

**FORMAL ENFORCEMENT AND RATIONALITY.  
THE IMPACT OF MENTAL MODELS IN INSTITUTIONAL PERFORMANCE**

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**RESUMEN**

*Este trabajo es un ensayo en la economía de las ideas, que analiza cómo las instituciones informales afectan el desempeño de las instituciones cruciales para el funcionamiento de los mercados. Argumenta que las tradiciones legales, las instituciones políticas y los arreglos administrativos que sostienen las instituciones afectan los modelos mentales que la gente emplea para interpretar el sentido del mundo de transacciones que ocurren alrededor de ellos. Estos modelos se hacen así centrales en la elección de los agentes en los mercados, influyendo en el desempeño económico. Después de presentar la literatura sobre el tema, el trabajo presenta ejemplos tomados de las instituciones judiciales, de garantías, y de propiedad de países como Bolivia, México y Perú. Concluye argumentando que estos modelos deben ser considerados en los intentos de reforma institucional, junto a las aproximaciones funcionales y de elección racional de la literatura existente.*

**ABSTRACT**

*This paper is an essay in the economy of ideas. It analyzes how informal institutions affect the enforcement of key market institutions. It argues that legal traditions, political institutions, and administrative arrangements affect the mental models that people employ to interpret the world of transactions around them. These models in turn are a key to individual choices that affect economic performance. After presenting the existing literature on this topic, the paper present examples taken from enforcement, collateral and property institutions from Bolivia, Mexico and Peru. It concludes arguing that if reform is sought, these mental models should also be taken into account, alongside the current functional and rational choice approaches of recent literature.*

Institutional enforcement has become central in the study for the success or failure of transactions. However, little has been done to compare the specific causes through which societies have failed or succeed in trying to achieve this. There are crucial differences, both formal and informal, between enforcement procedures among countries. These differences are even more bizarre when countries with similar formal institutions are compared. The countries of Latin America are excellent examples. Although they imported most of its formal legal and political institutions from Western Europe and the U.S., they operate in quite different ways there that in their place of

origin. Recent reform attempts have had mixed results.

This paper seeks to analyze the role of informal, non-written, interpretative constraints, which might help explain these differences in performance, and provide paths to reform. Advances have already been made in the role of rent seeking mechanisms and corruption<sup>1</sup> and institutional inertia<sup>2</sup> as explanations of the poor performance of Latin American enforcement institutions. This paper explores a complementary line of research, in which there is a significant amount of research yet to be done. It argues that legal traditions, political institutions, and administrative arrangements in enforcement institutions affect

the intersubjective "models" that people poses to interpret the world of transactions around them. These models in turn are a key to individual choices that affect economic performance. If reform is sought, these models should also be taken into account in the process, alongside the current functional and rational choice approaches of the recent literature.

The paper is organized in four sections. First, a brief revision of the literature on core formal enforcement institutions is presented. The second section deals with the role of non-written informal institutions in formal enforcement, arguing that these intersubjective traditions frame the way rationality operates. A third section develops these ideas in the Latin American context, showing how it impacts upon the functioning of the institutions of property rights, collateral, and courts. Finally, a fourth section concludes, stressing the need to include the analysis of an economy of ideas in attempts of institutional reform.

### 1. The Role of Enforcement in the New Institutional Economics Literature

As Commons noted, price and quantities define a transaction, and thus it can be argued that economics is a science of transactions. For a transaction to take place, there is a need to delineate and define a right over what is going to be exchanged (property rights) as well as the possibility of agreeing on such a exchange (contracts). Coase<sup>3</sup> argued that it is costly both to delineate such rights, and to exchange. Thus transaction costs affect the way exchange takes place. Following these insights, North and Thomas<sup>4</sup> argued more generally that a general equilibrium model explains prices and quantities in an economic system by focusing on four categories of exogenous variables: endowments, technologies, preferences, and rules. These rules are part of the institutional environment, a set of formal and informal restrictions to human behavior.

It is in the later that enforcement of institutions such as contracts and property

rights become an important variable, which should be studied in its own. As Williamson<sup>5</sup> argued, when parties agree conditions that allow them to develop complementary assets, ex-post conditions will arise that were not fully anticipated. This will open the door for the possibility of opportunistic behavior. Enforcement can then appear as a crucial issue, in which the institutional embeddedness of contracts becomes central.

In this context, there is already a body of literature focusing on a similar, albeit more restricted, area of research. The Law and Economics movement has tried to prove that the common law, centered -in fact, created by- courts, judges and lawyers, is efficient, in the sense that it tends to increase the wealth of the parties. As Posner<sup>6</sup> hypothesizes, the "efficiency theory of the common law" sets a specific economic goal for a limited subset of legal rules and institutions (i.e. those of the judge-created common law). The central core of legal rules in the legal system -those involving contracts, property, collateral, etc.- as the result of a continuous interaction between judicial actors, lawyers, and parties, that has produced effective and efficient rules for exchange. In a sense, the market has produced the efficient rules that define it. This is indeed the case in the textbooks of Posner<sup>7</sup>, Cooter and Ullen<sup>8</sup>, or Pollinski<sup>9</sup>.

However, an approach that sees only efficiency in a subset of legal rules and institutions, particularly so in those "core" legal institutions involving the courts, property rights and institutions that facilitate exchange seems only partial. This framework is clearly set in the Anglo-American common law context, a case where the interpretation of basic market institutions and the organizational and political background might coincide in an efficient arrangement. In this context, the lack of a comparative perspective hides several crucial aspects from analysis. These emerge when contrasting different sets of institutions across countries. In spite of major similitudes among legal systems, the institutions that comprise them can be interpreted and analyzed in many

different ways, and as we will see, these can result in momentous differences in their operation. One of the possible consequences is that these same basic "core" rules might not be efficient in all cases.

However, these differences have seldom been explored. As Menard<sup>10</sup> argues, surprisingly enough the research agenda of the law and economics program has been dominated by a more standard approach so far, concerned more with efficient sanctions and penalties than with the conditions under which the judiciary can facilitate transactions in providing adequate support to contractual arrangements.

The acknowledged central role of public ordering in enforcement suggests an alternative route for analysis. It might be advisable to study the actual institutions of formal enforcement, and then see how these affect other related institutions. This alternative approach does not deny the analysis of complementary private enforcement mechanisms, but rather seeks to widen the focus of research, providing both a view of their relation with the "other side of the coin", related to organization and operation of formal enforcement systems, and to the interpretation of their role that mental models provide.

Partially following this second approach, Stone, Levy and Paredes<sup>11</sup> studied the role of various private enforcement mechanisms in the machine tool and textile industries in Brazil and Chile. As they argue, formal enforcement institutions influenced the operation of private arrangements, as they are always an alternative that could be more or less effectively used in each case. If this insight is right, "pure" private orderings are rare, most arrangements are a blend. Even in instances where purely private orderings are present, the possibility of using a public ordering system provides a reference and affect the way the private ordering of enforcement operates and is interpreted<sup>12</sup>. Completing this same line of research, Garibaldi<sup>13</sup>, Buscaglia and Dakolias<sup>14</sup>, and Burki and Perry<sup>15</sup> analyze the main lines of the organization of Latin American Judicialia-

ries from an institutional economics perspective, emphasizing the role of incentives and organization in the performance of enforcement institutions.

