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# Demand for Law in the African Private Sector

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**Abstract:** This article develops a model for explaining private sector response to law reforms in developing countries. The dependent variable in this model is the demand for law – the extent to which business owners and firm managers engage the formal legal system and attempt to mobilize the law to their advantage when making market decisions. Demand for law is a crucial micro-connection in the causal chain linking law and law reform to market expansion and economic development. The theoretical framework developed here focuses on the interplay between informal and formal social institutions in influencing market decisions made by private sector actors. The article tests hypotheses generated by this framework by analyzing survey data collected from business firms in Dar es Salaam, Tanzania. The results support the hypothesis that demand for law is shaped by informal market institutions, particularly the informal business networks developed and maintained by firms. The analysis further suggests that these “demand-side” variables matter more than “supply-side” variables identified in the social science literature. These findings have important implications for law reform initiatives in developing countries and suggest avenues for further social science research on the relationship between law and economic development.

**Keywords:** law and development, Africa, private sector, demand for law, empirical

## 1 Introduction

Over the past several decades, policy makers, social scientists and legal scholars have increasingly acknowledged the role that law and legal institutions play in the economic development process.<sup>1</sup> Much of the literature on law reform in

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<sup>1</sup> See, e.g., Linn A. Hammergren, *Justice Reform and Development* (New York: Routledge, 2014); Michael J. Trebilcock and Mariana Mota Prado, *Advanced Introduction to Law and Development* (Cheltenham, UK: Edward Elgar, 2014); Shailaja Fennell, *Rules, Rubrics and Riches: The*

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developing and transition countries focuses primarily on the *supply* of legal institutions by the state – the assumption is that, as long as the state supplies the correct legal rules and institutions, the desired development outcomes will automatically follow.<sup>2</sup> This condition may be necessary, but it is not sufficient. The law and development literature largely ignores the factors that shape levels of social *demand* for reformed laws and legal institutions.<sup>3</sup> For law to play a role in promoting economic development, and more generally for the rule of law to emerge in Africa and other developing regions, law and legal institutions must matter to social actors.

This paper develops a model for explaining private sector response to law reforms in developing and transition countries. It then proceeds to test hypotheses suggested by the model by analyzing survey data collected from business firms in Tanzania. The dependent variable in this model is the *demand for law* – the extent to which business owners, firm managers and other private sector participants in developing and transition countries engage the formal legal system and attempt to mobilize the law to their advantage when making market decisions.<sup>4</sup> Demand for law is a crucial micro-connection in the causal chain linking law and law reform to market expansion and economic development. This variable is all the more important in societies characterized by a high

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*Interrelations Between Legal Reform and International Development* (New York: Routledge, 2010); *Symposium: The Future of Law and Development*, 104 Northwestern University Law Review Colloquy (2009); and Tamara Lothian and Katharina Pistor, *Local Institutions, Foreign Investment and Alternative Strategies of Development: Some Views from Practice*, 42 Columbia Journal of Transnational Law (2003), 101 (“According to this new consensus, law plays a crucial role in the process of market-oriented development”).

2 See, e.g., David K. Linnan, “The New, New Legal Development Model”, in David K. Linnan (ed.), *Legitimacy, Legal Development and Change* (Burlington, VT: Ashgate Publishing Company, 2012), p. 27 (“American [rule of law] views seemingly assume that changing law will change behavior directly”).

3 See, e.g., Julio Faundez, “Rule of Law or Washington Consensus: The Evolution of the World Bank’s Approach to Legal and Judicial Reform”, in Amanda Perry-Kessaris (ed.), *Law in The Pursuit of Development* (New York: Routledge, 2010), p. 196 (the World Bank’s “approach to institutional reform all but ignores the role played by informal constraints”).

4 See Jordan Gans-Morse, *Demand for Law and the Security of Property Rights: The Case of Post-Soviet Russia*, 111 American Political Science Review (2017), 338; Mary E. Gallagher, *Mobilizing the Law in China: “Informed Disenchantment” and the Development of Legal Consciousness*, 40 Law and Society Review (2006), 783; Avner Greif, “Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange”, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics* (New York: Springer, 2005), p. 727; Kathryn Hendley, “Demand” for Law in Russia – A Mixed Picture, 10 East European Constitutional Review (2001), 72; and *Symposium: Demand for Law*, 8 East European Constitutional Review (1999).

degree of legal pluralism, where the formal legal system competes with a variety of other pre-existing norms in shaping patterns of social behavior.<sup>5</sup>

Improvements in the quality of formal legal institutions may promote market expansion by mitigating transactional risk and encouraging more robust market activity. But this can only happen if the law matters to private sector actors in the first place, if the law factors into their decision-making calculus. If law is to have any impact on the private sector, it must have some degree of relevance and importance to private sector actors. If law is irrelevant to private sector actors, it is largely irrelevant to private sector development.<sup>6</sup> Private sector actors face a choice when structuring transactions or resolving disputes with customers and suppliers: they can engage the formal legal system or fall back on informal market institutions.<sup>7</sup> If they attempt to mobilize formal legal institutions to their advantage when making market decisions, they exhibit demand for law. Understanding the factors that shape social demand for law is therefore important for evaluating the impact that law reform may have on economic development.<sup>8</sup>

The theoretical framework developed here focuses on the interplay between informal and formal social institutions in influencing market decisions made by private sector actors. Demand for law is shaped by both the nature of pre-existing informal social institutions (“demand-side” variables) and the perceived quality of formal state institutions (“supply-side” variables). The characteristics

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5 See Brian Z. Tamanaha, “The Rule of Law and Legal Pluralism in Development”, in Brian Z. Tamanaha, Caroline Sage and Michael Woolcock (eds.), *Legal Pluralism and Development* (New York: Cambridge University Press, 2012), p. 34; and Veronica Taylor, “The Law Reform Olympics: Measuring the Effects of Law Reform in Transition Economies”, in Tim Lindsey (ed.), *Law Reform in Developing and Transitional States* (New York: Routledge, 2007), p. 100 (legal norms “occupy a spectrum of legal pluralism that embraces the differing perceptions by elites and the disadvantaged; by business ...”).

6 See, e.g., Katharina Pistor, *The Demand for Constitutional Law*, 13 *Constitutional Political Economy* (2002), 75 (“If the formal law fails to provides solutions for actual conflicts, it will be ignored”); and Jonathan R. Hay, Andrei Shleifer and Robert W. Vishny, *Toward a Theory of Legal Reform*, 40 *European Economic Review* (1996), 559 (social actors must find it in their interests to “use the legal system to structure their economic activities and resolve disputes”).

