



**OECD Development Centre and Development
Assistance Committee – Network on Governance**

International Seminar on

Informal Institutions and Development— What do we know and what can we do?

**Input Paper for Session C:
Private-sector development**

PRIVATE SECTOR DEVELOPMENT: HOW BUSINESS INTERACTS WITH INFORMAL INSTITUTIONS

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Summary:**Private Sector Development - How business interacts with informal institutions**

Today's development challenge lies not in technological solutions to production and distribution, but in structuring institutions to promote economic exchange and growth. Formal institutions comprise the constitutional framework that sets the political, economic and social rules for how organisations and individuals interact. Formal institutions, such as the law, reduce uncertainty, provide information and enforce contracts for private business. The formal rules may closely control or lightly manage firms. By giving certainty to economic exchange, formal institutions enhance business performance, resulting in growth and economic development. Informal institutions are the mores, norms, conventions and ways of doing things that can also reduce the costs of undertaking economic, political and social interaction. Informal institutions provide information to firms that allow them to undertake business activities.

In many developing countries, the formal and informal institutions do not reduce uncertainty, provide information and enforce economic exchange relative to the institutions in other countries. Corruption and rent seeking reduce information flows and weaken contract enforcement, reducing economic activity, especially foreign investment. Informal institutions can also protect the interests of entrenched elites and resist the reform of existing formal institutions. As a result, an economy with institutions that do not protect economic exchange suffers economic stagnation and decline.

Informal economic institutions exist in all countries, even developed countries with efficient formal economic institutions. But their importance and prominence is greater in countries with weak formal economic institutions, such as non-existent or un-enforced bankruptcy and contract laws, that fail to support business. While informal institutions may share superficial similarities, for example all kinship systems are based on familial, ethnic or religious connections, in practice they are very diverse across countries and across time. Operating differently in each country, informal business systems rely on providing information on the reputation of group members and excluding poor performers from group trade. Business activity grows, and an economy develops, when members can identify and only trade with members with a reputation for high performance. Open business systems where all firms can participate may in the long-run promote more rapid economic development than kinship systems that can exclude innovative and efficient firms.

It is not sufficient to rely on formal or informal business institutions to undertake trade and production. Given the society's formal and informal institutions, each firm must write and operate specific contracts with partners, suppliers, distributors and employees. Contracts will be specified differently when there are strong formal rules, such as courts for determining contract breach, than when informal rules, such as trust and cooperation are the basis for resolving disputes. The design of contracts by private business will largely shape the country's economic trajectory.

How well managers specify and design contracts for business exchange depends on how well they understand the country's formal and informal institutions. Writing 'good' contracts results in high levels of performance and economic development; writing 'bad' contracts results in poor performance and economic stagnation or decline.

From the case studies of contracts written by international business firms, the following policy implications emerge:

- Development agencies should foster informal economic institutions that support private business, especially open business networks over kinship networks.
- Development agencies should support programs to enhancing the flow of information about the availability, reliability and skill levels of suppliers, distributors and partner firms reduces the costs of designing and managing contracts.

Introduction: Formal and informal institutions for economic development

The technical requirements of combining capital, labour and inputs to secure economic growth are well understood after two centuries of economic expansion. Why then does nearly half the world's population (roughly three billion people) currently live on less than two U.S. dollars per day? Why, in the last decade, have some parts of Asia, sub-Saharan Africa and South America experienced negative growth, including Indonesia, where per capita income was lower in 2004 than 1997 (van der Eng, 2004)?

Today's development challenge lies not in technological solutions to production and distribution, but in structuring institutions to promote economic exchange and growth (North, 2005, 1990). Without the ability to engage in economic exchange – the trade of goods for services, labour for goods, and goods for goods – a society's growth is limited. Economic exchange is supported and shaped by formal institutions, including legal rules, regulations and policies, and informal institutions, comprising the web of social, cultural and, often, religious rules of behaviour. To reduce uncertainty, create information and provide enforcement mechanisms, societies develop institutions as 'rules of the game' by which private business plays. For example, language, money, and contract law can decrease the costs of economic exchange and activity by providing standardised terms of interaction— language acts as a standardised means of communication; money is a standardised unit of account or value, and contract law provides a common commercial standards.