In this context, Burki and Perry<sup>16</sup> note a obvious requirement of reform is changing their 'internal relationships and understandings'. However, this has seldom been attempted; most approaches to this topic address the need for 'education' and 'training' but without considering the role that these 'understandings' can have in the performance of enforcement institutions. The next section turns to this topic.

### 1.1 The role of an intersubjective rationality in enforcement

As this paper tries to show, the agents' interpretation of various key economic institutions can affect economic performance. As Simon<sup>17</sup> showed, human rationality is a limited resource. However, he argued, it was precisely this element which opened the door for a realistic theory:

"it is precisely in the realm of where human behavior is *intendedly* rational, but only *limitedly* so, that there is room for a genuine theory of organization and administration"<sup>18</sup>.

In this context, it seems consistent to argue that the intersubjective models that societies build to explain the rationality of a particular set of rules are a valuable way to save on that limited resource, rationality<sup>19</sup>. This framework is not only a "subjective" model as North<sup>20</sup> would argue, but rather a set of shared collective ideas (thus intersubjective, and in this sense, objective to those that use them), employed by individual agents when they need to frame complex problems in simple formulas. Thus, it allows them to focus on a more limited set of variables, those that according to the model are crucial to the operation he has at hand, and devise the most efficient way to achieve his goals.

Following this line of ideas, it could be argued that rationality is not only bounded and opportunistic, but also framed by these intersubjective models. Individual rationality does not operate in a vacuum; it is continuously interpreting the horizon of events in which it operates. As we will see, the frames of interpretation that arise and evolve –and, occasionally, congeal– from the never ending human activity of interpretation, have economic consequences: the resulting intersubjective rationality can be more or less efficient, according to the efficiency of the procedures of the models embodied in traditions and other sets of organized knowledge. In this context, identifying some of the components and operation of these frameworks could be a contribution to developing an economic theory of ideas following the sense outlined by North<sup>21</sup>, in his 1993 Nobel Prize address. It is important to note, however, as North<sup>22</sup> would warn, that there is no guarantee that the "beliefs and institutions that evolve through time will produce economic growth".

In this sense, this approach is complementary to the transaction cost and public choice approaches of the literature on this subject. As the three-legged approach of Williamson's<sup>23</sup> would sustain, the enforcement of institutions combines economics, law, and organization. It is backed by organizations: courts, registries, notaries' offices, and shaped by the interaction of transaction cost economics, administrative and organizational constraints. Furthermore, as an institutional public choice perspective would argue, rent seeking, rational ignorance or institutional inertia also affect the evolution of enforcement institutions. However, this approach differs in that it would additionally claim that the intersubjective models that inform agent's decisions affect the institutional path of evolution, either by forcing changes or preventing them. Some institutional arrangements can be inefficient, but nevertheless stable and considered legitimate, due to the intersubjective rationality they are operating within. Thus, changes in

these models could be a source of institutional change or inertia.

This approach can be fruitful by various reasons. On the one hand, employing traditions as basis for the study of mental models avoids the potential pitfalls that the study of culture at large might face, due to lack of clear criteria to study it; or arguing that mental models are just "what people have in their mind", and thus basically unknowable. As the character of legal traditions has already been studied in detail by comparative law, they provide a coherent framework to study the articulation of the "unwritten" but real intersubjective structure that rules the interpretation of specific institutions, and through this channel effectively constrains behaviors in society. Furthermore, they provides means to test the effects of this non-written framework on economic performance, and its impact in specific areas of the economy. On the other hand, the approaches of the already mentioned literature on the organizational and political background of specific legal institutions allows to focus on possible important sources of differences among legal institutions within the same legal tradition, which might also help explain differences in performance between countries that share the same formal institutions.

## 2. Traditions, institutions, and economic performance

To take these advantages to its full extent, it is necessary to understand the articulation of institutions by legal traditions in their own terms, and the role of organizations within them, so the full extent of their combined reach can be grasped. As David<sup>24</sup> shows, the Common and Civil Law traditions are the two most important legal traditions in the world. In fact, the differences between the operation of the common law tradition of the Anglo Saxon world and the civil law of Western Europe and Latin America are important and significant. Despite changes in the rules as

they exist in any given moment, there is continuity in the law which draws upon a range of elements subjacent to those rules. A crucial element in these is the techniques through which these rules are themselves discovered, interpreted and evaluated. These unwritten characteristics affect the way legal practitioners approach the law. A lawyer in a legal tradition might not understand the sense and extent of the rules of another, either because the terminology or hierarchies of sources in the law are different, or because the techniques we just mentioned differ.

Legal traditions and other non-written institutions allow agents to organize the sense of the data upon which legal and economic activities take place. They are related to the "bounded rationality" that Simon<sup>25</sup> presented. They provide means to analyze and process a large number of events. Those within the legal system, for instance, "see" the world through these frameworks. The same event can be interpreted differently if the agent is acting within a common law tradition than within a civil law one. This does not mean that one of the actors is mistaken and the other is right: they are different ways of seeing the same thing. This is particularly true if we refer to specific legal institutions, such as contracts, penalty clauses, property, collateral, or judicial cases. Although they share a single core -there is in fact a contract, property, or judicial case, etc.- which allows to translate their meaning from one system to another, this meaning is not exactly the same in one tradition and in the other. The differences that these interpretations impose can play an important role in the way these institutions operate in the economy.

This task of understanding is consistent with rational choice approaches to the study of those political institutions that have a bearing on the operation of formal market institutions. In fact, legal institutions are embedded in political ones; they not only have economic functions, but political roles as well, that continuously interfere with their eco-

nomical functions. This is particularly true with regards to judiciaries, which are not only enforcement institutions, but political organs as well: they are partly involved in the protection of property rights and the enforcement of contracts, and partly in the classical checks and balances scheme, in counterweighting the other powers. This political role is crucial to protect property rights and contracts. If they fail to comply with their political functions, it is most likely that they will also fail, in varying degrees, to perform the economic duties that standard economic theory assigns to it as well. Thus, the judiciaries' institutional arrangement should take into account the political framework.

In this same vein, as transaction cost economics would claim, organization matters. Legal institutions do not operate in a vacuum, but they are embedded in administrative structures. More immediately, these structures provide the means through which legal proceedings take place. But seen on a larger canvass, these organizations provide a more subtle but crucial role in the operation of mental models. They have embedded monitoring and control mechanisms that complement some of the functions of legal traditions. Thus, for instance, court organization can complement the role assigned to judges by the interpretation of a legal tradition, jurisprudence records show the sense and evolution of a particular institution, and registries signal the commitment of the parties in a contract, or the status of a particular piece of property.

Legal institutions of a same juridical tradition can operate in different administrative settings. An example is the Civil Law tradition operating in Western Europe and in the various regions of Latin America. The administrative settings in which a single juridical tradition is embedded can help explain the poor or good performance of the legal duties of the organizations involved. Thus, the same civil law institution could be effective in the administrative setting of the courts of France, but could not operate as well in that of the courts of Peru.

