Generalizing the Law Merchant Story

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Lex Mercatoria, or the "Law Merchant," provides classical liberals and libertarians with an important example of effective law without coercive state authority. Within the legal and classical liberal literaturse, *Lex Mercatoria* usually refers to the privately produced, privately adjudicated and privately enforced body of customary law that governed virtually every aspect of commercial transactions in Europe and the Middle East by the end of the eleventh century. Many writers suggest that this system of law was largely displaced in Europe by the end of the seventeenth century, but beginning in the mid-1950s, *Lex Mercatoria* also began to be applied to certain aspects of modern international commercial law (De Ly 1992: 1). The argument presented below, however, is that the historical Law-Merchant story has considerable more relevance today than its implications for international commercial activity.. The fact is that a law merchant arises any time that a commercial system begins to evolve, so many of the events underlying the emergence of commerce after the "dark ages" of medieval Europe are being replayed as Eastern Europe emerges from the dark ages of communist rule. The same is true in parts of Asia as a commercial sector attempts to emerge in the face of ongoing totalitarian political control, and in various parts of Latin American where economies are attempting to escape the effects of long periods of political turmoil and totalitarian governments. Furthermore, the emergence of a law merchant is likely to be necessary for the successful evolution of a commercial society into a strong and healthy market economy.

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Liberal Düşünce, Cilt: 12, No: 45, Kış-Bahar 2007, s. 187-202.

In order to support these contentions, Section I provides a very brief overview of the medieval Law Merchant and its modern international counterpart. Section II suggests that the same processes are important for the development of intranational commercial activity. Concluding remarks appear in Section III.

I. Lex Mercatoria

Rapid expansion in agricultural productivity during the eleventh and twelfth centuries meant that less labor was needed to produce sufficient food and clothing for Europe's population, so individuals began specializing in crafts, and population began to move into towns, many of which rapidly became cities. Trade is required with specialization, and the class of professional merchants expanded to facilitate such trade. Merchants spoke different languages and had different cultural backgrounds, however, while geographic distances often prevented direct communication let alone the building of strong interpersonal bonds to facilitate trust, and numerous middlemen were frequently required to move products from their producers to consumers. All of this generated mistrust between merchants. Internationally recognized commercial law, essentially to substitute for trust, was required, and as Berman (1983: 333) emphasizes, it was during this period "that the basic concepts and institutions of ... *lex mercatoria* ... were formed, and, even more important, it was then that [this] ... law ... first came to be viewed as an integrated, developing system, a <u>body</u> of law." This argument is actually too strong if it implies that the Law Merchant was created out of nothing. Indeed, while the "great commercial development was new in European hands, it was of centuries standing in the hands of the Eastern nations.... [So] Europe may be indebted to the East for the earliest form of shipping documents, as well as for the law merchant generally" (Bewes 1923: 8-11). However, both this Middle Eastern foundation and the continued evolution of legal institutions in European commercial society, was spontaneous and undesigned. Indeed, the Law Merchant evolved just as markets evolve, from the bottom up through individual interaction.

The Law Merchant developed within the decentralized merchant community rather than through coercive government, so police power was not the source of incentives to recognize its rules. Indeed, the Law Merchant was voluntarily recognized, as Benson (1989) explains. The reciprocity necessary for voluntary recognition arose, in part, from the mutual gains generated by repeated exchange. Furthermore, each merchant traded with many other merchants, so the spread of information about breaches of commercial conduct within one interaction could affect a merchant's reputation. Therefore, the Law Merchant was ultimately backed by the threat of ostracism by the

merchant community at large, since individuals known to engage in "illegal" behavior could not find trading partners.

Merchants also established their own courts. One reason for this was that royal courts often would not enforce customary merchant practices and usage (e.g., they would not recognize contracts involving interest charges: all interest was usurious). In addition, merchant court judges were merchants chosen from the relevant trading community (fair or market), while lawyers and royal judges often had no knowledge of commercial issues, so the risk of an inefficient ruling was lower in a merchant court, particularly when highly technical commercial issues were involved. Merchants also had to complete their transactions in one market or fair and quickly move to the next, but the resulting desired speed and informality could not have been equitably achieved without the use of judges knowledgeable of commercial issues.