7 See Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism* (Chicago: University of Chicago Press, 2008), pp. 39–44 (discussing supply and demand for law and the substitutes for law in society).

8 See John Gillespie, “Developing a Theoretical Framework for Evaluating Rule of Law in Developing Countries”, in Michael Zurn, Andre Nollkaemper and Randall Peerenboom (eds.), *Rule of Law Dynamics* (New York: Cambridge University Press, 2012), p. 233 (emphasizing importance “for donors to understand and recalibrate their projects to accommodate the factors that motivate recipients in developing countries to adopt, resignify, or reject [rule of law] promotion”).

of the business networks that private sector actors develop and maintain are critical demand-side variables shaping levels of demand for law. Supply-side variables may also shape levels of demand for law, particularly the perceived quality and credibility of formal state legal institutions. Where private sector actors perceive the legal system to be relatively fair, inexpensive, efficient and effective, they should exhibit higher demand for law. Where these actors perceive the legal system to be unjust, corrupt, costly, inefficient and ineffective, we would expect lower levels of demand for law.

The article tests this theoretical framework by examining the case of Tanzania, a developing African country attempting the transition from socialism to a market-oriented economy.<sup>9</sup> Over the course of this ongoing transition, Tanzania has attempted to credibly commit to improving the legal system by tabling a host of business-friendly law reforms.<sup>10</sup> Despite these attempts, Tanzania has struggled to address deficiencies in the quality of the formal laws and legal institutions it supplies the private sector.

A survey of business firms in Tanzania demonstrates that, despite these systemic deficiencies, firms do engage the legal system by consulting attorneys for legal advice and litigating disputes with customers and suppliers. An analysis of the survey data supports the hypothesis that this demand for law is shaped by informal market institutions, particularly the informal business networks developed and maintained by firms. The analysis suggests further that these “demand-side” variables matter *more* than the perceived quality and credibility of the legal system in the eyes of private sector actors, a “supply-side” variable that the social science literature deems critical.

Section 2 of the article locates the demand for law variable within the larger framework of law and development theory. Section 3 then develops and describes a theoretical model for understanding the institutional factors that shape levels of social demand. Section 4 presents the results of a survey of Tanzanian business firms. The survey was designed to elicit information about the respondent firms’ customer and supplier networks, attitudes toward the formal legal system, and engagement with the formal legal system, particularly with the courts and practicing bar. The resulting data afford a detailed look at

<sup>9</sup> See Benno Ndulu and Nkunde Mwase, “The Building Blocks to Tanzania’s Prosperity”, in Christopher S. Adam, Paul Collier and Benno Ndulu (eds.), *Tanzania: The Path to Prosperity* (Oxford: Oxford University Press, 2017), p. 9; and Michael F. Lofchie, *The Political Economy of Tanzania: Decline and Recovery* (Philadelphia: University of Pennsylvania Press, 2014).

<sup>10</sup> See, e.g., United Republic of Tanzania, Legal Sector Reform Programme: Medium Term Strategy FYs 2005/06-2007/08, Vol.1 (December 2004). For an overview of the Tanzanian legal system, see generally Jennifer A. Widner, *Building the Rule of Law: Francis Nyalali and the Road to Judicial Independence in Africa* (New York: W.W. Norton and Company, 2001).

the characteristics of the Tanzanian private sector and how firms in Tanzania structure and approach market transactions. The data also permit an analysis of the factors that influence demand for law among private sector actors in Tanzania. The results of a statistical analysis of the firm data are discussed in Section 5. Section 6 of the article offers a brief conclusion, reviews several implications of the findings, and suggests avenues for further social science research on law and development.

## 2 Law and Development Theory

Over the past 20 years, a consensus has developed among social scientists and policy makers that macroeconomic reform and stabilization is insufficient by itself for economic expansion in developing countries.<sup>11</sup> The analytical focus has increasingly turned to an examination of microeconomic factors, chief among them the adequacy of state institutions that support private market activity.<sup>12</sup> Recent social science inquiry suggests that there is a relationship between a state's institutional make-up and development outcomes.<sup>13</sup> One of the institutional factors identified in the literature is the design and quality of the laws and legal institutions supplied by the state.<sup>14</sup> The idea is that law matters for

**11** See Tor Krever, *The Legal Turn in Late Development Theory: The Rule of Law and the World Bank's Development Model*, 52 *Harvard International Law Journal* (2011), 287.

**12** See Robert Bates, *Beyond the Miracle of the Market* (2nd ed., New York: Cambridge University Press, 2005), p. 150 ("The new development economics stresses the significance of markets").

**13** See, e.g., Mary M. Shirley, *Institutions and Development* (Cheltenham, UK: Edward Elgar, 2008); Janine Aron, *Growth and Institutions: A Review of the Evidence*, 15 *World Bank Research Observer* (2000), 99; Stephen Knack and Philip Keefer, *Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures*, 7 *Economics and Politics* (1994), 207. But see Matt Andrews, *The Limits of Institutional Reform in Development* (New York: Cambridge University Press, 2013); Edward L. Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Do Institutions Cause Growth*, 9 *Journal of Economic Growth* (2004), 271 (finding methodological flaws in the literature on institutions and growth and questioning the relative importance of institutions); and Kerry Rittich, *The Future of Law and Development: Second Generation Reforms and the Incorporation of the Social*, 26 *Michigan Journal of International Law* (2004), pp. 206–213 (describing and critiquing the current emphasis by international financial institutions on legal and institutional reform as a path to development).

**14** See, e.g., John Gillespie, *Transplanting Commercial Law Reform: Developing a "Rule of Law" in Vietnam* (Burlington, VT: Ashgate Publishing Company, 2006); David M. Trubek and Alvaro Santos (eds.), *The New Law and Economic Development: A Critical Appraisal* (New York: Cambridge University Press, 2006); Kenneth W. Dam, *The Law-Growth Nexus: The Rule of Law and Economic Development* (Washington, DC: Brookings Institution Press, 2006); Kevin E. Davis

development. This insight is not new of course – the legal realist movement of the early twentieth century<sup>15</sup> and the law and development movement of the 1960s and early 1970s<sup>16</sup> explored the relationship between law and economic activity.

Much of the earlier scholarship analyzing the relationship between law and economic development failed to articulate a clear theoretical framework for understanding and explaining the relationship. In the late-1970s, John Henry Merryman criticized the first wave of law and development scholarship on these grounds for its failure to present a coherent and testable theory to explain the relationships posited.<sup>17</sup> The law and development literature suggested a correlation between a state's institutional make-up and development outcome, but failed to develop a robust positive theory about the nature of the relationship or the correlations described, about the conditions under which law can play a meaningful role in the development process, or about the conditions under which the reform of commercial law and legal institutions will operate to expand the market and enhance private sector activity. Instead, the literature exhibited a strong normative and policy orientation.<sup>18</sup> It concentrated on describing the role state law should play in developing countries and advocated prescriptions about what should be done to promote and enhance this role.