## 2.1 Mental models, institutional change, and interpretation

As this paper tries to show, this combination of legal traditions, political settings, and administrative arrangements provides an "interpretative horizon" for agents to develop and refine intersubjective models from which to judge the sense of specific rules and events. If from this perspective a specific institution is deemed legitimate, it might continue to be respected even if it is not efficient, and *vice-versa*. As we will see in the cases of collateral and property, this does not mean that an institution will be very much used, but rather, that it will continue to affect the operation of the rules that interpret its sense and operation. These horizons affect the *ideas* that agents have over institutions, and in that sense, affect the role of the institutions themselves.

This horizon can be quite resilient to change. Although organizational and political changes might help in the margin to foster changes in the intersubjective framework, they will not affect legal traditions, which are a crucial and relatively independent component of the interpretation of formal institutions. To the fact that these traditions evolve slowly and mostly in their own terms, it could be added that this is partly due to the fact that its function is not completely acknowledged by agents (they are themselves *within* the horizon), and partly to the fact that it is intersubjective, and thus, even if they realize their function, it is out of reach of decisions of any specific agent.

In fact, as Clague<sup>26</sup> would argue, rule obedient behavior can be modeled as function of the resources available to enforce a rule, and the conviction with which agents follow it on their own. If this conviction is not the same in all agents, multiple equilibria results arise. Thus, the agents that realize the inefficient character of a particular formal institution will employ informal institutions which however, are considered 'corrupt', 'illegitimate', or, at least 'exceptional' by the formal system, or otherwise be forced to follow formal rules,

due to the fact that it is being observed and considered legitimate by the state and other key actors within the formal enforcement systems, but at a higher cost. Optimal solutions will occur when the interpretation of formal institutions coincides with the rules themselves, such as in the common law world of the law and economics movement.

These elements suggest some of the reasons for the evolution of formal rules. These do not need to evolve towards the most efficient outcome in any scenario. Rather, it is possible that they might evolve towards the most efficient outcome possible *within* that horizon. This would hinder the apparition of formal institutions that might have proved effective in a different tradition, but which were unsuitable, or deemed illegitimate, for the one in which they are actually operating. In fact, this can reinforce a relatively stable, albeit suboptimal arrangement. In this context, it can be argued that public discussion and criticism of the legitimacy of formal institutions could alter the sense of their interpretation, and provide an additional channel for institutional change.

## 3. The framework applied: the Latin American Case

Latin America has imported most of its legal institutional framework from Western Europe, and part of its formal political institutions from the U.S. However, although their common origin has set a path for their development, this differs markedly in both cases<sup>27</sup>. A common characteristic in the Latin American version of them is that their performance has been rather inefficient if compared with the role that standard economic theory would call on them. In particular, contrary to what the Law and Economics movement would suggest, these "core" market institutions do not seem to be maximizing wealth, but rather seem to be imposing high costs on the transactions that employ them. In spite of these high costs, however, these institutions continue to be very much alive. As the analysis below

would suggest, one of their major functions seems to be, paradoxically, to affect these basic institutions in ways that depart from the most efficient alternative.

In this context, this section provides examples of the interaction of legal traditions, organizational constraints, and political settings in the evolution of key market and enforcement institutions, including judiciaries, collateral, and property rights. In all cases, the predominant interpretation of the role of institutions and the organizational settings element is an important element in the explanation of their poor performance. Isolating the effect of intersubjective models is more complex in the case of judiciaries: as the configuration of their organization is also affected by the intersubjective models, it can then also contribute to shape agent's incentives, including rent seeking behavior or corrupt practices. However, in the examples of collateral and, to a lesser extent, property rights, the role of interpretation in specific institutions is more acutely felt, as the consequences arise directly from distinctions based on the legal tradition itself, and then compounded by a separate factor, the already mentioned poor performance of the judiciaries, the formal institutions in charge of their enforcement. Having presented these examples, some lessons will be drawn for reform attempts.

### 3.1 Political and Legal Institutions and Enforcement

Formal enforcement is at the crossroads of political, legal and economic institutions. Its legal and economic functions are embedded in its political role. This is particularly true not only when we consider contract enforcement, but also when protecting property rights. Judiciaries are supposed to check the other powers of the state, and thus protect minority and property rights. Thus, it can be central how legal traditions and politic traditions interpret the articulation of its political functions with the economic and legal ones. In this task, organization matters. It completes

this interpretation with organizations that are consistent with the interpretation at hand.

In this context, the common civil law tradition of Latin America, and the similar colonial Spanish administrative background provides a setting to examine variations within single theme. Thus the first section will examine the civil law interpretation of the role of judiciaries in this environment, while the second will examine the role of organization in the performance of the courts.

#### *The interpretation of the political and economic role of the Judiciary*

There are important variations in the interpretation of the role of a judiciary in common and civil law systems. It is generally the case that in the former, economic and political are closely intertwined, in such a manner that legal institutions comply with their economic functions as they are performing their political duties. This is true both with regard to central market institutions, such as courts and property rights. As Hayek<sup>28</sup> has pointed out, Judicial systems provide stability not by serving as a counterbalance to the legislative and the executive, but rather by creating a consistent set of rules through jurisprudence. This in turn provides a setting not only for open-society politics, but also for markets to develop. In a similar line of argument, Nedelisky<sup>29</sup> argues, referring to the U.S. constitution, an institution that has operated quite effectively in a common law environment, that it has stricken a balance between political participation and protection of property rights, in which the latter have the preponderant role. Thus, the pursuit of politics is not distinct from the rule of law.

However, the same is not always true in civil law institutions of Latin America. As is well known, in civil law courts do not create law as in the common law system, but only interpret it. The difference is important, as it implies a different role for the judiciary and the legal actors in this tradition. In Latin American courts, borrowing heavily from the

French approach, judges -and lawyers, we may add- are in Napoleon Bonaparte's phrase, only the "voice of the law", they are supposed to say what the law says, but nothing more<sup>30</sup>. The source of law in this tradition is the legislative, and due to political preponderance of the executive, the former tends to be dominated by the latter<sup>31</sup>. This might even be true with regards to the interpretation of the constitution: Congress, and not the courts, interprets disputed aspects of the constitution through "interpretative laws" that impose a view on this disputed matter on the courts. This is true not only with regards to politics, but also with the areas of contract and property law.

This interpretation of the role of the judiciary has effects both externally on several other related institutions, as well as internally, in the organization of the judiciary itself. This section will deal with the first, while the next will with the second one. Externally, some consequences are more visible than others, although all are quite strong. In the first place, this interpretation distinguishes between politics and law: the pursuit of politics is different from the rule of law, if by this we understand the supremacy of the courts, and the protection of economic and civil rights by them. Law and Politics might follow similar ends, but this is an accident, the result of more or less liberal politics by the dominant party. In this tradition, if there is not a long social and political experience of protection of property and individual rights, property rights and contracts risk being under the tutelage of either the legislative or the executive, or both, as the courts can do no more than interpret what they decide<sup>32</sup>. In many Latin American countries, this can result in a heavily regulated institutional environment that nonetheless is not completely reliable. It can change in radical ways if there is a political change in the legislative or in the executive. In fact, the rights supported by the law can operate more as a "prize" to be obtained by a successful player in the political or regulatory game, than an

effective rule of behavior. These are something different, the game in which all the parties are engaged to obtain the rights they wish.