Where alternative rules might apply (as international trade was beginning to evolve for instance, and conflicting local customs were discovered) those practices which proved to be the most effective at facilitating commercial interaction supplanted those which were less effective. When new conditions arose which were not obviously covered by an existing rule, the scope of rules expanded or new rules developed. Contract was a primary mechanism for instituting legal change in the Law Merchant, as individuals agreed to new practices. Another mechanism for change was dispute resolution. In either case, however, a new "rule" only applied to the parties directly involved. If others saw the contract clause or dispute resolution to be useful, they adopted it in future interactions, so the rule spread through a process of voluntary acceptance.

Considerable change in the Law Merchant occurred in a relatively short time. In fact, Berman (1983: 350) concludes that, "a great many if not most of the structural elements of the modern system of commercial law were formed in this period." By the twelfth century, commercial law in Europe provided alien merchants with substantial protection "against the vagaries of local laws and customs," and by the early thirteenth century the Law Merchant clearly was an integrated system of principles, concepts, rules and procedures. In fact, another reason for the use of merchant courts was that royal judges would not or could not adopt new rules as fast as the rapidly changing commercial system required. Berman (1983: 341) notes that over the period from 1000 to 1200, and especially 1050 to 1150, the rights and obligations of merchants in their dealings with each other "became substantially more objective and less arbitrary, more precise and less loose." After all, no one would voluntarily recognize such a legal system that was not expected to treat him fairly.

Kings gradually asserted authority over commerce, generally in order to tax it or to extract other types of revenues by selling monopoly franchise or other

special privileges to politically powerful business interests, as noted in Benson (1989). The Law Merchant became less recognizable as royal courts supplanted merchant courts, and as statutes, precedents, and treaties supplanted or supplemented business tradition and practice. Nonetheless, it has survived in varying degrees in international trade, so, as noted above, beginning in the mid-1950s, *lex mercatoria* also began to be applied to the private institutions of modern international commercial law. International commercial law is largely still is customary law, as explained by Berman and Dasser (1990). The customary rules of international trade are still backed by the desire to maintain reputations and repeated-dealing arrangements, and therefore, ultimately, by a boycott threat. Furthermore, almost all international trade contracts expressly mandate arbitration rather than adjudication by national courts. International arbitration procedures are speedy and flexible, but it is also chosen because traders generally assume that national courts will not enforce obligations derived solely from commercial practice and usage, while arbitrators "do not hesitate to refer to international commercial custom, including contract practices in international trade, as a basis for their award," as Berman and Dasser (1990: 33) stress. Lew's (1978: 581) detailed analysis reveals that in arbitration, at least in principle, "The answer to every dispute is to be found *prima facie* in the contract itself. What did the parties intend, what did they agree and what did they expect?" When a contract does not reveal the intentions of the parties, arbitrators still do not refer to any nationalized system of law unless the parties have specified one in the contract. Instead, Lew (1978: 585) explains that they apply a "non-national and generally accepted rule or practice" that the parties should have been aware of within their international business community. Thus, there is growing recognition that in international trade, the Law Merchant continues to govern. But the Law Merchant is much more important for modern commercial activity than many writers recognize.

II. Intranational Law Merchants

In order for widespread trade to occur, and for the development of capital markets that ultimately allow economies to flourish, traders and lenders require some degree of assurance that the people they are dealing with will live up to their promises. There is no assurance problem when information is free and complete, but such perfect knowledge does not exist anywhere except in some economists' mathematical models. Information is so scarce in the real world that trust or recourse often must substitute for knowledge in order to make promises credible.

Trust and recourse are both substitutes for knowledge, but they are not perfect substitutes for each other. Tradeoffs mean that under some circum-

stances trust provides a superior solution to assurance problems, while recourse may be more desirable under other conditions. Furthermore, there are alternative institutional mechanisms for the provision of recourse, and they also are imperfect substitutes. While the governments of nation states are often seen as a potential source of recourse, for instance, the law merchant that evolves within the commercial community is an alternative which is likely to be a superior source of recourse in emerging commercial economies. The fact is that the legal systems in many countries with emerging economies do not provide consistent and predictable recourse. In order to illustrate this, let us examine some of the tradeoffs between alternative institutional sources of trust and recourse in emerging markets, many of which can be described as low-trust societies.