To the extent that a positive theoretical perspective is reflected in the literature, the emphasis was on supply-side factors, principally the design and quality of formal legal institutions and substantive and procedural state law.<sup>19</sup> In the language of social science, law was viewed as an independent variable:

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and Michael J. Trebilcock, *Legal Reforms and Development*, 22 *Third World Quarterly* (2001), 21; Julio Faundez (ed.), *Good Government and Law: Legal and Institutional Reform in Developing Countries* (New York: St. Martin's Press, 1997); and Robert M. Sherwood, Geoffrey Shepherd and Celso Marcos De Souza, *Judicial Systems and Economic Performance*, 34 *Quarterly Review of Economics and Finance* (Special Issue 1994), 113.

<sup>15</sup> See, e.g., K.N. Llewellyn, *The Effect of Legal Institutions Upon Economics*, 15 *American Economic Review* (1925), 665. See also Stewart Macaulay, *The New Versus the Old Legal Realism: "Things Ain't What They Used to Be"*, [2005] *Wisconsin Law Review*, 335; David M. Trubek, *Max Weber on Law and the Rise of Capitalism*, [1972] *Wisconsin Law Review*, 720.

<sup>16</sup> See Jeswald W. Salacuse, *From Developing Countries to Emerging Markets: A Changing Role for Law in the Third World*, 33 *International Lawyer* (1999), 875; and Brian Z. Tamanaha, *The Lessons of Law-and-Development Studies*, 89 *American Journal of International Law* (1995), 470.

<sup>17</sup> See John Henry Merryman, *Comparative Law and Social Change: On the Origins, Style, Decline & Revival of the Law and Development Movement*, 25 *American Journal of Comparative Law* (1977), 457.

<sup>18</sup> See Linnan (2012), *supra* note 2, p. 21.

<sup>19</sup> See, e.g., David M. Trubek and Marc Galanter, *Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States*, [1974] *Wisconsin*

changes in and reforms of the formal state-supplied laws and legal institutions may prompt and contribute to desired economic or social changes. The instrumentalism implied by this approach came under heavy criticism from law and society scholars, who posited a more reflective view of the law.<sup>20</sup> These scholars emphasized demand-side factors, viewing the law primarily as a dependent variable: under certain circumstances, economic or social change may prompt changes in the formal state-supplied law or legal institutions.

Regardless of the particular theoretical perspectives embraced in the literature, law and development scholarship was problematic on several levels. First, the literature was overly normative and prescriptive in its orientation. The emphasis was on recommending policy changes and reforms intended to achieve desired results, rather than on promulgating theories for explaining and understanding legal change and then testing theory against the empirical data. This article takes as its point of departure the view that efforts should be made to understand and explain first, if only to aid the normative discourse. The emphasis is thus on generating *positive* theory and testable hypotheses rather than advocating for particular *normative* prescriptions.<sup>21</sup>

Second, the literature tended to focus on “grand theories” of law and development that are difficult to specify and test, rather than digging into the “micro-foundations” of particular law-society relationships.<sup>22</sup> The analytical framework considered here focuses on a particular law-society relationship, the relationship between informal and formal institutions in shaping levels of

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Law Review, 1079 (questioning the presumption that “the behavior of social actors tends to conform to the rules”).

**20** See, e.g., Eliot M. Burg, *Law and Development: A Review of the Literature & a Critique of “Scholars in Self-Estrangement”*, 25 *American Journal of Comparative Law* (1977), 516 (describing a reciprocal model of state-society relations).

**21** See Jennifer A. Widner, *Comparative Politics and Comparative Law*, 46 *American Journal of Comparative Law* (1998), 739.

**22** David Nelken, “Comparatists and Transferability”, in Pierre Legrand and Roderick Munday (eds.), *Comparative Legal Studies: Traditions and Transitions* (New York: Cambridge University Press, 2003), p. 451 (empirical legal inquiry should focus on the “micro-social connections between law, social norms and social action”); Mathias Reimann, *The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century*, 50 *American Journal of Comparative Law* (2002), 698 (micro comparison involves “testing limited falsifiable hypotheses,” “pursuing explanations of the data found,” and “seeking to understand discrepancies” in the data); and William P. Alford, *On the Limits of “Grand Theory” in Comparative Law*, 61 *Washington Law Review* (1986), 945. In this regard, Avner Greif advocates for a closer examination of “the micro-foundation of contract enforcement institutions.” Greif (2005), *supra* note 4, p. 729. See also Avner Greif, *Institutions and the Path to the Modern Economy* (New York: Cambridge University Press, 2006).

private sector demand for business-related law and law reforms. The goal is to generate a positive theory of legal change in developing and transition countries. Rather than attempting to build a grand theory of legal change, the focus is on a more narrow foundational question: What factors influence and give rise to social demand for the protections afforded by formal state law and legal institutions? The hope is that a testable theory can be generated, that variables can be specified and operationalized, and that empirical data can be collected and assessed as means of reaching an understanding of social demand for law.

Third, much of the literature on law and development was based on the anecdotes of Western experts working on law reform projects in developing countries rather than on the systematic collection and analysis of empirical data.<sup>23</sup> This article tests theories of social demand for law by examining data on business firm engagement with the legal system in Tanzania. As such, it contributes to the empirical literature on comparative law in general and “law and development” in particular.<sup>24</sup>

### 3 Modeling the Demand for Law

The conventional approach to building competitive markets emphasizes changing laws, regulations and state organs to make them more conducive to encouraging and sustaining private economic activity.<sup>25</sup> This literature focuses on the supply side – “get the rules right and all else will follow.” The assumption of the supply-side theories is that, if the quality of legal institutions supplied is sufficient, social actors will demand the protections afforded by these institutions and conform their behavior to legal requirements – supply generates its own demand.<sup>26</sup> Particular laws, legal institutions and enforcement

<sup>23</sup> See David Louis Finnegan, *Applied Comparative Law and Judicial Reform*, 8 Thomas M. Cooley Journal of Practical and Clinical Law (2006), 97. See also Erik G. Jensen and Thomas C. Heller, “Introduction”, in Erik G. Jensen and Thomas C. Heller (eds.), *Beyond Common Knowledge: Empirical Approaches to the Rule of Law* (Stanford: Stanford University Press, 2003), p. 1.