This intersubjective institutional framework also affects internally the judiciary, both in the ways the judges and personnel that work in them perceive their jurisdictional and administrative role. This interpretation calls for a passive role for the judges. As Pásara<sup>33</sup> argues, referring to Peru, even high-ranking judges seldom consider they have a crucial role in checking the other powers. However, they do believe they are at the head of the system, and that they are in charge of all affairs, administrative and jurisdictional, unless there is a different opinion in the executive in jurisdictional matters. This interpretation is reinforced by an administrative procedure, the judge selection process. Candidates to the higher ranking Judicial Positions (from Superior Courts up) have traditionally been nominated by Congress and appointed by the Executive. Usually, the Executive selected the judge among three candidates nominated by Congress. Any promotion had to follow a similar procedure. In practice, this procedure insured that the Judges would lean towards the party in power, as Congress and Presidential elections are simultaneous, and it is usually the case that the winning party controls both the Executive Power and Congress. This introduced strong incentives within the judicial career to avoid any conflict with the powers that be.

### *The Organization of the Judiciary*

Furthermore, the internal organization of the judiciaries is consistent with this interpretation. The Civil law tradition -and particularly, its Latin American version- has seldom paid any attention to the actual operation of the courts, stressing instead the study of substantive law. However, if it had, it would discover that the courts' organization is not designed to solve equal cases equally, but



rather to allow "flexibility" in deciding them. This happens through a combination of elements that affect both the supply and demand of judicial services. Dakolias<sup>34</sup> presents a view of the elements in the side of supply that affect the performance of the Latin American judiciary. These include the poor organization in individual courts, the complex procedures, and/or poor internal incentives of judicial agents. On the side of demand, Garibaldi<sup>35</sup> argues that the lack of mechanisms to insure consistency in decisions, the lack of jurisprudence, an institution that can provide signals as to whether parties should go to court, and simultaneously an external check on the actions of judges.

Most Latin-American judiciaries are organized following a hierarchical structure, in which a Supreme Court sits on top. Cases are started either at first instance courts, or in some countries (Peru, Bolivia, Venezuela) a Justice of the Peace system. Most cases can be appealed up to the Supreme Court, as only in isolated cases (such as Mexico, where it is called *absorption*) there is no *certiorari* process.

The organization of the individual courts has been affected -although not as deeply as in the previous case- by its colonial administrative origins. In the Spanish colonies, the Judges (*oidores*) that decide cases, lawyers that argue them, and scribes that handle the Courts paperwork were initially, with Notaries, the main agents of each court. They have remained so until not so distant a past<sup>36</sup>. In this arrangement, their role was quite different from what is to be expected from a separation of powers scheme: the judges were part of the executive, and the scribes were free agents, paid by the parties.

The transformation of the colonies into republics forced some changes in the political and legal ideology, but not so much in the organization. The *Oidores* and scribes became what would be known as the Judiciary. Judges would retain, together with their jurisdictional functions, their administrative duties. However, the liberal ideology of the new republics called for a new role for them. In

spite of being formally a part of the judiciary -a supposedly public service- scribes continued to charge both parties for their services, and acted as independent agents in all of their operations.

The resulting organization at the individual courts set various very serious organizational failures at the basis of the judicial systems, which provided a basis for corruption, rent seeking and poor management within the system. Parties had to pay the scribe, an agent for the judge, for his services. The opportunity for corruption was obvious. In this structure, the impartiality of the scribe depended mostly on his personal honesty, which was an heroic assumption.

An additional problem with this arrangement is that Judges had an added workload, as they had to take care not only of their jurisdictional duties, but administer this new judicial system as well, as if it were the central administration of the executive power. In fact, as the following section argues, most of the systems in the region have lacked until very recently a separate administration, in the sense that the judges themselves manage most judicial systems<sup>37</sup>. The typical Latin-American court has a judge and several secretaries (usually between three and four) operating under the judge in charge. In this context, as judges are usually overloaded with work, it is generally the case that they rely on these secretaries not only to help them with administrative matters, but also to prepare drafts to admit the demands presented, as well as the those of sentences. The judge will review these projects and accept them for good if he believes that they are well written. This places important discretionary power in the hands of the secretaries. In fact, a secretary could lie by telling a party that the judge is going to decide against them, while in fact he is going to decide favoring him. However, the secretary can always ask for a bribe to "set" the sentence to favor this gullible party. Of course, it could also be the case that the judge himself is the corrupt agent.

Variations of this organizational scheme are present in several Andean coun-

tries, but particularly so in Bolivia, Ecuador and Peru<sup>38</sup>. The incentives this scheme introduces within the judicial process are perverse. Since the secretary can maximize its payments by dividing them in several steps, they would strive to lengthen the judicial process, and include as many steps as possible within it. Thus he never really finishes to transfer rights to the parties involved in the process. Not surprisingly, in a 1993 survey in Peru, 37% of the population considered secretaries the most corrupt within the judicial system, surpassing both judge (29%) and lawyers (27%). Furthermore, 39% considered that the secretaries behavior was the main explanation for judicial delays, more than the legal process (35%) or "lawyers' tricks" (27%). In a different study, information was collected from a selected group of lawyers, so as to calculate how much would be spend in each step of the process. It was found that most of them concentrated at the first instance courts, and that around 25% of the expenses were illegal (acceleration) payments.

This problem has been compounded by the complex procedural regulation, which makes it easier to ask for illegal payments, and by the lack of mechanisms that insure consistent and public decisions.

### *The role of Jurisprudence*

The emission of Jurisprudence has not only legal functions, but other as well, which are embedded in the operation of the judicial system. Jurisprudence affects the demand for judicial services, as it provides useful indication for judges, lawyers, and interested parties on the sense and trends of judicial decisions. This helps them to assess the chances a particular claim has in Court, and thus to decide whether to go or not to Court. This function also affect the internal operation of the judiciary, as it also helps judges to decide cases in a consistent manner, and provides a context in which crucial issues for civil society can be debated publicly. In this sense, jurisprudence increases the transparency of the system as it

provides a means through which other agents of the system can monitor and openly discuss not only the judiciary's performance, but also its role in society.

These roles of Jurisprudence are to an extent independent of the legal tradition in which the judiciary is placed. Although the *stare decisis* doctrine makes the role of judiciaries different in the Civil and the Common law tradition, in both cases jurisprudence plays an important if not key role in the operation of the legal system. Both traditions take into account the value of previous decisions to inform judicial deliberation<sup>39</sup>. In fact, jurisprudence is actively used not only in western Europe, but also in some Latin American Countries (notably in the case of Mexico, but also in Costa Rica, for instance).

However, the legal dispositions established to insure consistent decisions are most of the time ignored in practice by the Latin American judiciaries, and are not used<sup>40</sup>. This is related to a crucial element in the interpretation of the role of judiciaries. As Burki and Perry<sup>41</sup> note, there is a dilemma at the root of any effort taken to improve a judiciary's performance. If taken as a hierarchical agency, efficiency requires effective command and control systems, while at the same time improving internal (individual judges) and external (*vis a vis* other political powers) judicial independence requires autonomy. Achieving both results is a difficult endeavor, which stresses the role of jurisprudence as a set of coherent decisions according to law.