Informal institutions are often overlooked as mechanisms that reduce uncertainty, provide information and enforce contracts for private business. While some informal institutions are relatively trivial, such as bowing when exchanging business cards, they retain their importance to business by signalling a willingness to cooperate (Ellickson, 1994; Landa, 1994). Other informal institutions are powerful mechanisms that can contribute to economic efficiency or distort resource allocation, such as corruption practices sustained by insider knowledge of who, when, and how much to bribe to win government contracts. Many informal institutions emerge within business communities to reduce the costs of searching for reliable partners, writing business agreements, and enforcing mutually beneficial exchange. The rules devised by business communities are frequently complex and multidimensional and include the desire to maintain profitable relationships and standing among peers (Macauley, 1963; Charny, 1990; Landa, 1994; McMillan and Woodruff, 1999). By identifying and ostracising poorly behaving firms and individuals, these networks reduce the costs to all members of doing business (Williamson, 1993; Grief, 1993). A key distinction between different business communities is the extent to which they are 'open' to all players or whether they are kinship based, where familial, religious or ethnic bonds tie group members together, but typically exclude outsiders.

Identifying institutions, and differences in institutions between countries, is the first step in understanding how an economy grows, stagnates or declines. A second step is to understand how businesses match specific contracts for exchange and trade to particular institutional environments. This is a distinct challenge for multinational firms, which operate simultaneously in different countries with different formal and informal institutions. Managers face two challenges: how to understand the host country's institutions, and, second, to design contracts with local firms, consumers and governments in each location. Managers' cognitive limitations play a central role in designing contracts. Faced with uncertainty and incomplete information in a foreign environment, how do managers know what is and what is not optimal—such as selecting a partner or going it alone, relying on host country courts or depending on trust for dispute resolution, or writing detailed, rather than verbal or implicit contracts?

This paper addresses the following issues:

- How do open and kinship informal institutions facilitate or impede economic growth, within a country's formal institutional environment?
- How do managers write specific contracts, given the informal and formal institutions in a host country?
- How do the cognitive limitations of managers shape the design of contracts in different institutional environments?

To illustrate the influence of informal norms and codes of behaviour on firms, the paper draws on historical examples and unique case studies. The case studies include the experiences of Hong Kong firms in their cultural 'homeland' of Guangdong province and Australian multinational enterprises (MNEs) in China, India, Indonesia and Vietnam.

Institutional Evolution: Open and Kinship Business Communities

Businesses create private ordering of exchange through open and kinship systems, based on reputation mechanisms. Poor behaviour colours the offending firm's or individual's reputation, resulting in blacklisting by other businesses. Three conditions are central: the prospect of repeat interaction; a system for transmitting relevant information to participants; and punishment for cheaters. These systems are path-dependent, evolving over time in response to the weakness or absence of formal law-based systems to protect trade. Kinship systems, like the 11th century Mediterranean Maghribi traders, are exclusionary, based on ethnicity, language, familial ties and religion, as described in Box 1.

Box 1. 11th Century Mediterranean Maghribi traders: A kinship system for information and enforcement of trade

The 11th century Mediterranean merchants, the Maghribi traders, developed a kinship-based business network, where ties of family, religion and ethnicity functioned to support complex business relationships over considerable geographic distances (see Grief, 1993). The Maghribi traders were Jewish merchants, who operated in the western basin of the Mediterranean, using agents to supply services, such as information on trading conditions and prices, loading and unloading of ships, paying duties, storing and selling goods, providing credit, and remitting funds, to facilitate trade. Each service was subject to potential opportunism, where inaccurate information, delays in loading and unloading, spoilage of stored goods, under-pricing of products and the extension of finance to un-creditworthy buyers imposed high costs on merchants.

Grief (1993) has shown that the Maghribi merchants had contracts with many Maghribi agents in different trade centres. Maghribi merchants only traded with Maghribi agents; and Maghribi agents only traded with Maghribi merchants. The merchants rewarded agents with a 'wage' or commission high enough to encourage honest behaviour, coupled with the punishment of contract termination for cheating. But, termination or the threat of termination from one merchant was not sufficient to deter cheating. Merchants entered into repeat contracts with each agent; contracted with numerous agents; and shared the same agents, creating an extensive information network. By sharing their information on agents, merchants undertook collective punishment, where an agent cheating one merchant, was then ostracised by all merchants. A reputation for honesty by an agent ensured trade with all merchants. During a period of slow communications, the presence of uneven knowledge sets and the absence of formal legal systems, the informal social network of the Maghribi traders created the information flows that identified dishonest agents and a punishment system that excluded opportunistic agents, enabling trade across large geographic distances.

Open systems, which may be based on membership of an association or residence in a particular city or country, are more inclusive than kinship systems, but may be weaker in enforcing agreements and provide poorer quality information flows. Both the Merchant courts at the 12th and 13th century Champagne fairs and manufacturers in 1990s Vietnam created informal community systems for identifying both reliable and unreliable suppliers and buyers, as illustrated in Boxes 2 and 3.