Building Trust

Trust, a willingness to make oneself vulnerable to another even in the absence of external constraints, certainly can evolve to support trade. It is widely recognized, for instance, that repeated dealings create an environment conducive to the development of trust, because incentives to employ cooperative strategies (e.g., live up to promises) arise. In emerging economies, repeated-dealing arrangements must be established, however. For instance, McMillan and Woodruff (1998), in their study of emerging trade in Vietnam explain that an entrepreneur tends to be very cautious when considering a potential trading partner. He often visits the plant of the firm he is considering in order to see if the facility appears to be permanent and efficient. He inspects the output of the plant, ask other trusted traders if they have dealt with or know about the potential partner, and so on. The information gathered can never be perfect but if it is positive, a small trade is often arranged. If that one works out, the next one is larger. It is only after several deals that the transactions reach a level that involves a substantial commitment. This can take time, of course, and that is obviously one of the drawbacks of relying on trust relationships.

Traders may be able to gain the trust of others relatively quickly by investing in signals that demonstrate a commitment to fair dealing. For instance, Nelson (1974) explains that the advertising of experience goods serves two primary functions for the rational buyer, and neither of these functions focus on the provision of direct information about the experience quality of commodities that are advertised: first, “advertising relates brand to function” and provides information about the general uses of the product, but second and more important, the volume of advertising is a signal to buyers that shows the extent of committed investment by the seller. According to Nelson, then, what matters most to a rational buyer is not what advertising says about qual-

ity, but simply that it is a recognizable investment in non-salvageable capital: brand name. Advertising may not be as important in an emerging economy as it is in a developed economy, but there are other non-salvageable assets (e.g., elaborate store fronts, charitable contributions, community service) that can serve the same function. Essentially, investments in non-salvageable assets are offered as a bond to insure credibility. Buyers must be aware of such commitments, and if so, as Klein and Leffler (1981) explain, the marginal cost to buyers of measuring such specialized or non-salvageable investments must also be less than the prospective gains: "If the consumer estimate of the initial sunk expenditure made by the firm is greater than the consumer estimate of the firm's possible short-run cheating gain" then they will tend to trust the seller. Furthermore, when effective recourse is not available, firms have very strong *incentives* to make such investments (incentives that could be much weaker if they were relying on some third party to impose sanctions).

From Trust to Reputation and Recourse

Most arguments about the inability of private parties to cooperate without backing from a coercive power (e.g., a government) are explicitly or implicitly prisoners' dilemma arguments. As suggested above, however, the one-shot prisoners' dilemma analogy does not characterize most kinds of commercial interactions, even in emerging economies. When repeated dealing arrangements and/or non-salvageable investments are valuable, traders obviously have recourse. If a trader partner fails to live up to a promise, commits fraud or behaves opportunistically, the victim can threaten punishment. Sanctions can involve tit-for-tat or exit in repeated dealing arrangements, for instance, but non-salvageable investments create a potential threat that is even stronger: a threat to spread information about non-cooperative behavior. Traders have strong incentives to avoid dealing with a firm they believe may not be trustworthy, so if the spread of information is sufficiently effective a spontaneous boycott can be anticipated. Such an ostracism threat can be a very powerful source of recourse, since the offending firm will lose all of the value that attaches to its non-salvageable asset. Therefore, traders have strong incentives to establish communication mechanisms. They may be very informal, as groups of merchants meet and "gossip", but they can become more formal (e.g., commercial associations with formal meetings, news letters, etc.). When information can be spread at low cost, the individual trader has incentives to establish and maintain a reputation for fair and ethical dealings. Each transactor's dominant strategy is likely to be to cooperate throughout each transaction that he is involved in with other members of the network of communicating merchants, whether it is a repeated or a one shot deal. Under these circum-

stances recourse is not likely to be required very often, although it is always available.

Time is also required to build reputations, of course, so emerging markets may not have many transactors that can offer valuable reputation bonds to contractual partners. Firms with international reputations may enter an emerging market and become established very quickly, but new firms may have to suffer through a considerable period of losses before they can expect to see investments in reputation building pay off. Indeed, since the payoff to such investments are delayed and very uncertain, incentives to make them tend relatively weak, and the emergence of commerce based on such sources of recourse also can be quite slow. Much of this uncertainty is due to the state, however. As Pejovich (1995: 17) notes, "The 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 rules... [M]ost countries in Eastern Europe [and many other parts of the world] are arbitrary states." When property rights are insecure due to 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), incentives to invest in reputation or to count on future dealings are weak and the kinds of private sanctions discussed here are likely to be relatively weak. But that also means that the state cannot be relied upon to provide consistently effective recourse, as traders clearly recognize. McMillan and Woodruff's (1998) interviews of entrepreneurs in Vietnam show that despite their frequent reliance on informal sanctions (tit-for-tat, exit, spreading information about non-cooperative behavior), these entrepreneurs do not want the state to get involved in contract enforcement because they do not trust the state either.

