessary.

The coexistence of formal contracts and informal (frequently tacit) arrangements is also highlighted by Macaulay (1963), who investigates when and why managers decide to formally enforce a contract, and the reasons why third-party enforcement is not invoked more often when the letter of a contract would favor the claimant. He concludes that "businessmen often fail to plan exchange relationships completely, and seldom use legal sanctions to adjust these relationships or to settle disputes" (p. 55). This implies that also individualist, liberal, and developed economies use informal contracts and enforcement arrangements much more extensively than generally assumed in the law and economics and institutionalist literatures. This line of reasoning would conclude that what matters for development is the existence of *some* enforcement capacities rather than specific formal laws and enforcement mechanisms.

Regarding the *actors* of the enforcement process, in contemporary societies, enforcement can come from societal sanctions, from second-party retaliation or from a coercive third party (typically, the state). Given the diversity of contracts, legal traditions, codes, and informal institutions, there is a range of possible innovations that may directly or indirectly impact on the enforcement of contracts. Typically, donor-funded reform programs, for example, tend to tackle simultaneously a number of perceived gaps in the written laws and the functioning of the judiciary (for example, fixing loopholes in commercial or civil legislation, creating non-judicial arbitration mechanisms, facilitating access to the judicial system, reducing costs of litigation, strengthening the capacities of the courts and judges). All of them have some bearing on the speed and effectiveness of contract enforcement, and more broadly on "the rule of law" (see, e.g., World Bank, 2001), but they focus on formal institutions and assume that the rule-enforcement distinction is unproblematic.

(b) *Contract enforcement and investment*

This article focuses on a relatively narrow, yet fundamental "corner" of the broader "institutions and economic performance" literature. Figure 1 is a graphical representation of the field. In the top block, research strands are organized according to the nature of the institutions that might impact on economic performance. Political institutions that set the rules about who governs and how (investigated among others by Alberto Alesina, Thorsten Persson,and Barry Weingast), and legal rules excluding those that allocate political power (i.e., what is most often understood to be "the Law" in "Law and Economics") are represented as the complements of informal economic institutions (investigated, for example, by Sam Bowles, Herbert Gintis, Pranab Bardham, and others). For our purposes it is useful to distinguish within the Law and Economics space a sector that gathers works on the effects and determinants of unilateral state regulations (studied, e.g., by Peter Klein and Pablo Spiller, among others), and which is distinct from the research on institutions that support voluntary dyadic exchanges (exemplified by writings by Benito Arruñada, Katharina Pistor or Holger Spamann, but also by Thorsten Beck and Ross Levine. [1]

Theoretical and empirical works can be thought to cluster around some of the (causal) connections between "institutions" from the Figure's top block and economic outcomes from the bottom area. The similarity between the labels that would result and the sections and chapters of a comprehensive handbook such as Menard and Shirley (2005) suggest the diagram is a reasonable representation of the relevant research fields. In that framework, work on "contract enforcement" and investment occupies a narrow but fundamental space, encompassing formal and informal contracts and enforcement mechanisms (the figure has to be interpreted as covering also studies that would challenge the simpler formal-informal dichotomy, such as Macaulay's, or that highlights the incompleteness of the Law and the ensuing ambiguities of enforcement; Pistor & Xu, 2003). The rationale for the restrictive definition of our focus is discussed below but we can say in advance that it is best suited to undertaking a thorough appraisal of the evidence in support of an influential hypothesis.

The diagram reflects that research on the link between contract enforcement and investment is a cross-cutting sector of the complementary fields of Law and Economics and the study of economic consequences of informal institutions. As defined in this article, the field of unilateral regulations by governments does not intersect with our object of analysis; nor does the field of political institutions and economic outcomes).

Analytically, weak enforcement of contracts has been argued to impact on investment through a number of channels. First, it could most directly influence the uncertainty surrounding a project, and therefore influence investors' decisions by increasing the project's costs, reducing its expected returns, causing both, or generally increasing the value of the "wait" option (Dixit & Pyndick, 1994).

Second, weak enforcement could act indirectly on agents' willingness or ability to invest: it could induce them to choose less-efficient technologies, inhibit them from building relation-specific assets when those relations are dependent on contracts, or amplify the adverse effects of infrastructure or regulatory shortcomings. All these could in turn affect a firm's access to external financing, while capital markets and the banking industry might be more generally crippled by an environment of insecure contracts. These various channels and some others may combine in complex ways. For example, some authors have found analytical support for the idea that weak enforceability increases firms' "sensitivity to the arrival of new technologies and generates greater macroeconomic volatility" (Cooley, Marimon, & Quadrini, 2004). To the extent that aggregate (output) volatility influences investment, there would be a causal chain from enforcement of contracts to capital accumulation. Others have argued that, through financial contracts, imperfect enforcement influences the size distribution and heterogeneity of firms, which could be reflected in aggregate investment levels (Monge-Naranjo, 2009).

(c) *Empirical approaches*

Research on the effects of institutions on economic performance has grown very rapidly since the early 1990s. Theoretical developments such as North's contributions have prompted the search for and elaboration of indicators and proxies for the introduction of institutional variables in empirical (usually econometric) analyses (see, e.g., Knack & Keefer, 1995; Kaufmann, Kraay, & Mastruzzi, 2005). The proliferation of datasets that include such indicators have stimulated

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