Box 2. Enforcement of Trade by Medieval Merchant Courts

The emergence of developed countries' formal and informal institutions to support private economic exchange was a long-term path dependent, historical process. In the 12th and 13th centuries, merchant courts at the Champagne fairs were economic organisations that established 'rules of the game' for economic exchange, given weak formal institutions supporting trade (Greif, Milgrom and Weingast, 1994). The rules permitted only merchants in

good standing to trade at fairs, disciplined and excluded untrustworthy merchants from trading, and encouraged western European rulers to provide safety and fair treatment for foreign traders. In the absence of comprehensive formal laws and regulations, the merchant courts were privately ordered organisations that developed informal rules that reduced the costs of economic exchange. The merchant courts were a step between personal trade and state regulated market systems of impersonal exchange, offering information on traders, sanctions for non-performance and restitution of losses from bad deals with trading partners who cheated.

It is a mistake to assume that informal institutions to facilitate economic exchange arise only in the absence of formal institutions. For example, under Vietnam's system of central planning, formal laws and regulations did not allow private entrepreneurial activity (see Box 3). From 1986, a series of economic (*doi moi*) reforms were introduced to encourage the growth of private enterprise. But these changes were hampered by a lack of reform to existing political and legal structures, which functioned to directly control and undertake economic activity. Correspondingly, new legislation was subject to differing interpretations, applications, and significant administrative discretion (Chi, 1996). Enforcing contracts for private business was hampered by lack of precedence, judicial inexperience, and police discretion when enforcing court and arbitral awards. As one local entrepreneur observed, '[t]he courts normally just create more problems....in Vietnam no one believes we have a good legal system' and that the '...the local authorities "just create problems for us rather than supporting us"' (McMillan and Woodruff, 1999: 641). Given the failure of formal institutions, businesses created a system of private ordering to promote trade.

Box 3. Informal Institutions and the Dead Hand of the Past

Without a credible legal system, access to financial markets or protection from corrupt bureaucrats, the private sector in Vietnam still accounted for 29 percent of the country's industrial output and was responsible for much of the 8-9.5 percent annual GNP growth between 1992 and 1997 (McMillan and Woodruff, 1999). In the absence of courts and unbiased regulators, economic exchange in Vietnam occurred through informal rules. Manufacturers structured written incentive contracts with suppliers and buyers to limit cheating by either party, where the written contract added clarity, if no legal benefit, to the exchange. Since non-debt repayment was not court enforceable, community sanctions were used in place of formal rules. Manufacturers developed information systems, trading information on poorly performing and opportunistic suppliers and buyers to identify those most likely to cause contracts to fail. Manufacturers also used business contacts to create information on potential buyers and suppliers. Finally, repeat contracts with previous buyers and suppliers were types of repeat economic exchange games, which provided increasing levels of information on supplier and buyer behaviour and performance. Occurring in the absence of appropriate formal institutions for a market-based economy, informal institutions or rules for sharing information developed through private ordering to reduce the costs of exchange. The business system was open to all and not restricted to traders from a particular clan, family or ethnic group (such as Chinese, Hmong or local Vietnamese).

The risks of economic reform are great, and governments are cautious about implementing new formal institutions. Box 4 discusses the problems of formal institutional change in the Soviet Union, where informal systems of power and privilege have impeded the emergence of new formal institutions to support private sector development.

Box 4. Political Lessons from Institutional Change: The rise and fall of the Soviet Union

Russia's post-Imperial and post-Soviet experiences starkly illustrate the impact of formal institutions on existing informal institutions and economic structures. The 1917 Russian Revolution triggered the development of new formal and informal economic, political and social institutions. These emerged over 50 years of civil war, purges, public ownership and dictatorship. The 'command economy', state planning bureaux, investment in heavy industry (as opposed to consumer goods), and collectivisation of agriculture created a concentration of political and economic power in individuals, the state bureaucracy, and the Communist Party.

Perestroika, Gorbachev's economic liberalisation reforms, unhinged Russia's existing institutional arrangements with their embedded power structures, including the informal institutions that gave party leaders and economic managers privileges and responsibilities different from ordinary people (North, 2005; McFaul, 2001). Gorbachev's reforms were met by resistance from Party officials. When new formal institutions were introduced, existing political and economic arrangements were eroded, upsetting existing economic, social and political balances and resulting in disorder.

One challenge for developing country governments undertaking economic reform is how to manage the introduction of new formal institutions, without undermining the delicate balances within a society, potentially leading to disorder and economic decline. Governments also need to recognise the important role of informal institutions in promoting economic exchange, facilitating informal institutions that promote growth.