Formalizing Spontaneous Sanctions: Recourse Through Trading Organizations

Both commitments and threats can be made more credible, and some uncertainty can be eliminated, if individuals with mutual interests in long-term interactions form "contractual" groups or organizations rather than waiting for trust or reputation institutions to evolve more slowly. Potential contractual arrangements are numerous, including the implicit contracts of family bonds and ethnic networks, indirect equity ties through pyramidal ownership structures, direct equity ties, and interlocking directorates. As Khanna and Rivkin (2000) explain, such business groups are actually "ubiquitous in emerging economies" (as evidence, they cite a large number of studies about groups such as grupos in Latin America, business houses in India, *chaebol* in Korea).

In addition to creating strong bonds that facilitate interaction and the spread of information, as suggested above, an affiliation with such a group can also be information generating in that it can imply a bond or assurance (a credible signal of reputable behavior) so potential transactors can circumvent the slow process of building reputations in order to create trust.

A business organization such as a trade association can also form through contract and substitute for family, ethnic, ownership, or directorate linkages. These organizations 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. Then group membership can include a contractual obligation to boycott anyone who fails to live up to a contractual obligation: specifically, any non-cooperative party will be automatically expelled from the organization. Such automatic ostracism penalties make the reputation threat much more credible (Williamson 1991: 168). These groups can also lower transactions costs by establishing their own unbiased dispute resolution arrangements. After all, allegations of non-cooperative behavior are not necessarily true, so they may have to be verified. Furthermore, if a contract does not clearly address some unanticipated occurrence, a dispute can arise over how to treat the new situation.

A group of traders can institute mediation or arbitration alternatives (or both, as illustrated by Bernstein's (1992) study of diamond traders). These services can be produced internally, perhaps by elected members of the organization (as in the diamond traders' organization), or by mediation and/or arbitration specialists, or they can be obtained externally by employing arbitrators from organizations like the International Chamber of Commerce, the American Arbitration Association, the Hungarian Chamber of Commerce, or any number of other private dispute resolution providers. Mediation and arbitration selection mechanisms actually vary widely, but in general, they guarantee that a choice is made without requiring explicit agreement by the two parties while still allowing for prescreening, and possible more than one level of screening (Benson 1999). Biased rulings are not likely in a competitive environment where potential adjudicators are chosen before hand by the trading community or where both parties have the power to reject adjudicators proposed by the other.

When a dispute involves new and unanticipated issues, a mediator or arbitrator may be required to determine what rule should be applied to the situation. As noted above Lew (1978, 581) that an arbitrator first attempts to see what parties intended, agreed to and/or expected by examining the contract. When an arbitrator cannot discover the parties' intent in the contract, he must decide what the parties expected or should have expected using some other

source of information, and in this regard, an arbitrator draws upon accepted "practices and usage" (customary rules) of the relevant business community (Lew 1978: 582-585). The same is often true within domestic commerce as trade association mediators or arbitrators apply the associations own rules rather than those of the government of the territory within which the commercial transactions take place (Bernstein 1992, Benson 1995). Indeed, historically, as trade evolved beyond small close-knit groups formed on the basis of trust and reputation, "legal systems" arise as a substitute for more informal arrangements, but these legal systems generally are not the product of nation-states (Benson 1989, 1995).

Lex Mercatoria: Customary Commercial Law

A system of behavioral rules backed by institutions to induce recognition, resolve disputes, and facilitate change, also is a substitute for knowledge (as well as for trust relationships, and reputation backed by spontaneous ostracism). After all, as Hayek (1937) explains, rational individuals are not able to use conscious reason to evaluate every option, because there are significant limits on abilities to reason and to absorb knowledge. This means, among other things, that rational individuals will often find it beneficial to voluntarily develop and conform to rules to guide their actions. In this context, "rules" should be seen as behavioral patterns that other individuals expect a person to adopt and follow in the context of various interdependent activities and actions -- that is, rules specify obligations. The rules one individual is expected to follow influence the choices made by other individuals: like prices, rules coordinate and motivate interdependent behavior.