<sup>24</sup> See Holger Spamann, *Empirical Comparative Law*, 11 Annual Review of Law and Social Science (2015), 131; and Sally Engle Merry, Kevin E. Davis and Benedict Kingsbury (eds.), *The Quiet Power of Indicators: Measuring Governance, Corruption and Rule of Law* (New York: Cambridge University Press, 2015).

<sup>25</sup> See generally Richard A. Posner, *Creating a Legal Framework for Economic Development*, 13 World Bank Research Observer (1998), 1.

<sup>26</sup> See Kathryn Hendley, *Rewriting the Rules of the Game in Russia: The Neglected Issue of Demand for Law*, 8 East European Constitutional Review (1999), 89.



policies will promote economic development if they are appropriately designed and tailored to facilitate efficient market behavior.

The emphasis on the quality of supplied laws and institutions is not too surprising – after all, state law, as opposed to custom or certain other forms of social organization, is a formal institution defined and enforced by state organs. Certain types of questions tend to dominate the inquiry here, questions relating to the quality of legal institutions established by the state: Are laws properly drafted? Are legal institutions properly designed? Is the legal system efficient (however efficiency is imagined and measured)? Is the system staffed by competent and well-trained officials? Is it corrupt? Are the laws adequately enforced?

The quality of laws and legal institutions is indeed important, as are state enforcement policies.<sup>27</sup> *Although the condition of supply quality may be necessary, it is not sufficient.* Other independent variables influence social demand for law. Even assuming perfectly designed, implemented and enforced state laws and legal institutions, absent other variables shaping levels of demand, law may be ignored by the social actors it is supposed to govern. According to Cheryl Gray, “[t]he *demand* for legal and institutional reform that arises from economic liberalization is as critical to legal reform as the supply of good laws and functioning legal institutions.”<sup>28</sup> The conventional approach ignores this demand side – why don’t entrepreneurs in developing or transition economies avail themselves of supposedly superior legal rules/institutions, the product of western-style reform initiatives, when structuring business relations?

There are both supply-side and demand-side components to the question of effective law reform. A functioning market economy “requires at least a modest legal infrastructure centered on the protection of property and contract rights.”<sup>29</sup> The state must therefore supply and enforce efficiency-promoting laws and legal institutions. There must also be sufficient demand for those laws and institutions – private actors must find it desirable to conform their behavior to the requirements of the reformed legal order. These actors must find it in their interests to “use the legal system to structure their economic activities and

<sup>27</sup> See Simon Deakin, David Gindis, Geoffrey M. Hodgson, Huang Kainan and Katharina Pistor, *Legal Institutionalism: Capitalism and the Constitutive Role of Law*, 45 *Journal of Comparative Economics* (2017), 188; and Gillian K. Hadfield, “The Many Legal Institutions that Support Contractual Commitments”, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics* (New York: Springer, 2005), pp. 194–197.

<sup>28</sup> Cheryl W. Gray, *Reforming Legal Systems in Developing and Transition Countries*, 34 *Finance and Development* (1997), 15 (emphasis added).

<sup>29</sup> Posner (1998), *supra* note 25, p. 1.

resolve disputes.”<sup>30</sup> In order to be successful in promoting and facilitating private market activity, the formal legal system must therefore “outcompete other, typically private, mechanisms of enforcing agreements and resolving disputes.”<sup>31</sup> The success of market-oriented law reform initiatives in developing and transition countries depends on the ability of reforming governments to account for and address both the demand-side and supply-side dimensions.

### 3.1 Social Distance

Social distance theory, emerging from the “law and society” literature, offers a framework for understanding how informal social institutions affect demand for law in society. Social distance refers to the extent to which social actors “participate in one another’s lives,” as measured by “the scope and frequency, and length of interaction between them, the age of the relationship, and the nature and number of links between them in a social network.”<sup>32</sup> The theory predicts that the demand for law will be relatively low in communities marked by low social or relational distance.

In communities with relatively tight social networks, relational distance is low and informal social institutions may suffice to regulate and structure behavior.<sup>33</sup> For business communities in developing countries, such informal institutions include ethnic trading networks and/or close trading circles (e.g., repeated interaction with the same small set of suppliers/buyers).<sup>34</sup> In this context, entrepreneurs and other business decision-makers may rely on self-help or the threat of social/reputational sanctions to enforce agreements and to reduce transactional risk. These types of informal social institutions are often more important within transacting business communities as risk mitigation and dis-

<sup>30</sup> Hay *et al.* (1996), *supra* note 6, p. 559.

<sup>31</sup> *Ibid.*, at 560.

<sup>32</sup> Donald Black, *The Epistemology of Pure Sociology*, 20 *Law and Social Science Inquiry* (1995), 829. See also Donald Black, *The Behavior of Law* (New York: Academic Press, 1976), p. 107 (“Law varies directly with stratification” and “inversely with other social control”).

<sup>33</sup> See, e.g., Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* (Cambridge, MA: Harvard University Press, 1991).

<sup>34</sup> See James T. Murphy, *Networks, Trust, and Innovation in Tanzania’s Manufacturing Sector*, 30 *World Development* (2002), 591; Marcel Fafchamps, *Networks, Communities and Markets in Sub-Saharan Africa: Implications for Firm Growth and Investment*, 10 *Journal of African Economies*, no. Supp. 2 (2001), 109; and Janet T. Landa, *A Theory of the Ethnically Homogenous Middleman Group: An Institutional Alternative to Contract Law*, 10 *Journal of Legal Studies* (1981), 349.

pute resolution mechanisms than formal state law and legal institutions.<sup>35</sup> As social distance increases, the effectiveness of these informal institutions at regulating behavior and reducing risk break down and actors increasingly demand the protections afforded by formal law and legal institutions.<sup>36</sup>

From the standpoint of the law and society literature, then, a critical independent variable shaping levels of demand for the protections of reformed state-supplied legal institutions is the nature and character of pre-existing informal institutions structuring social relations. If these pre-existing informal institutions are non-existent, relatively weak, or ineffective in regulating interaction within or between groups given levels of social distance, the demand for the protections of state-supplied law, norms and institutions should be high.

### 3.2 Credible Commitment

Although the nature and characteristics of informal social institutions influence the demand for law, this is not to say that supply-side variables are irrelevant. The quality of the formal laws and institutions supplied by the state also has an effect on demand. The “new institutional economics” provides a framework for analyzing the manner in which institutions evolve and shape behavior, and so sheds some light on the question.<sup>37</sup> Indeed, social scientists have increasingly relied upon the new institutional economics to explain economic and political change in the developing world.<sup>38</sup>

The new institutional economics predicts that institutional change in general, and law reform in particular, will only be successful in promoting private economic activity if it is capable of reducing the costs associated with

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<sup>35</sup> See, e.g., Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *American Sociological Review* (1963), 55. For a discussion of the African context, see generally Marcel Fafchamps, *Market Institutions in Sub-Saharan Africa: Theory and Evidence* (Cambridge, MA: The MIT Press, 2004).