Writing Specific Contracts: Informal institutions are a necessary, but not sufficient, condition for development

Institutions create the conditions for writing firm-to-firm and firm-to-customer contracts. Analysing a country's institutional environment, by identifying the mix of formal and informal institutions and the operation of business communities, is one part of understanding a society's economic trajectory. The next step is to discern how managers respond to the prevailing institutional environment, by writing and operating specific contracts with partners, suppliers, distributors and employees.

China's transition from central planning to 'new' formal and informal institutions to encourage private sector development provides a case study of how MNEs designed specific contracts during a period of rapid institutional change (Appendix 1 sets out the major trends in China's FDI environment, including the formal institutions). Two very different groups of foreign investors in China are studied: Hong Kong firms, which relied on kinship systems, and Australian firms, which depended on open systems, to structure contracts. As depicted in Table 1, foreign firms use a range of equity and non-equity arrangements for investing in China.

Table 1 Contractual Arrangements for Investing in China

	Equity	Description
Wholly owned subsidiary	Yes	Foreign owned and controlled entity
Joint venture	Yes	Limited liability firm between one Chinese and one or more foreign firms
Contractual joint venture	No	Long-term agreement between a Chinese and foreign firm; no separate legal entity established
Strategic alliance	No	Alliance formed to achieve a set objective, such as developing a new technology
License	No	Contract designed for technology, brand and trademark transfers between a licensor (company that owns the assets) to a licensee; the contract specifies a period of use by the licensee, in return for a set fee (royalty) to the licensor on every unit sold
Franchise	No	Special type of licensing agreement specifically for retail activities
Build-operate-transfer	No	Contract to build infrastructure and operate for a set period, before ownership reverts to the state
Processing and assembly	No	Contracts specifying subcontracting activities related to production of basic products

Hong Kong Manufacturers in Guangdong Province

Before 1985, contractual joint ventures in China accounted for almost twice the realised foreign direct investment (FDI) of equity joint ventures and wholly foreign-owned enterprises combined (US\$465m vs. US\$270m). In Guangdong province, which adjoins Hong Kong, contractual joint ventures remained the dominant form of FDI until 1998, when they were finally overtaken by equity joint ventures and wholly foreign-owned enterprises (see Wang and Nicholas, 2005).

Contractual joint ventures are non-equity strategic alliances between Hong Kong firms and Chinese enterprises formed by the Government at the township and village levels to further China's economic transformation. Until the late-1980s, contractual joint ventures operated under

the formal legal institutions of central planning, with specific equity joint venture (1979 and 1984 Laws) and wholly foreign-owned enterprise (1986 Law) laws implemented before contractual joint venture laws (1988 and amendments in 1995). Given the formal institutions in China, how did Hong Kong managers design contractual joint ventures for day-to-day control of economic exchange?

Contractual joint ventures were concentrated in China's Pearl River delta area of Guangdong, a province that has maintained its unique spoken language (Cantonese) and a distinctive *Yue* culture. Historically strong ethnic, cultural and language links between Hong Kong and Guangdong are reflected in the majority of Hong Kong people being either born or descended from counties and villages in Guangdong, approximately 80 percent of Hong Kong's Chinese population having relatives in the province, and around 95 percent of Hong Kong's six million residents being Cantonese-speakers (Child and Mollering, 2003: 74). These strong kinship ties made Guangdong's township and village enterprises attractive partners for Hong Kong's labour-intensive manufacturers looking to outsource production activities. The ties between the two groups facilitated the development of informal institutions based on reputation and the sharing of information within business and social networks, whereby poor behaviour by a Guangdong or Hong Kong firm would be publicly revealed and punished through exclusion by other firms.

Both sides also carefully structured their incentive contracts to control day-to-day economic exchange. Drawing on interviews with 73 contractual joint venture managers (43 from Hong Kong and 30 from Guangdong), Wang and Nicholas (2005) detailed the operation of these contracts. Direct monitoring by the Hong Kong side was relatively inexpensive, since geographic proximity made it possible for Hong Kong managers to cross to Guangdong every day to oversee their production activities. The Hong Kong side usually provided the chair of the board and the CEO of the contractual joint ventures, and Hong Kong managers were in charge of key positions in finance and production.

Repeat contracting provided the Hong Kong firms with information about their Guangdong partners that allowed contracts to be fine-tuned. Contractual joint ventures had up to four amendatory contracts and many attached supplementary terms and remarks, to cover profit distribution and production rates with their Guangdong partners. The flexibility of contractual joint ventures was reflected in the continuous negotiation and re-negotiation of the contracts to fit changing conditions, rather than being bound by the original terms and conditions typical of equity joint ventures and wholly foreign owned firms. Even when the 1995 Implementation Regulations of the Contractual Joint Venture Law restricted some of the flexibility, by detailing regulatory guidance on some operational matters (for example, spelling out more clearly the methods and proportions for profit distribution), the Guangdong partners cooperated with the Hong Kong side to by-pass the local agencies and bureaucracies implementing the new provisions.