The most visible types of rules are the "laws" designed and imposed by those with authority in nation-states, but there are other rules (e.g.., habits, conventions, norms, customs, traditions, or standard practices) that are actually much more important determinants of behavior in many aspects of human activity, including commerce. A key distinguishing characteristic of such rules is that they are initiated by an individual's decision to behave in particular ways under particular circumstances. As Hayek (1973: 96-97) emphasizes, adopting a behavioral pattern creates expectations for others who observe it and this create an obligation to live up to those expectations. Furthermore, as Mises (1985: 192) explains, when individuals who interact with one another observe each others' behavioral patterns they often emulate those that appear desirable so such behavior and accompanying obligations spread. In other words, these rules evolve spontaneously from the bottom up rather than being intentionally designed by a legislator, and they are voluntarily accepted rather than being imposed. For an obligation to achieve the status of a "customary law" it must be recognized and accepted by the individuals in the affected group.

Customary law tends to be quite conservative in the sense that it guards against mistakes. Nonetheless, flexibility and change often characterize customary law systems (Pospisil 1971; Benson 1989). For instance, 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 a new behavioral rule. Thus, 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 learn about the contractual innovation, however, and/or others outside the contract observe its results, so if it provides a more desirable behavior rule than older custom, it can be rapidly emulated. Contracting may actually be the most important source of new rules in a dynamic system of customary law (Fuller 1981: 157; Benson 2005, 2006), and many innovations in commercial law have been initiated in contracts and dispersed quickly through the relevant business community (Benson 1989, 1999).

Alternatively, as conditions change, the inadequacy of existing customary rules can be revealed when a dispute arises. Negotiation is probably the primary means of dispute resolution for members of a close-knit customary law community, however, reinforcing the contention that contracting is a primary mechanisms for initiating rapid change in customary law. If direct negotiation (perhaps facilitated by a mediator) fails, however, the parties to a dispute often turn to an arbitrator. Since a dispute suggests that existing rules are unclear or insufficient, new customary rules can be and often are initiated through third-party dispute resolution (Fuller 1981: 90, 110-111; Lew 1978: 584-589; Benson 1989, 1999, 2005). Unlike legislation, or public court precedent in a common law system, such a decision only applies to the parties in the dispute, but if it effectively facilitates desirable interactions the implied behavior can spread rapidly through the community, becoming a new rule.

Recourse Through the State: More Powerful Sanctions and More Rapid Rule Creation?

The high likelihood of unbiased dispute resolution creates strong incentives to accept arbitration under customary law for parties who want to maintain the benefits of group membership. In addition to such positive incentives, refusal to accept arbitration under customary rules often results in automatic ostracism. Of course, for some individuals, long-run benefits and ostracism threats may not be sufficient. Thus, a stronger sanction might be desirable, and nation-states with coercive power certainly can provide strong threats. Furthermore, a state's legal system can provide recourse for traders who are not members of informal or formal trading communities. And while customary law can evolve quite rapidly under some circumstances, it does tend to be

conservative, so perhaps the state, through legislation, can create beneficial new laws even more rapidly. Perhaps commercial law for emerging markets should be produced by governments? Actually, despite such potential (although certainly not guaranteed) benefits, there are a number of reasons for avoiding substitution of the state's legal system for alternative (although always imperfect) private (Law Merchant) solutions to the assurance problem. One is simply that governments of the nations where markets are attempting to emerge face a tremendous knowledge problem which means that they are not capable of doing the things that various commentators suggest that they should do. For instance, legislators, bureaucrats, and judges in places like Russia, Poland, Vietnam, China, and Brazil, are even less likely to understand the important underpinnings of a successful market system well enough to provide effective support for them than the Western European and North American judges, bureaucrats, and politicians who frequently seem to make decisions that undermine rather than support market processes (Pejovich 1997).