<sup>36</sup> See David M. Engel, *The Oven's Bird Song: Insiders, Outsiders and Personal Injuries in an American Community*, 18 *Law and Society Review* (1984), 551.

<sup>37</sup> See Douglass C. North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990); and Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).

<sup>38</sup> See Christopher Clague, “Economics, Institutions and Economic Development”, in Karol Soltan, Eric M. Uslaner and Virginia Haufler (eds.), *Institutions and Social Order* (Ann Arbor: University of Michigan Press, 1998), p. 201; Kathryn Fermin-Sellers, *The Transformation of Property Rights in the Gold Coast* (New York: Cambridge University Press, 1996); and John Harriss, Janet Hunter and Colin M. Lewis (eds.), *The New Institutional Economics and Third World Development* (New York: Routledge, 1995).

transacting.<sup>39</sup> When private sector actors approach business transactions, when they assess market conditions and make decisions about resource allocation in the face of market opportunities, they do so with an acute appreciation of the attendant risks.<sup>40</sup> If private sector actors perceive that formal laws and legal institutions supplied by the state fail to address or adequately mitigate these risks, the reformed legal framework will largely be ignored as meaningless to the business decision calculus.

In this light, the academic literature suggests two critical features of the formal institutional setting that affect the perceptions of private sector actors, and therefore the exhibited levels of social demand for law: capacity and credibility. According to this view, commercial law reform initiatives are likely to fail where the state (a) exhibits low levels of institutional capacity via dysfunctional legal institutions, corrupt or incompetent judges, or lack of enforcement capabilities<sup>41</sup>; and/or (b) is unwilling or unable to signal a credible commitment to the reformed legal regime.<sup>42</sup>

These two theoretical approaches – social distance theory and transaction costs economics – must be linked if we are to understand the conditions under which law reform will take root in developing countries.<sup>43</sup> Standing alone, each of the theories offers an incomplete picture of legal change. Social distance theory fails to account adequately for the supply-side factors that enhance or suppress demand for law, in particular the effects of the credibility and capacity of state-supplied legal institutions. Although the new institutional economics

**39** See Edgardo Buscaglia, “Introduction”, in Edgardo Buscaglia, William Ratliff and Robert Cooter (eds.), *The Law and Economics of Development* (Greenwich, CT: JAI Press, 1997), p. 1.

**40** See Oliver E. Williamson, “Economic Institutions and Development: A View from the Bottom”, in Mancur Olson and Satu Kähkönen (eds.), *A Not-So-Dismal Science: A Broader View of Economics and Societies* (Oxford: Oxford University Press, 2000), p. 118.

**41** See Simon Johnson, John McMillan and Christopher Woodruff, *Entrepreneurs and the Ordering of Institutional Reform*, 8 *Economics of Transition* (2000), 1.

**42** See, e.g., Barry R. Weingast, “Why Developing Countries Prove So Resistant to the Rule of Law”, in James J. Heckman, Robert L. Nelson and Lee Cabatingan (eds.), *Global Perspectives on the Rule of Law* (New York: Routledge, 2010), pp. 28–29; Silvio Borner, Aymo Brunetti and Beatrice Weder, *Political Credibility and Economic Development* (New York: St Martin’s Press, 1995); Kenneth A. Shepsle, “Discretion, Institutions, and the Problem of Government Commitment”, in Pierre Bourdieu and James S. Coleman (eds.), *Social Theory for a Changing Society* (Boulder: Westview Press, 1991); and Douglass C. North and Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 4 *Journal of Economic History* (1989), 803.

**43** See, e.g., Amanda J. Perry, *The Relationship Between Legal Systems and Economic Development: Integrating Economic and Cultural Approaches*, 29 *Journal of Law and Society* (2002), 282.

recognizes the importance of informal, non-state variables, the literature fails adequately to account for the effects that informal social institutions have on the demand for law. It is the interactive effect of informal and formal institutional variables that explains the extent of legal change in developing countries.<sup>44</sup>

This theory yields the following predictions: Although one might expect that demand for formal institutions in communities where social distance is relatively high, if the institutional framework supplied by the state is dysfunctional/not credible, state law and legal institutions will largely be ignored by social actors.<sup>45</sup> Conversely, even where the state exhibits a sufficient degree of institutional capacity and credibly commits to its legal system, if social distance is low within a given community, formal law and legal institutions will be of limited relevance to patterns of social behavior in that community.<sup>46</sup>

These predictions may help explain the persistence of marketplace inefficiencies and the path dependence of the informal institutional environment in Africa and other developing regions.<sup>47</sup> They may also help explain the widely recognized failure of commercial legal and judicial reforms in Africa and elsewhere to bring about intended outcomes, including the expansion of private sector market activity.<sup>48</sup>

## 4 Law and the Private Sector in Tanzania

There is a dearth of empirical data on the nature and extent of business firm engagement with the legal system in Africa and other developing regions. As a

<sup>44</sup> See Douglass C. North, *Economic Performance Through Time*, 84 *American Economic Review* (1994), 366 (“It is the admixture of formal rules, informal norms, and enforcement characteristics that shapes economic performance”). See also Satu Kähkönen, Young Lee, Patrick Meagher and Hadji Semboja, “Contracting Practices in an African Economy: Industrial Firms and Suppliers in Tanzania”, IRIS Working Paper No. 242 (University of Maryland, May 2001).

<sup>45</sup> See, e.g., Murphy (2002), *supra* note 34, p. 591 (even where Tanzania entrepreneurs would otherwise be inclined to innovate and expand their market presence, “weak formal institutions discourage manufacturers from extending their social relations beyond core networks”).

<sup>46</sup> See, e.g., Ellickson (1991), *supra* note 33.

<sup>47</sup> See North (1994), *supra* note 44, p. 364. See also Frederick Schauer, *Legal Development and the Problem of Systemic Transition*, 13 *Journal of Contemporary Legal Issues* (2003), 261.