In this context, the dilemma seems to have been solved by granting independence to judges in all matters that do not affect issues of importance to the existing government. This solution is coherent with the judiciaries' weak external independence, and with the poor observance of the regulations concerning jurisprudence. As a result, a Court can decide similar cases in different ways, and even if similar cases are decided equally by the same court, the superior court can decide differently. Furthermore, even if both first instance and superior courts decide consistently, the

courts of a different judicial district can decide otherwise. Thus judiciaries lack a system through which consistent decisions could be produced, and which could provide a basis to make reasonable predictions about the outcome of potential conflicts. In this context, it makes little sense to publish jurisprudence. In fact, most Latin American judiciaries seldom report it, and that which is produced is not really useful, as it only states the sense of the final sentence, but does not reproduce the cases from which it sprung.

This situation has several interesting consequences. Since there is no consistent predictable outcome, the plaintiff can "try its luck" at the judiciary, trying to find the judge and the court which could be more favorable to its claim. The lack of standards increases the workload of judges, as there are no clear guidelines on which to decide similar cases.

On the other hand, potential parties perceive the system as a threat, rather than as a means through which conflicts can be solved. Starting a lawsuit is imposing on the other party the uncertainty and anguish that a judicial process entails. Neither of them is really interested in finishing it. Once this threat has been used, the parties can then return to negotiations out of court, and try to solve the dispute through other means. If the negotiations enter into a deadlock, the affected party returns to the judicial power<sup>42</sup>. This game however, only increases the number of cases which are entered into the system, as there is no deterrent signal telling potential parties on the possible outcome of their case. This, coupled with the poor management of the cases, and the complex procedural systems, causes severe delays, and floods the judicial system with cases.

Last but not least, if the government is a party in a case, no formal track will exist of the sense of the decisions the judiciary took.

The consequences of this shortcomings are multifarious. The population at large have an extreme mistrust of the judicial system, and so does the private sector. In Argentina, only 13% of the population trusts the

judiciary<sup>43</sup>, while in Brazil 74% of the population thinks it is fair or poor. The most severe case, however, seems to be Peru, where 86% of the population has little or no confidence in the judiciary<sup>44</sup>. World Bank studies on the constraints the private sector faces in Peru<sup>45</sup> and Ecuador<sup>46</sup> cite the poor performance of the judiciary as one of the top constraints for the development of the private sector in these countries.

This analysis shows that in this context, the judiciary as a third party in enforcement is working poorly. An alternative to overcome the opportunism that can arise in intertemporal transactions could be to replace this kind of transaction with a simultaneous one. The use of collateral is the most common way out of this problem. We turn now to the analysis of this institution, applying the same framework than before.

### 3.2 Collateral

The basic idea of collateral is the same in different legal traditions: it entails employing a good to that is used as "hostage" to secure other transactions. However, once again the treatment of this same institution can differ markedly in a civil or in a common law context. This difference can be significant, as we will see when we compare the case of collateral in selected Latin American countries with the case of the U.S. In the latter's treatment of collateral, there is a uniform regulation of possessory and non-possessory collateral of all kinds of goods, with a uniform treatment of the creation, perfection and execution of collateral, which allows for a flexible and efficient treatment of this matter.

However, while the US has developed a single and relatively uniform framework for this matter, Latin American systems are marred by a multitude of different regulations in collateral. These have biased the institution towards the use of real estate, personal guarantees, and possessory interests, neglecting the use of other kinds of goods. Not only do they treat this institution in a very different

way, they have also evolved along different lines. This not only makes difficult for anyone without real estate to have access to credit, but significantly increases the cost of lending. Although the different endowments, technologies and preferences in the economies might help explain the differences in the evolution of these rules, an important component of the explanations for this difference is the interpretation of this institution by the legal tradition in which it operates.

In the Civil law tradition, collateral is divided among certain "kinds" of goods, based originally in the Roman law distinction between their "moveable" or "unmoveable" character. This distinction has evolved a great deal, and now for instance, a ship -an obviously moving object- would be considered a non-moveable good, rather than a moveable one. As Garro<sup>47</sup> notes, the contemporary mold of Latin American Law is the French regulation of the collateral, which is also within this civil tradition. This regulation distinguished between *antichrese*, if the object delivered to the creditor was immovable property, and if the object delivered was movable, it was called *gage*, or pledge. The only non-possessory collateral -that in which the creditor is not in possession of the good employed as collateral- was the *hypothèque*, or the mortgage over unmoveable property. It is upon this framework that Latin American evolution of secured transactions started. It must be noted that in this framework, almost all non-possessory security devices are assimilated to the *hypothèque* form, and can operate only accompanied with a written record of the transaction involved.

Currently, the civil and commercial codes provide the basic rules for collateral. In case collateral is not real estate, the most common legal form for collateral is a pledge. Its definition involves three essential components: 1) the pledge arises from a contract, 2) it can only affect movable property, 3) the secured creditor must be put in possession of the object pledged. Although this latter characteristic can be seen as an important security de-

vice (it makes it clear who is the creditor, and which is the good employed as collateral) it is also an important drawback. Possessory pledges impede the owner of the good to continue using it while it is pledged<sup>48</sup>.

In spite of this restrictions, the development from agricultural to more industrialized economies in the first half of this century pressed for the need to keep movable goods while using it as collateral in several areas. This forced developments in the law that would allow non possessory pledges under certain circumstances. However, the law has treated these cases with deep suspicion. In fact, as the Codes forbid the use of non-possessory pledges, these forms of collateral had to be created by statute. These statutes allowed these forms of collateral, but imposed several restrictions on its. In most of the Latin American regulations, these are related to the kind of good that is going to be employed as collateral, the kind of obligation that is going to be guaranteed, and/or the type of creditor that is being supported by the guarantee. The variations in the kind of collateral that is going to be employed affect in turn the kind of rules that define the creation, perfection, and execution of each form of collateral. Thus, for instance, there can exist a pledge for agricultural, industrial, fishing, and/or mercantile goods. Each of these in turn supports only obligations that are related to these activities, and might have a different registration and execution procedure.

Two additional problems are worth mentioning. In the first place, the *hypothèque* mold of the Latin American interpretation of the civil law tradition also imposes the need to register the goods that are being used as collateral. The suspicion with which this mold is held by the legal tradition has also found ways to express itself here. This registration rather than indicative (an indication to any possible third parties that such a good might have been pledged) is quite exhaustive. This has two additional consequences. It increases the security of the pledge, but at the expense of higher transac-

tion costs. It also places the registries, a crucial and poorly functioning element of the property rights environment, in center stage.

Secondly, this mold calls for the judiciary to participate in the execution of collateral. In trying to protect the pledger, the law disposes that collateral cannot be sold by the creditor, but rather that it has to be disposed through a judicial process. In this context, the problem is compounded for non-possessory security interests. There, the creditor would have to recover the good first, before being able to execute his payment. The gist of this issue is that it introduces to the already severe restrictions that the multiple regulations impose, an additional problem related to poor performance of the judiciary.

The result of this framework is a bias towards employing real estate, possessory interests, and personal guarantees (where the creditor can proceed against the patrimony of another party as a guarantee of payment) as collateral, and towards Banks as main suppliers of credit. Fleysig<sup>49</sup> reports that in Bolivia in 1994, 48% of credit was granted with real estate, while 42% is granted with personal guarantees. Similarly, commercial banks concentrate 89% of total credit. In that same year, the U.S. commercial banks had only 31.1% of all credit, while only 30.4% of all credit was granted with real estate collateral. The situation is similar, although less acute, in Mexico and Peru.