There is another problem with state made commercial law. The wide variety of activities and relationships that exist in commerce mean that many rules that are effective for one type of transaction or one group may not be effective for another. The diamond traders discussed by Bernstein (1992) may prefer a very different set of rules and institutions than those adopted by the oil traders discussed by Trakman (1983), for instance. The products being traded are very different, of course, suggesting that very different contractual issues are likely to be relevant, but the trading communities are also very different. Diamond merchants share common ethnic and religious backgrounds, creating an environment of mutual understanding (e.g., of common trade practices and usage) and trust, thus reducing the need for highly technical and specific contracts, while oil traders display much greater ethnic and religious diversity as well as differences in motivations (a number of oil producing states have nationalized production, for instance, so political considerations can have major impacts of decision-making), so the level of common understanding is low, trust relationships are weak, and much more specific and complex contracts are required. Imposition of a homogeneous set of rules on these two groups would lead to higher transactions costs for at least one set of these traders, if not both. Yet, national legal systems tend to produce homogenized although very complex law that limits the potential for specialization, but as Cooter (1994: 216) explains, more decentralized lawmaking is desirable in increasingly complex economic systems.

There is another problem that arises with state-made law. Any legal system that is larger than what would spontaneously evolve through individual interaction will, by definition, require some concentration of coercive power. While such power might be used to simply extend the scope of basic cus-

tomary rules, this is unlikely because, in addition to a knowledge problem there is also an interest problem. Coercively imposed rules can internalize externalities and facilitate voluntary interaction, but they also determine the distribution of wealth, and these distributional consequences create incentives to use coercive law to transfer wealth. Indeed, an understanding of state-made law requires recognition of the resulting conflict between incentives to pursue wealth through both productive and transfer processes (Benson 2005). The use of law to transfer wealth actually reduces wealth for at least five reasons. First, comparative static analysis of a transfer points to a deadweight loss. Second, as Tullock (1967) explains, the resources consumed in the rent-seeking competition for such transfers also have opportunity costs: they could be used to produce new wealth. Third, potential victims of the transfer process have incentives to resist, of course, so rent-avoidance costs also arise through investments in political information and influence. Exit is another option, however, whether by moving to an alternative political jurisdiction, or by hiding economic activity and wealth (e.g., moving transactions "underground" into what de Soto (1989) calls the informal sector). Therefore, in order to induce compliance with discriminatory transfer rules, the rule makers will generally have to rely on an enforcement bureaucracy, both to limit exit and to execute the rules. These high enforcement costs are a fourth source of opportunity costs that accompany a wealth transfer process. The fifth consequence is likely to be even more significant than the other four, however. Faced with the probability of involuntary transfers, productive individuals' property rights to their resources, wealth, and income flow are perceived to be relatively insecure, so their incentives to invest in maintenance of and improvements to their assets, and their incentives to earn income and produce new wealth that might be appropriated, are weak. If transfers are expected to be large, frequent, and arbitrary, production will be low and wealth expansion (economic growth) will be very slow if it occurs at all.

III. Conclusions

If we look to the relatively advanced economies of Western Europe and North America for models of how market economies emerge, we find that markets were well established and governed by customary law long before states got involved in the making and enforcing rules of commerce, and that even when the states did so, they generally started by recognizing established custom (Benson 1989, 1995). Furthermore, after state intervention previously established institutions of trust, informal recourse (e.g., spontaneous ostracism), commercial groups, and customary law survived as an ongoing source of competition for the state, helping to constrain its activities. As Feldbrug-

ge (1996: 568) observes, of course, "the 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, still-communist parts of Asia, and numerous non-communist totalitarian governments around the world are not able to start with the types of private commercial institutions that have provided the foundation for trust and recourse in the West. The West did not have them either, however, until they became desirable (Benson 1989). The evolution of the private institutions of commercial law and of market institutions themselves has always been simultaneous rather than sequential (Benson 1989). And in this regard, it is not surprising to find that repeated dealings and reputation effects are being used to support trade in many emerging economies. Informal and formal groups of trading partners are developing quite rapidly in many emerging economies (Pejovich 1995; McMillan and Woodruff 1998; Khanna and Rivkin 2000). During the early stages of group formation arbitration arrangements may not arise as members rely instead on negotiation and threatened sanctions to resolve disputes (McMillan and Woodruff 1998), but arbitration is also developing in some emerging economies (Jankovich 1996: 539). While these developments are often quite slow, that is generally because the threats of an arbitrary state stand in their way. Even if that is not the case, however, reliance on the state for rules and/or legal sanctions at this early stage is likely to mean that the future evolution commercial law will be along a very different path than the one taken in the economies of Western Europe and North America, where the state did not claim jurisdiction until long after the evolutionary process was under way. The withdrawal of the state from any efforts to influence commerce will do more to stimulate commercial activity than any proactive efforts by the state to speed up the process, since such efforts will inevitably be undermined by the problems of knowledge and interest.

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