Without a formal legal framework prior to 1988, contractual joint ventures were structured to ensure investments by both the Hong Kong managers (in the form of long-term orders, high rent, knowledge about final markets and consumer tastes, and managerial assistance) and the Guangdong side (labour, factories, plant and equipment facilities, and bureaucratic connections). The two partners were mutually dependent on each other. Such mutual 'hostage' imposed high costs of contract termination on both parties, encouraging cooperative behaviour.

Finally, path-dependency was important. Many contractual joint ventures evolved out of previous business relationships, such as process and assembly contracts between the same Hong Kong and Guangdong partners. Repeat interaction between the partners built trust and cooperation.

Contractual joint ventures were dynamic, adjusting for changes in China's formal institutions. There was a notable shift over time from negotiated to more legalistic approaches in dispute resolution. At the formation stage of the contractual joint ventures in the 1980s, interviews revealed no case in which disputes were solved by legalistic approaches, such as referring to the letter of contract, third party arbitration, resorting to courts or termination. In 1999, however, six contractual joint ventures were terminated. Similarly, disputes were increasingly resolved by reference to the letter of contract. These changes reflected the development of China's formal

legal institutions. According to many interviewees, the 1995 contractual joint venture implementation law significantly reduced the costs associated with using courts or other third party enforcement.

The development of China's formal institutions also explains the decline in the use of contractual joint ventures for new investments and the rise in equity joint ventures and wholly foreign owned enterprises by Hong Kong managers. While fewer Hong Kong managers opted for new contractual joint ventures, selecting joint ventures and wholly foreign owned enterprises instead, few also exited their existing contractual joint ventures. Among the six contractual joint ventures that terminated, only one became an equity joint venture and only one a wholly foreign owned enterprise. In spite of changes in the formal legal environment, existing contractual joint ventures continued as efficient economic organisations, with low costs of economic exchange.

Writing Contracts without Informal Institutions: Australian MNEs in China

Operating in the same institutional setting as the Hong Kong investors, Australian managers were denied access to the informal institutions (social networks, language and culture) that supported Hong Kong-Guangdong contractual joint ventures. Drawing on a survey of 171 Australian MNEs in China before 2000, we illustrate how Australian managers structured specific contracts given China's institutional environment.

Before entering China, Australian investors relied on their existing commercial networks for information on business opportunities and operational challenges. While these were not the deep networks open to Hong Kong investors, many Australian firms learned about their China business opportunity, or were introduced to the China market, through informal business links. Australian investors also experienced more problems in communicating and negotiating in China than Hong Kong investors. Fifty percent of Australian MNEs encountered moderate levels of difficulty communicating and negotiating in China, and 20 percent were subject to high levels of difficulty. Australian firms found the responsiveness of Chinese government agencies slow, fairly difficult, and less open than desired, though not hostile. This was a different experience to Hong Kong investors, who collaborated with their Guangdong partners to by-pass government officials.

Uncertainty and incomplete information meant Australian investors sought a range of entry forms in China, including wholly foreign owned enterprises (8 percent), equity joint ventures (29 percent), representative office or agents (22 percent), management contracts (17 percent), export (12 percent) and licences, franchises and build-operate-transfer contracts (12 percent). The most important entry form, equity joint ventures (JVs), were formed mainly with state-owned enterprises (68 percent), drawing on their Chinese partners' strengths in interpreting the surrounding environment and providing downstream distribution connections. Through their joint venture partners, Australian managers gained knowledge of local markets, government and commercial contacts, cultural and social contexts, and marketing and distribution networks.

In contrast to contractual joint ventures, the Chinese partners exercised on-site and day-to-day operational control, reflecting the skills of Chinese partners in communicating with local suppliers, logistics providers, and the workforce. To counter immediate operational control by their Chinese partners, Australian firms received formal monthly reports and informal reporting on a daily or weekly basis, supplemented by numerous written and verbal communiqués, and frequent visits by Australian executives. Australian partners had equal or dominant control at the Board level and most board meetings (63 percent) were held in China, providing a further opportunity to directly monitor operations. Approval from Australian headquarters or the equity joint venture Board was required for all decisions affecting financial and growth strategies for the venture.

Besides monitoring their partners, Australian managers had to resolve disputes. The leading sources of JV disharmony were cultural and linguistic differences, different short-term expectations, and general misunderstandings. Serious problems, related to benefiting at the expense of the other party, were not major issues for most Australian firms. Although 81 percent of JVs had disputes, most were solved by negotiation, based on the written contract. Recourse to legal and third party enforcement was rare, reflecting the reality of a deficient formal court

system. The dominant factor in negotiated equity joint venture conflict resolution was the desire to maintain an on-going partnership.