In this latter country, as in Bolivia, commercial banks concentrated around 85% of all formal credit in 1997, and banks overwhelmingly preferred real estate, possessory interests, and personal guarantees. In Peru, however, the problem of collateral is compounded by the poor enforcement that the Judiciary delivers. Even the banking system statistics are organized according to difficulty in processing claims. Most Banks prefer to employ collateral that can be readily cashed, such as warrants, bonds and titles, and prefer to avoid goods that might force them to go to the judiciary. In Mexico, the problem seems

to be somehow eased due to the more flexible regulation of collateral, and allows for a larger set of non-possessory interests.

It is important to notice here that this is not a problem of regulations. To change the collateral system to a single legal framework that would regulate equally all forms of collateral, ease the role of registration in the process, and allow the parties to regulate the procedure to take the collateral as payment is no simple task. It would require major changes in core areas of the civil law, including law of contracts, of obligations, of legal procedure, etc. This is a problem of the way the law interprets and approaches the problem. Its focus is then the rules of interpretation of the specific rules of an institution, rather than a problem of regulation, which could be solved simply by changing the law. The situation seems to be pervasive to the region, as similar cases have been reported for Uruguay and Argentine<sup>50</sup>.

### 3.3 Property Rights

This situation seems to have spilled into property rights. As in collateral, the legal tradition seeks to insure the owners claim over property, particularly with regards to real estate. The French model has also inspired here the regulation of property rights, particularly with regards to real estate. In this model, an agreement allows for the transfer of property. However, it is registration that provides the order of claims in case a seller sells to several buyers. Thus, here as in collateral, registration becomes a central issue. Registration procedures can become quite elaborate, and require the participation of lawyers, notaries, specialized registries' officers, and eventually engineers or architects –to draft the plans that explain the property's boundaries, and to insure that the property is not violating zoning or urban laws.

The complexity of this regulation has had some unexpected consequences. De Soto<sup>51</sup> analysis of informal housing built in Lima between 1920 and the mid 1980s, argued that almost 70% of all the housing available in

Lima was regulated by a parallel system of rules, created by informal settlers<sup>52</sup>. This percentage had been increasing persistently since the 1920s. However, this regime was seldom followed by formal law. Instead, he argues that the inefficiency of this law forced housing to be built upon the base of an informal "expectative right". It included 1) the presence of the interested parties at the location claimed, 2) the progressive perfection of the right, as the party complies with the numerous administrative steps required to formalize his tenancy; 3) the granting, through a recognition, via an exception to the law, of a right to the lot.

In this process, formal law persistently sought to impose conditions on the settlers as a condition for granting them formal recognition. After several tugs with the authorities, in the late 1970s laws were passed that allowed informal settlements to turn into normal neighborhoods, provided they registered their rights with the same procedures that were followed in the neighborhoods regulated by formal law. However, the registries and the formal system in general were incapable of processing the amount of claims that were required to formalize all of these properties<sup>53</sup>.

At this point, it is interesting to note that in spite of the fact that almost seventy percent of the city was regulated by a separate legal system, this system lacked legitimacy, and has to try to be admitted by the formal legal system. In the absence of these recognition, the settlers' housing was nonexistent for the law, and in a diminished status in the economy. De Soto's calculations show that housing with legal standing was valued almost 12 times more than that which lacked it. The reasons are several: it could not be rented, mortgaged or sold to strangers, and it forced its owners to use it as housing, as any other use would be difficult without the protection of the law.

#### 4. Reforms

There have been several attempts to reform the organizations behind some of these

institutions. In these attempts, when the reform of an organization has been at odds with its expected (interpretation, once again) role within the institutional framework, most of these reforms have not taken hold, or backfired. In fact, the same tradition has created other more compatible means to partially achieve similar, albeit not optimal, results. This reinforces the view that the intersubjective framework needs to be addressed head on if further advance is sought. Examples from reforms of the Courts and the registries, organizations linked to formal enforcement, collateral and property rights within this tradition, support this view.

The reforms in the courts have centered in their organization and managerial capacity. In recent times, a Judicial Council with governance functions has been introduced in the judicial structure<sup>54</sup>. This structure, imported from recent institutional developments in Italy and Spain, have only had limited results. The Supreme Court perceives the creation of a Judicial Council at least as a threat to their leading role within the system, and at the most as a direct attack to Judicial Independence. Thus, in Bolivia and Ecuador, where they have been implemented most recently, they have experienced a complete lack of collaboration from other parts of the system, and in some cases, such as in Bolivia and in Mexico, outright hostility. In other countries, such as in Ecuador and Peru, these councils have been in place since the early 1990s, they have been weakened by the lack of budget, staff, or political support<sup>55</sup>.

Furthermore, in the late 1980s, most Countries in the region changed the political designation process with another one based on autonomous Judiciary Councils, which would nominate and ratify judges after a 5 - 7 year period. Although the system is still young, it has faced a shortage of personnel and budgetary support in the region in its still short life. In some countries, such as Venezuela and Peru, they lack the means to systematically evaluate judges, and can barely nominate them judges as the need arises.

Additionally, there have been important attempts to improve the internal organization of the courts, by controlling or replacing the scriveners through their incorporation into central administrative structures. These reforms seem to be the most plausible of success, as they do not touch any of the institutions that are interpreted to be central to the operation. Thus in Peru and Bolivia, for instance, these changes have remained, in spite of deep initial opposition, due to the losses in rents that some agents within the system experienced.

However, the lack of attention to the political role of the judiciary has continuously undermined this organizational reform attempts. Even if judiciaries are improving in their role of enforcing contracts, its lack of standing in political cases, underscores the fact that eventually, they are not independent and operate more as an administrative agency than as a autonomous power.

This poor performance suggests that the kind of transactions being supported vary from what would be expected with a better performing judiciary. Additionally, it could also be the case that other mechanisms might have evolved within the same legal tradition to partially solve the same problems. In this sense, it is clear that Judicial systems are operating as passive courts. As Schwartz<sup>56</sup> argues, this might be useful in supporting "classical" contracts in Williamson's<sup>57</sup> terminology, but rather ineffective in neoclassical contracts in this same terminology. Menard<sup>58</sup> provides a framework to further extend this kind of analysis to other transactions. Thus as Shepherd *et al.*<sup>59</sup> would suggest, judiciaries would be operating more as administrative supplement in a mercantilistic type of economy, than as a effective third party system to enforce transactions.

Furthermore, the inefficacy of judicial systems have brought administrative means to achieve some of the results that the judiciaries can not deliver. Thus, it is not uncommon to create parallel regulatory institutions, that perform some of the enforcement duties that

judiciaries could do in key areas of the economy. In this context, we could close the loop, and note that this view of the poor performance of the formal enforcement of courts is coherent with the analysis of enforcement institutions in the telecommunications industry by Spiller<sup>60</sup>, or with the role that political institutions in enforcement performed by Shirley<sup>61</sup>.