<sup>48</sup> See, e.g., Rosa Ehrenreich Brooks, *The New Imperialism: Violence, Norms, and the “Rule of Law”*, 101 *Michigan Law Review* (2003), 2280 (“Despite billions of aid dollars, programs to promote the rule of law have been disappointing”); and Bryant G. Garth, *Building Strong and Independent Judiciaries Through the New Law and Development: Behind the Paradox of Consensus Programs and Perpetually Disappointing Results*, 52 *DePaul Law Review* (2002), 384.

result, social scientists and policy makers lack an adequate understanding of the determinants of private sector demand for law. This lack of understanding makes it difficult to effectively gauge the relationship between the quality of the legal framework supplied by the state and development outcomes. If business firms remain disengaged with the formal legal system, then increasing the reliability and effectiveness of the legal system will have limited relevance to firm behavior and therefore little impact on private sector growth. If there is indeed a positive relationship between institutional quality and private sector growth, then demand for law among business firms is a crucial link in the causal chain.

To fill the gap in our knowledge about business firm engagement with the legal system in developing countries, a survey was administered to a random selection of firms in Dar es Salaam, Tanzania. The survey was designed to elicit information about the respondent firms' customer and supplier networks, attitudes toward the formal legal system, and engagement with the formal legal system, particularly with the courts and practicing bar.<sup>49</sup> The resulting data permit an analysis of the factors that influence demand for law among business firms in Tanzania.

#### 4.1 Firm Characteristics and Business Networks

The survey collected data from the respondent firms on a number of dimensions, including the nature of their business operations, size, ownership structure, and recent investment and borrowing activity. A summary of firm characteristics is presented in Table 1. The number of workers employed by the firm is used here to measure firm size.<sup>50</sup> All respondent firms were willing to share information

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<sup>49</sup> The survey was administered between June and September 2001 to a randomly selected sample of business firms operating in Dar es Salaam, Tanzania's largest city and commercial hub. The respondent firms were selected from four business sectors: manufacturing, construction, transportation, and professional services. The respondent firms surveyed were randomly drawn from a list of firms compiled from two sources: (1) a publicly available membership directory of the Tanzania Chamber of Commerce, Industry and Agriculture ("TCCIA"), the largest and most widely subscribed trade association/chamber of commerce in Tanzania at the time; and (2) the Central Register of Business Establishments for the Dar es Salaam Region, a government directory compiled by the National Bureau of Statistics. Overlap in the two listings was eliminated from the combined list. Only firms listing 10 or more employees were selected, although more than 26 (26%) of the respondent firms ultimately reported 10 or fewer employees.

<sup>50</sup> Using the number of employees as a measure of firm size is consistent with the approach taken by the government of Tanzania. See United Republic of Tanzania, Small and Medium Enterprise Development Policy (2002), p. 3. The Tanzanian government classifies businesses by size in the following manner: micro-enterprises employee between 0 and 4 workers; small enterprises employee between 5 and 49 workers; medium enterprises employee between 50

Table 1: Summary of firm characteristics.

Category	All Firms	≤50 Employees	>50 Employees
Number of firms:	102	68	34
<b>Number of employees (N = 102)<sup>a</sup></b>			
Mean	75	20	184
Median	30	17	109
<b>Age – % of firms (N = 96)</b>			
1–10 years	25 %	21 %	33 %
11–20 years	39 %	41 %	30 %
> 20 years	37 %	38 %	36 %
<b>Majority ownership – % of firms (N = 97)</b>			
Family-owned	47 %	54 %	34 %
Other private domestic	23 %	25 %	19 %
Foreign	26 %	17 %	44 %
State	4 %	5 %	3 %
<b>Business sector – % of firms (N = 102)</b>			
Manufacturing	49 %	47 %	53 %
Construction	13 %	12 %	15 %
Transportation	10 %	7 %	15 %
Professional services	28 %	34 %	17 %
Average number of licenses & permits required to operate (N=94)	2.9	2.7	3.4
Upcountry offices – % of firms (N=102)	35 %	27 %	53 %
Recent significant investments – % of firms (N=101)	41 %	32 %	58 %
Borrowed money from creditors – % of firms (N=90)	51 %	46 %	62 %
Recent bank loans – % of firms (N=93)	27 %	22 %	38 %

<sup>a</sup>One firm reported significantly more employees (1,342) than the others. By comparison, the next largest firm reported 498 employees. If the largest firm is excluded, the mean number of employees for all firms is 62 and the median is 30; the mean for firms with more than 50 employees is 149 and the median is 108.

about the number of employees. Overall, the respondent firms averaged 75 employees. Micro and small firms, those with 50 or fewer employees, averaged 20 employees per firm. Medium and small firms, those with more than 50 employees, averaged 184 employees per firm. The smallest firm in the survey reported just two employees; the largest reported 1,342.

and 99 workers; and large enterprises employee 100 or more workers. *Id.* Other potential measures of firm size such as fixed assets or annual turnover are not typically used in Tanzania because firms are generally unwilling or unable to provide this information. See United Republic of Tanzania, Draft SME Development Policy 2001–2011 (April 2001), p. 15.

The theoretical framework summarized in Section 3 generates the hypothesis that the nature and extent of the relationships firms maintain with transacting partners affect the level of their engagement with the formal legal system and thus the demand for law. These relationships give rise to a particular form of informal social institution, customer and supplier networks. An evaluation of this hypothesis requires information about firm relationships with their transacting partners. As such, the survey collected customer and supplier information from the respondent firms to assess relational distance within transactional networks.

The survey captured five dimensions of the business networks developed and maintained by respondent firms: (1) network size – as measured by the number of firm customers and suppliers; (2) geographic dispersion – the extent of spatial distance within networks, as measured by the percentage of transactions conducted with local customers and suppliers; (3) network density – the relative importance of the firms largest customers and suppliers, as measured by the percentage of overall sales or purchases accounted for by those customers and suppliers; (4) the length of relationships with transacting partners – as measured by the number of years a firm has transacted with its most important customers and suppliers; and (5) family relationships – whether a firm's most important customers or suppliers have family ties to the firm's owners. Table 2 summarizes the characteristics of the customer and supplier networks of the respondent firms.

As a general matter, the respondent firms were somewhat reluctant to share detailed information about their customer and supplier relationships. For example, only about two-thirds of the firms were willing or able to identify the number of their customers and suppliers, the extent of their dealings with their largest customers and suppliers, or the length of their relationships with those customers and suppliers. The low response rates do not permit statistical analysis of most network variables. Nonetheless, the responses that were collected offer some insight into the nature of customer and supplier networks.

The respondent firms sold their products or services to an average of 141 different customers each. As might be expected, larger firms tended to have more customers than the smaller ones – small firms averaged around 68 customers per firm while medium and large firms averaged 336 customers. The firms also were asked about their relationships with suppliers, the firms or individuals from whom they obtained raw materials, equipment, inputs or other supplies. The respondent firms each purchased their supplies on average from 11 different suppliers. Small firms averaged 8 suppliers per firm; medium and large suppliers averaged 17 suppliers per firm.