Australian investors in China were aware that formal institutions to reduce the costs of exchange were weak or nonexistent and that many of the informal institutions utilised by Hong Kong investors were closed to them by culture, family and language. While Australian managers 'negotiated' with their Chinese counterparts when disputes arose, these negotiations were not in Cantonese or supported by ethnic and familial connections, which meant they were not comparable to those between Hong Kong and Guangdong managers. As a result, only half the Australian firms made a profit.

Cognitive Limitations and Contract Design: How Australian managers structured 'good' and 'bad' contracts

The cognitive limitations of managers, coupled with unfamiliar and uncertain host country informal and formal institutions, constrain the design of contracts. Managers specify both 'good' and 'bad' contracts, given their perceptions of the existing institutional environment. Good contracts further the involvement of international firms in a country's economic development. Bad contracts result in the termination of foreign firms' involvement or suboptimal transfers of knowledge and skills, to the detriment of the developing country. To illustrate the challenges of specifying contracts, we use a case study of how Australian-based managers' perceptions of institutional proximity between Australia and different host locations affected the design of their investment contracts. Managers' assessments of these differences resulted in sub-optimal outcomes in India, but efficient outcomes in Indonesia and Vietnam. Two elements were critical to these outcomes: the impact of prior experience in emerging markets and the decision to seek local partners for their rich, context-specific knowledge and relations.

When determining new foreign strategies, managers engage in a two-stage process of decision-making. Scanning across a range of countries, they first select a non-equity (strategic alliances, licenses, R&D agreements) or equity (joint ventures and wholly-owned subsidiaries) economic organisation (see Table 1). Managers then design control and incentive mechanisms to safeguard exchange, appropriate to the economic arrangement selected, as we have described in the China case study.

To simplify decision-making on country choice and the design of contracts, managers look for 'common' elements between the home and host country institutional environments. Focusing on the common characteristics of the formal institutions of two countries, such as language, legal system, or political structure, may disguise the divergence between informal norms, and how informal institutions distort the operation of formal institutions. This may lead managers to select and design inappropriate contracts. Outward signs of the 'wrong' choice of contract design include dissatisfaction with the performance of a new venture against unrealistic or inappropriately specified performance targets, or reliance on law-based mechanisms to resolve disputes with partners in countries subject to corruption in the judiciary. Finally, prior (or lack of prior) multinational experience will increase (decrease) the probability of managers selecting and designing effective contractual forms.

These propositions were tested using data on 64 Australian companies operating long-term contractual arrangements in Indonesia, 33 in India, and 19 in Vietnam. Using the surveys and other data, Table 2 outlines the institutional similarities and differences between each host country and Australia. With respect to formal institutions, India clearly shares a number of common elements with Australia, including a common commercial language, legal system, and parliamentary governance. All three host locations were characterised by informal norms associated with strong business-government-bureaucracy ties and entrenched rent-seeking, including India.

Yet, Australian firms entering India chose not to align themselves with local firms familiar with and embedded in these informal norms and practices. The types of economic organisations varied significantly across the three countries: 50 percent of all firms selected equity joint ventures in Vietnam and Indonesia, but only 22 percent did so in India (where licenses, wholly-owned and non-equity contracts were common). Compared to Australian firms in India,

Table 2 Comparative institutional environments: Vietnam, Indonesia, India and Australia