Something similar has happened with the registries, an organization crucial for the operation of the institution of property and to a lesser degree, collateral, in this tradition. Thus for instance, in the early 1990s various attempts were started in Peru to radically alter their operation, so they could cope with the increased demand they faced. These reforms included the creation of a number of special registries in and out of Lima, and processes to speed the process of registration. This was particularly the case in situations where the lots occupied by the settlers was originally owned by the state, and thus was not subject of a lawsuit in which another private part was involved. This allowed to have the judicial power out of the process, which sped out considerably the whole procedure. These registries, operated by a separate organization, were quite successful, and were able to produce titles in excess of the 150,000 titles per year.

However, the registries have been continuously under attacks based on the same logic that permeated the whole process of exceptions and negotiations described above. Several attempts have been made to include these separate registries within the formal registry system, under the argument that a different system could not be tolerated by the formal registry system, as this would imply having a separate property system. This is an argument based on the interpretation of the legal institutions. It is made in spite of the fact that the traditional system is grossly inefficient<sup>62</sup>. The legitimacy of the whole process was also an issue, and this was part of the legal tradition, which provided the mold upon which the adequacy of the solutions to these

problems could be judged. This "idea" of what a proper title should be also affected the performance of this institution.

These considerations underline the importance of taking into account the role that this interpretative horizon plays. Reforming the organization might not be enough. As these examples have shown, the problem is not only in the organization but also in the models that people employ to process information about the choices that they are going to make. This has been the case in the judiciaries, in collateral, and in property rights. The interpretative molds upon which these institutions operate are quite strong, and resilient to change. In spite of the fact that their performance could imply severe losses if compared with other institutional arrangements, these have persevered. Furthermore, radical reforms of the regulations themselves might be eschewed by the traditional mold upon which

they are implanted, as they can be attacked as illegitimate by a majority of other agents.

This effect is in part the result of the intersubjective character of the models that agents use. If it were just an individual framework, it would be relatively easy to change it. However, the fact that this mold is shared and collective, makes it crucial to take into account their political role, and proceed to reform through a discussion of the elements that affect its performance. Thus, institutional reforms should start from the actual role institutions are supposed to be playing within it, and combine it then with reforms to the organizations that underlie their operation. In this context, it might be wise to propitiate reforms that start at the path of evolution of a specific institutions, and translate more efficient institutional arrangements within the terms of the so that the reform is not only more efficient, but also legitimate.

## NOTAS

1. Moore, R. and J. A. Garibaldi, *Peru, Judicial Sector Assessment*, Washington, D.C.: The World Bank, November 30, 1994.
2. Buscaglia, E. and M. Dakolias, *Judicial Reform in Latin America: Economic Efficiency vs. Institutional Inertia*, Working Paper Series, Econ-2377-06-495, School of Business Administration, Georgetown University, 1995.
3. Coase, R., *The Firm, The Market, and the Law*, Chicago: The University of Chicago Press, 1988.
4. North, D. and R. Thomas, *The rise of the Western World*, Cambridge: Cambridge University Press, 1973, p. 78.
5. Williamson, O., *The Economic Institutions of Capitalism*, New York: The Free Press, 1985.
6. Posner, R., *Economic Analysis of Law*, New York: Little, Brown, 1989.
7. *Ibid.*
8. Cooter, R. and T. Ullen, *Law and Economics*, New York: Harper Collins, 1989.
9. Pollinski, M., *An Introduction to Law and Economics*, New York: Little, Brown, 1989. The character of these rules can be seen better if seen in contrast with the "interventionist" rules of public utility regulation. Posner clearly distinguishes this from what he calls the "economic theory of law" which needs not to be efficient.
10. Menard, C., "Enforcement of Contractual Arrangements", Paper presented at the Inaugural Conference of the International Society for the New Institutional Economics, St. Louis, Washington University, 1997.
11. Stone, Andrew, B. Levy and R. Paredes, "Public Institutions and Private Transactions: A comparative analysis of the legal and regulatory environment for business transactions in Brazil and Chile" en Alston, L., T. Eggerston, and D. North, *Empirical Studies in Institutional Change*, Cambridge: Cambridge University Press, 1996, pp. 92-128.
12. The informal "judges of the peace" in several andean countries is an interesting example. The "judge of the peace" a community member with a cuasi judicial role, seeks to mediate and solve conflicts by threatening the parties involved in them to take the case to a formal court of law if they cannot solve the problem on their own. To avoid this possibility, parties usually come to an agreement.
13. Garibaldi, J. A., "Organización, incentivos, y desempeño en el Poder Judicial", *Actas del*



- Congreso sobre reforma del Poder Judicial*, Lima, Peru: Oficina Técnica del Banco Mundial, 1996.
14. Buscaglia, E. and M. Dakolias, *op. cit.*
  15. Burki, S. and G. Perry, *Beyond the Washington Consensus: Institutions Matter*, Washington, D.C.: The World Bank, 1998.
  16. *Ibid.*
  17. Simon, Herbert, *Models of Man*, New York: Wiley & Sons, 1957.
  18. *Ibid.*, p. xxiv.
  19. These models are not only a subjective set of ideas –no agent would be able to build all of them on its own- but rather a common property of society, built by the past, the culture, and the continuous interaction in society. From here each agent draws when needed.
  20. North, D., *Transaction Costs, Institutions and Economic Performance*, San Francisco: International Center for Economic Growth, 1992.
  21. North, D., "Economic Performance Through Time", in *The American Economic Review*, vol. 84, No. 3, June, 1994.
  22. *Ibid.*
  23. Williamson, O., *op.cit.*
  24. David y C. Brierly, *Major Legal Systems in The World*, New York: The Free Press, 1989.
  25. Simon, Herbert, *op.cit.*
  26. Clague, C., "Rule Obedience, Organizational Loyalty, and Economic Development", in *Journal of Institutional and Theoretical Economics*, vol. 149, No. 2, 1993.
  27. Spain has had an important role in the articulation of many of the original administrative structures that underlie organizations such as the Courts, the property registries and the public administration in general. The colonial administrative arrangements were the bedrock upon which the contemporary forms of these institutions developed. Other countries, such as Italy, Germany and particularly France have had an important influence in the development of the contemporary legal institutions of many of these countries, particularly those dealing with the core legal market institutions. Finally, the constitutional model of the United States, and in a minor way, those of France and contemporary Spain, have had an important influence on the evolution of political institutions that have an important effect on institutions such as property.
  28. Hayek, F., *Law Legislation and Liberty*, New York: The Free Press, 1989.
  29. Nedelsky, J., *Private Property and the limits of American Constitutionalism*, Chicago: University of Chicago Press, 1994.
  30. They can in fact say more, as each case is different, and the judges and lawyers cannot avoid interpretation. However, this interpretation is only at the margin left by the arrangements explained below. Arguing that their scope of interpretation is larger than this margin would only increase the problem in the Latin American region, as courts lack systems to insure consistency in decisions. Thus, cases argued by different lawyers in different courts can result in large variations in the result of similar cases. This is a poor argument for a consistent set of rules.
  31. For a comprehensive analysis of this issue, see Verner, J. G., "The independence of Supreme Courts in Latin America: A review of the Literature", in *Journal of Latin American Studies*, vol. 16, No. 463, 1984, pp. 468-477.
  32. It also has some other, less visible, consequences. Olson, M. ("Big Bills on the sidewalk: why some nations are rich and others are poor", in *Journal of Economic Perspectives*, vol. 10, No. 2, Spring, 1996) argued that an increase of government intervention in the economy would result in more and more areas of it being ruled by people with no direct experience of economic activities, which would result in less efficient policies, and increased economic distortions. Something similar happens in this case. Judges and lawyers, those directly involved with the cases, and more acutely aware of their economic consequences, become "second rate" legal citizens in this world. The legislators that create them and the legal experts that codify and teach them at universities become central figures. These, however, are those most removed with the world of actual litigation and case solving that is experienced in the courts. This results in legal institutions that do not always seek to maximize wealth, but rather can in fact contribute to diminish it.
  33. Pásara, L., *Jueces, justicia y poder en el Perú*, Lima, Peru: Ediciones El Virrey, 1989.
  34. Dakolias, M., *The Judicial Sector in Latin America and the Caribbean: Elements of Reform*, Washington, D.C.: The World Bank, 1996.