**Table 2:** Summary of customer & supplier networks.

Category	All Firms	≤50 Employees	>50 Employees
<b>Number of customers (N = 66)</b>			
Mean	141	68	336
Median	25	20	50
% of local customers (N = 99)	78%	83%	65%
% of sales to largest customer (N = 72)	32%	32%	31%
Average length of relationship with largest customer – in years (N = 72)	9.3	9.6	8.5
Largest customer is family-owned –% of firms (N = 78)	32%	36%	24%
<b>Number of suppliers (N=60)</b>			
Mean	11	8	17
Median	5	5	9
% of local suppliers (N = 82)	58%	61%	51%
% of purchases from largest supplier (N = 61)	55%	56%	53%
Average length of relationship with largest supplier – in years (N = 65)	9.6	9.9	9.0
Largest supplier is family-owned –% of firms (N = 67)	21%	26%	10%

In order to assess geographic or spatial distance within transactional networks, the firms were asked to report the percentage of their sales made to local customers (customers located in Dar es Salaam) and the percentage of their supplies obtained from local suppliers (suppliers located in Dar es Salaam). The vast majority of the firms were willing and able to provide this information. The greater the percentage of sales made locally, the less geographically dispersed the customer network; the smaller the percentage of sales made locally, the more geographically dispersed the customer network. Similarly, the greater the percentage of supplies obtained locally, the less geographically dispersed the supplier network; the smaller the percentage of supplies obtained locally, the more geographically dispersed the supplier network.

On average, the respondent firms sold 78% of their products and services locally. Slightly more than a quarter of all respondent firms sold 100% of their products and services locally. The data reflect variation in the geographic dispersion of customer networks depending on firm size: small firms sold considerably more of their products and services locally (83%) compared to medium and large firms (65%). The data also reflect variation depending on ownership structure and business sector. For example, family-owned firms tended to have

a slightly higher percentage of local sales on average compared to other firms. Similarly, manufacturing firms tended to have a slightly higher percentage of local sales compared to firms in other business sectors.

Although the survey results indicate only slight difference in geographic dispersion between the customer networks for foreign and domestic firms, the data revealed a stark contrast among firms that sell 90% or more of their services locally: only 16% of foreign-owned firms sold 90% or more of their products locally compared with 44% of private firms owned by Tanzanians. Only 12% of foreign firms sold 100% of their products locally, whereas 36% of domestic private firms did.

On average, the respondent firms obtained 58% of their supplies locally. Almost a third of the firms obtained 100% of their supplies locally. Again, small firms obtained a greater percentage of their supplies locally (61%) compared to medium and large firms (51%). Foreign firms obtained a much smaller percentage of their supplies locally compared to domestic firms. Significantly, only 36% of private domestic firms obtained most of their supplies from outside Dar es Salaam. By contrast, more than half (60%) of the foreign firms obtained most of their supplies from suppliers located outside of Dar es Salaam.

## 4.2 Views of the Legal System

The willingness of firms to engage the formal legal system might depend on the attitudes of their officers and directors toward the quality of laws and legal institutions supplied by the state. For example, firm decision-makers who perceive the formal legal system to be unfair, untrustworthy, too expensive, or corrupt might be less likely to take their business disputes to court, instead choosing available informal dispute resolution mechanisms. By contrast, decision-makers who perceive the formal legal system to be important, trustworthy, fair and cost-effective might be expected more often to take their business disputes to the formal judicial system. As such, the respondent firm officers and directors were asked about their views of the formal legal system along several dimensions, e.g., importance, familiarity, trustworthiness. The respondents were also asked about their views of judicial dispute resolution. As a general matter, firm decision-makers were much more willing to share their views of the legal system than information about their customers and suppliers. Table 3 presents a summary of respondent attitudes toward the legal system.

**Table 3:** Summary of firm attitudes toward the legal system.

Category	All Firms	≤50 Employees	>50 Employees
<b>Belief that the legal system is trustworthy</b>			
– % of firms ( <i>N</i> = 99)			
Very trustworthy:	15 %	15 %	15 %
Somewhat trustworthy:	71 %	67 %	78 %
Somewhat untrustworthy:	11 %	13 %	6 %
Very untrustworthy:	3 %	5 %	0 %
<b>Belief that the legal system has become more trustworthy</b>			
–% of firms ( <i>N</i> = 93)	70 %	71 %	68 %
<b>Belief that firm could obtain a fair judgment in court – % of firms (<i>N</i> = 95)</b>			
Always:	14 %	14 %	13 %
Mostly:	48 %	48 %	48 %
Seldom:	23 %	23 %	26 %
Never:	15 %	16 %	13 %
<b>Belief that courts could actually enforce a contract</b>			
–% of firms ( <i>N</i> = 96)	75 %	77 %	71 %
<b>How often a bribe must be paid to win in court – % of firms (<i>N</i> = 92)</b>			
Always:	20 %	22 %	14 %
Frequently:	36 %	27 %	55 %
Seldom:	29 %	37 %	14 %
Never:	15 %	14 %	17 %
<b>Familiarity with the legal system – % of firms (<i>N</i> = 100)</b>			
Very familiar:	37 %	31 %	50 %
Somewhat familiar:	52 %	57 %	41 %
Somewhat unfamiliar:	10 %	10 %	9 %
Very unfamiliar:	1 %	2 %	0 %
<b>Importance of the legal system to business success – % of firms (<i>N</i> = 101)</b>			
Very important:	55 %	54 %	58 %
Somewhat important:	37 %	37 %	36 %
Somewhat unimportant:	8 %	9 %	6 %
Very unimportant:	0 %	0 %	0 %

#### 4.2.1 Importance

As a general matter, the respondent firm decision-makers felt that the legal system was important to the firm's business success: 55% viewed the legal system as "very important" and 37% viewed it as "somewhat important." Only 8% of the firms felt the legal system was even "somewhat unimportant." None of the decision-makers felt that the legal system was "very unimportant." These views were fairly consistent across both the smaller and larger firms.

#### 4.2.2 Familiarity

Most firm decision-makers felt that they were at least somewhat familiar with the laws and regulations that affected firm business: 37% felt that they were "very familiar" and 52% felt that they were "somewhat familiar." Only 11% reported that they were either "somewhat unfamiliar" or "very unfamiliar." Again, these views were fairly consistent across both smaller and larger firms.