	Vietnam	Indonesia	India	Australia
Formal Institutions				
Form of legal system (Origin)	Socialist (French)	Civil (Dutch)	Common (British)	Common (British)
Form of political governance	Socialist	Nominal Democracy	Democracy	Democracy
Official language	Vietnamese	Bhasa Indonesian	Hindi	English
Tariff and non-tariff barriers ^a	Very high (5.0)	Low (2.0)	Very high (5.0)	Low (2.0)
Foreign investment restrictions ^a	High (4.0)	Low (2.0)	Moderate (3.0)	Low (2.0)
Property Rights enforcement ^a	Very low (5.0)	Moderate (3.0)	Moderate (3.0)	Very high (1.0)
Rule of law ^b	34.9 (-0.47)	39.8 (-0.34)	56.6 (-0.01)	93.4 (+1.79)
Control of corruption ^b	30.7 (-0.60)	35.3 (-0.44)	43.3 (-0.29)	93.3 (+1.73)
Religion (% of population) ^c :				
Protestant	0.2	4.8	1.1	23.5
Catholic	3.9	2.7	1.3	29.6
Muslim	1.0	43.4	11.6	0.2
Other	94.9	49.1	86.0	46.7
Informal Institutions				
Corruption ranking (out of 52 countries)	-	41	35	7
Black market activity ^a	-	45	46	10
Regulatory discretion ^a	Very high	Very high	Very high	Low
Language of commerce	Very high	High	High	Moderate
Voice and accountability ^b	Vietnamese	Bhasa Indonesia	English	English
Overall Institutional Environment	11.5 (-1.24)	16.2 (-1.08)	60.7 (+0.27)	99.0 (+1.65)
Gasiti Index (freedom status) ^d :				
1995/96	Not free (7,7)	Not free (7,6)	Partially free (4,4)	Free (1,1)
1996/97	Not free (7,7)	Not free (7,5)	Partially free (2,4)	Free (1,1)
Economic freedom ^a	Repressed	Mostly unfree	Mostly unfree	Mostly free
GDP per capita (US\$) ^e	273	1024	370	20,333
(figures in current prices)	312	1135	379	22,281
Political stability ^b	60.4 (+0.38)	30.5 (-0.34)	23.8 (-0.55)	91.5 (+1.08)
Government effectiveness ^b	55.9 (-0.18)	66.5 (+0.08)	56.4 (-0.16)	94.4 (+1.58)
Regulatory quality ^b	25.4 (-0.54)	65.7 (+0.19)	44.2 (-0.13)	89.5 (+1.15)

- a. Index of Economic Freedom, The Heritage Foundation (www.heritage.org)
- b. Governance indicators for 1996 by GRIICS, The World Bank (www.worldbank.org). Source: Kaufmann, Kraay, and Mastruzzi (2003). Figures depict the percentile rank on each governance indicator, each ranging from (0-100); figures in parenthesis are the margin of error estimates, ranging from (-2.5 to +2.5).
- c. Religious affiliations: percentage of population belonging to major world religions in 1980. Source: La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999). (See page 238 for original sources.)
- d. Freedom House Gasiti Index. Combined average for rating of political rights and civil liberties, each from 1 = highest degree of freedom, 7 = lowest (www.freedomhouse.org).
- e. United Nations Statistical Yearbook, 1997, Issue 45.

companies investing in Indonesia and Vietnam sought partners specifically to tap into local information sources through their partner's web of intertwining relations between the corporate, social and political spheres.

Further, Australian firms investing in Indonesia and Vietnam had pre-existing Southeast Asian subsidiary networks, while India investors had dispersed networks, with only one or two investments in any one region. The SE Asian experience of investors in Indonesia and Vietnam proxied information and expertise in operating in the institutional environments of emerging economies, with compromised and weak legal systems, long histories of state ambivalence towards FDI, and deep connections between local firms, the bureaucracy and government (Wade, 1990; Lassere and Schütte, 1999). Regionally experienced firms ranked the absence of strong commercial experience and networks, particularly in Vietnam, as a high risk factor, compared to a significantly lower risk assessment by regionally inexperienced firms. Not surprisingly, Vietnam and Indonesia investors designed contracts that demonstrated their awareness of the influence of informal norms.

In India, contract design and operation reflected overestimation of institutional proximity and lack of prior multinational experience. Despite India's weak intellectual property rights regime and history of barring foreign licensors from setting procurement, pricing and export restrictions on transferred technology (Shun, 1994), 52 percent of the managers in India placed legal limits on their agents, such as territorial limits on exporting, domestic sales, and production locations; and restrictions on the purchase or supply of managerial services, and on research and development. Only two firms in Indonesia sought such constraints. The heavier reliance on legal devices in India coincided with higher levels of disharmony: 82 percent of firms had disputes with their agents, with 27 percent experiencing difficulties monitoring contractual compliance. One-third of these disputes were resolved by reference to the legal contract and one firm sought recourse to arbitration. There were no monitoring problems or disputes with Indonesian agents.

Cognitive limitations and uncertainty about the informal institutions in India led Australian managers to select and design the 'wrong' contracts. Based on the parent managers' satisfaction with the profitability and success of their overseas operations, India clearly underperformed relative to Vietnam and Indonesia. These 'wrong' choices may be generalisable from Australian to many MNEs operating in India, helping to explain India's slower economic development relative to China.

Using the Lessons of the Past and Present to Understand the Future

By setting the 'rules of the game', a society's development depends on informal and formal institutions that shape the economic, political and social organisations that create economic growth, stagnation or decline. The context-specificity of experience in operating contracts in developing countries makes drawing universal lessons difficult.