35. Garibaldi, J. A., *op. cit.*
36. What could be called the judicial system in the Spanish colonial America was comprised of four bodies: notaries (of which more will come next), lawyers, judges, and scrivanes. The latter three were involved in arguing cases. Judges (or *Oidores*, "listeners") who were in fact, part of the Executive, decided them, lawyers argued their cases, and scrivanes took care of record keeping and the paperwork involved in the case. Notaries did a similar duty on private transactions.
37. This places a heavy administrative burden on the judges' hands. Reports from several sources in the region coincide in that they spend in important amount of time dealing with administrative issues rather than solving cases.
38. This latter country has been the most systematically investigated, and provides concrete evidence of the operation of these arrangements. In fact, until 1988 secretaries were not considered part of the legal system of the country, and were *de jure* and *de facto*, private entrepreneurs. They collected an equal "fee" from each party for each of the steps involved in the process, which although was not legal, it was tolerated by the Judicial establishment, as well as by the lawyers. However, due to increasing pressure from Superior Court Judges, and from the Ministry of Justice, secretaries were included into the Judicial career in 1988, and were given a monthly allowance to run their offices, usually located close, but not within, the judicial power. However, this amount was insufficient to cover their costs, and the hiperinflation of 1989 - 1990 only made matters worse. Thus, the allowance only operated as a subsidy, and they kept asking fees to parties in the process.
39. There are several mechanisms through which a Civil Law judicial system can provide relatively stable and regular jurisprudence. In particular, dispositions are usually taken to insure that under certain conditions (the decision a full court, for instance) the judicial decision will have precedence over those taken at inferior courts. Dispositions similar to these are included in the legislation of several Latin-American countries, and in force in some of them, particularly so in Mexico.
40. This dispositions are included in the legislations of Ecuador, Peru and Bolivia, but according to judges and judicial personel in these three countries, there have been only a handful of cases decided following this procedure.
41. Burki, S. and G. Perry, *op. cit.*
42. In fact, this is the explicit threat used by the Peruvian "justices of the peace", a communal institution dating back to the XVII century, which is still widely used in rural areas in Peru.
43. Gallup Argentina, *Estudio de Opinión acerca de la Justicia en Argentina*, Buenos Aires, Argentina: 1994.
44. Apoyo S.A., *Estudio de Opinión sobre el Poder Judicial*, Lima, Peru: Apoyo S.A., 1993.
45. World Bank, *Peru Private Sector Assessment*, Washington, D.C.: The World Bank, 1993.
46. World Bank, *Ecuador Private Sector Assessment*, Washington, D.C.: The World Bank, 1994.
47. Garro, A., "Security Interests in personal property in Latin America: A Comparison with article 9 and a model for reform", in *Houston Journal of International Law*, vol. 9, No. 2, Spring 1987.
48. Furthermore, the Latin American interpretation of the Civil Law tradition considers collateral as an ancillary contract to the principal contract, an obligation that the collateral is supporting. This in turn makes it difficult to use collateral for any future obligation, as if this were a sort of floating pledge that could guarantee any future transactions. As a result, the utility and flexibility of the pledge is seriously affected.
49. Fleysig, H., *How Legal Restrictions on Collateral Limit Access to Credit in Bolivia*, Washington, D.C.: The World Bank, 1994.
50. Correspondence with Geoffrey Shepherd, at the World Bank.
51. De Soto, H., *El otro sendero: la revolución informal*, Lima, Peru: Editorial El Barranco, 1986.
52. The process that De Soto studies started in the early 1920s. Then, a number of traditional neighborhoods were urbanized by its owners, via special exceptions to the law. Several rulings established procedures to solve the noncompliance of these practices with formal law. Upon this experience, the initial waves of the explosive migrations from rural areas to Lima in the 1930s settled

mostly state owned areas, and then negotiated with the authorities their reubication to new urban areas, specifically set apart by law. As political awareness grew among the new inhabitants in the 1950s, both them and the authorities arrived to a "live and let live arrangement", through which the inhabitants provided political support to the current authorities, and these in turn provided special rulings to authorize the new settlements. In all cases, however, these rulings would try to impose compliance on the settlers with a number of standards, taken from formal law. These were the conditions they had to abide to be recognized by the latter, which however they systematically ignored.

53. The peak was reached between 1981 and 1983, were the City hall was capable of issuing 22,000 titles that complied with formal requirements. This number was totally out of pace with the amount required to effectively conform the informal settlers' claims the requirements of formal law that run in the hundreds of thousands.
54. These Councils usually have as their duties the management of the Court system, and setting court policies, and are staffed by judges of the Superior and/or Supreme Courts. They have under their command a General Manager for the Court System.
55. One of the main reasons of the poor practical relevance these councils have had in the operation of the judiciary, is the weak effective management capacity they have been granted. In spite of the fact that they nominally have crucial responsibilities within the system, they lack budgetary and managerial resources to carry them through. In fact, the Supreme Court remains responsible of managing the

Judiciary's budget, and in most cases the Council's manager manages it with approval, first of the Council, and then of the Supreme Court. The result is most of the time an administrative paralysis that closely resembles the normal state of affairs under the previous judicial system of management.

56. Schwarz, A., "Legal Contract Theories and Incomplete Contracts", en Lars Werin y Hans Wijkander (eds.), *Contract Economics*, Oxford: Basil Blackwell, 1992, pp. 76-109.
57. Williamson, O., *op. cit.*
58. Menard, C., "Enforcement of Contractual Arrangements", Paper presented at the Inaugural Conference of the International Society for the New Institutional Economics, St. Louis, Washington University, 1998.
59. Sherwood, R., G. Shepherd, C. M. De Souza, "Judicial Systems and Economic Performance", in *The Quarterly Review of Economics and Finance*, vol. 34, No. 101, 1994, pp. 101-112.
60. Spiller, P. and B. Levy, "The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Industry", in *Journal of Law, Economics, and Organization*, vol. 10, No. 2, 1994, pp. 201-246.
61. Shirley, M., *Bureaucrats in Business*, Oxford: Oxford University Press, 1995.
62. Part of the explanation of these phenomenon lies in the institutional inertia of the system, and the rent seeking mechanisms that are operating in this process. The notaries and lawyers linked to the registries are those supposedly guarding the propriety of the whole process, and are at the same time those that have the most to lose from a reform of the procedure that simplifies the property process.

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