Institutions are dynamic and, as illustrated in the case studies, strongly path-dependent. Private businesses are always embedded in formal institutions, whether those of the feudal system in Charlemagne's 12th century Europe or Vietnam's 20th century state planning system. In many developing countries, prevailing formal institutions hinder private business development. Generally, institutional change is slow, and formal institutional change must be consistent with informal institutions, as *Perestroika* showed in the Soviet Union. Informal institutions co-exist with formal institutions in all economies, either impeding economic reform, as in post-Soviet Russia, or facilitating private business, as in Vietnam, China and 12th century Europe. Even when informal institutions facilitate economic growth, kinship systems (Maghribi traders) may be inferior to open systems (Vietnam and the merchant courts).

Lesson One: Development agencies and developing country governments should foster informal economic institutions that support private business, especially open business networks over kinship networks. Informal institutions that support private economic exchange are also likely to

support formal institutional change, such as impartial court systems for settling disputes. Informal institutions that impede private business are also likely to resist formal institutional reform and delay economic growth and development. Such institutions are 'perverse', impeding economic development.

Lesson Two: Development agencies should assist and encourage the replacement of 'perverse' informal economic institutions inimical to growth, a task likely to be beyond the capacity or willingness of developing country governments. When encouraging such changes, development agencies must understand that the new rules will compete with a developing country's existing institutions. The successful introduction of new institutions will depend particularly on their 'fit' with the existing matrix of political and social institutions, and may not facilitate economic growth, even when designed to support private economic exchange.

Lesson Three: For informal economic institutional reform to be successful, political institutional change may be necessary. Authoritarian governments can foster formal and informal economic institutional reform, but political elites frequently resist efficient formal and informal economic institutions. Development agencies and foreign and domestic governments need to determine what is 'doable', given a country's cultural heritage and prevailing power structures. Can economic development be sustainable without incentive structures embedded in western democratic institutions?

Lesson Four: Transplanting institutions into a developing country is unlikely to be successful and, where successful, is unlikely to be rapid. New institutions need to evolve from existing institutions. For example, a transparent legal system for developing countries should be designed using the informal institutions of the developing country as opposed to 'western' models. There may be a convergence in black letter law across countries, but the operation of legal systems is society-specific.

Lesson Five: Enhancing the flow of information about the availability, reliability and skill levels of suppliers, distributors and partner firms reduces the costs of designing and managing contracts. Development agencies' support for programs to achieve richer, deeper and more transparent information flows within business communities facilitates contract choice conducive to economic development. In particular, information on informal institutions will reduce the cognitive limitations of managers: Australian managers thought (correctly) that China's legal system would not support contract dispute resolution, but their misreading of India led them to the opposite (and false) conclusion for India.

Appendix —Trends in Legal Institutions and FDI in China

Four main types of FDI were approved during the first phase of liberalisation: equity joint ventures (EJV); cooperative operation enterprises, also known as cooperative (contractual) joint ventures (CJV); wholly-foreign owned enterprises (WFOE); and cooperative (joint) development projects restricted to the resource sector (Mathur and Chen, 1987; Pearson, 1991; Murray, 1994). The EJV is a limited liability company formed between a Chinese firm and one or more foreign firms. The CJV is a non-equity long-term contractual arrangement. No separate legal entity is formed, with each of the CJV parties retaining their autonomy and sharing in the benefits and burdens of the venture according to the specifications of the contract. The WFOE, as established under the 1986 rules, have become the preferred form of entry, and now account for almost as much investment as JVs (Shaw and Meier, 1994; Luo and O'Connor, 1998; SSB, 1998).

Table A1 - Summary of Legal and FDI Trends in FDI in China, 1979-1998

Period	Phase shifts in legal developments	FDI (US\$m) ¹
1979-85	First phase: Approval of the Special Economic Zones) in South China, and early FDI legislation such as the JV Law.	4,721
1986-90	Second phase: Revision of original FDI legislation, including more liberal foreign exchange rules, incentives for technology imports, and the rules for wholly-owned subsidiaries.	14,261
1991-93	Third phase: A raft of new or amended legislation presaged the 1990's FDI boom, including the Foreign Enterprise Tax Law, Copyright Law, and Software Protection Regulations.	42,888
1994-97	Fourth phase: The Company Law passed late 1993 takes effect in June 1994, covering all firms whatever their ownership form, and more effort to implement promulgated regulations.	158,271
1998-	Fifth phase: Increased recognition of the private sector, and of the need to further reform of the structure of state firm. Private equity investment funds appear.	45,580

¹: FDI amount is the cumulative sum of foreign investment used during the years of the particular phase. Excluded are other types of foreign capital, such as loans, leasing, assembly and compensation trade. Sum each of phases for cumulative FDI for 1979 to 1998.

Sources: Mofert 1984-99, Grub and Lin 1991, Roehrig 1994, Jia 1994, SSB 1998, China Daily, 1999a, 1999b; Tretiak and Holzmann 1993.

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