#### 4.2.3 Trustworthiness

A sizeable majority (86%) of the firm decision-makers viewed the Tanzanian legal system as trustworthy: 15% viewed the legal system as "very trustworthy," 71% viewed the legal system as "somewhat trustworthy." By contrast, 11% viewed the legal system as "somewhat untrustworthy" and only 3% viewed it as "very untrustworthy." Views of trustworthiness varied by firm size. A greater percentage of medium and large firms viewed the legal system as trustworthy (93%) compared with small firms (82%). Only 6% of medium and large firms viewed the legal system as untrustworthy compared with 18% of small firms.

#### 4.2.4 Judicial Dispute Resolution

The firm decision-makers were also asked about their views of judicial dispute resolution. A majority of the decision-makers expressed confidence in the judiciary. For example, 62% believed that their firm could "always" or "mostly" obtain a fair judgment in a court in a dispute with a customer or supplier. A total of 75% of the decision-makers believed that the courts could actually enforce a contract with a customer or supplier. These views did not vary considerably by firm size.

The decision-makers were asked to share their views about *corruption* in the judiciary. In particular, they were asked how often they felt that it was necessary to make an illegal payment like a bribe to win a case in court. There is a stark contrast between the reported beliefs about corruption in the judiciary and expressions of trustworthiness in the legal system as a whole. A majority of respondents felt that it was either “always” (20%) or “frequently” (36%) necessary to bribe in order to win in court. Only 29% of respondents felt it was “seldom” required; 15% felt it was “never” required. Here there was considerable variation across firms of different sizes. A very slight minority of small firms (49%) felt it always or frequently necessary to bribe to win in court. By contrast, a sizeable majority of medium and large firms (69%) felt it always or frequently necessary.

### 4.3 Engaging the Formal Legal System

To measure levels of demand for law among business firms, the survey gathered information on the extent of firm engagement with the formal legal system. The survey targeted three points of engagement: consultations with lawyers for purposes of obtaining legal advice; the extent to which respondent firms threatened other firms or individuals with litigation, or themselves were threatened by others with litigation; and the extent to which the respondent firm actually litigated disputes, either because they initiated lawsuits as plaintiffs or were brought to court by others as defendants. Table 4 summarizes the nature and extent of firm engagement with the legal system.

#### 4.3.1 Attorney Consultations

A majority of the respondent firms (66%) reported that they had consulted a lawyer for legal advice during the past two years. A much greater percentage of medium and large firms (85%) had consulted a lawyer compared to small firms (59%). The firms that consulted lawyers sought legal advice on a range of different issues, including labor and employment, property, taxation, contract and litigation matters.

#### 4.3.2 Threatened Litigation

The respondent firms also provided information about whether they attempted to mobilize the legal system by threatening legal action against other firms or

**Table 4:** Summary of firm engagement with the legal system.

Category	All Firms	≤50 Employees	>50 Employees
% of firms that sought legal advice from a lawyer:*	66 %	59 %	85 %
% of firms that sued another firm or individual in court:*	17 %	9 %	32 %
% of firms that threatened to sue:*	21 %	16 %	29 %
% of firms that sued or threatened to sue another firm or individual:*	28 %	19 %	47 %
% of firms that were sued in court by another firm or individual:*	17 %	9 %	32 %
% of firms that were threatened with a lawsuit:**	14 %	13 %	15 %
% of firms that were sued or threatened with a lawsuit:**	22 %	15 %	36 %
% of firms that sued or were sued in court:*	23 %	10 %	47 %
% of firms that sued, were sued, threatened another with a lawsuit, or were threatened with a lawsuit:**	34 %	24 %	59 %

\*N = 102. \*\*N = 101.

individuals. Less than a quarter of the respondent firms (21%) threatened to sue another firm or individual in court in the two years preceding the survey. Again, there was variation across firms of different sizes: while only 16% of small firms threatened litigation, 29% of medium and large firms did. The respondent firms were also asked whether they were threatened with a lawsuit by other firms or individuals in the two years preceding the survey. A total of 14% of the respondent firms reported that they had been threatened with litigation by others. Here there was little variation across firms of different sizes.

### 4.3.3 Litigation

The respondent firms shared information about the extent to which they had litigated disputes during the two years preceding the survey, either as plaintiffs or defendants. A total of 17% of the firms reported that they had brought suit in court against another firm or individual. While only 9% of small firms sued another firm or individual in court, almost a third of medium and large firms

(32%) did. Similarly, 17% of all firms had been sued in court by another firm or individual. Again, 9% of small firms compared to 32% of small and medium firms indicated that they had been sued in court by others.

The data suggest that larger firms are more likely to become embroiled in litigation compared to smaller firms. Overall, 23% of the respondent firms either initiated lawsuits as plaintiffs or were sued in court as defendants in the two years preceding the survey. The contrast between smaller and larger firms is stark: although only 10% of small firms sued or were sued, almost half of the medium and large firms (47%) were involved in litigation one way or the other. Overall, about a third of all respondent firms (34%) were engaged in some way with the judicial system during the two-year period, either because they threatened to bring a lawsuit in court or were themselves threatened by others with a lawsuit, or because they actually litigated as plaintiffs or defendants. Here again there is variation across different sizes of firms. While less than a quarter of small firms (25%) were engaged with the judicial system in this way, more than half of medium and large firms were (59%).

Beyond firm size, the data suggest a relationship between, on the one hand, ownership structure, and, on the other, engagement with the legal system. A greater percentage of foreign firms (84%) had consulted lawyers in the two years preceding the survey compared to domestic firms – only 54% of domestic family-owned firms and 72% of other domestic private firms had consulted a lawyer during that period. The difference between foreign and domestic firms is even starker when it comes to involvement in litigation. In the two years preceding the survey, 44% of foreign firms initiated litigation by suing another firm or individual in court. By contrast, only 7% of domestic family-owned firms and 9% of other domestic private firms brought suit in court.

## 5 Empirical Analysis of Demand for Law in Tanzania

The survey data summarized in the preceding section permit limited statistical analysis of the hypotheses suggested by the theoretical framework developed in Section 3. Two probit models were estimated to evaluate the factors that shape demand for law among business firms in developing countries like Tanzania. One model examines the factors that affect the likelihood that firms will engage the formal legal system by consulting a lawyer for legal advice. The other examines the factors that affect the likelihood that firms will become involved in litigation before the courts, either because they choose to initiate lawsuits as

plaintiffs or must respond as defendants to lawsuits filed by others. The dependent variable here is the demand for law – the extent to which a business firm mobilizes state-supplied law and legal institutions to its advantage. This dependent variable is operationalized in two distinct ways: (1) whether a firm engages the formal legal system by consulting attorneys for legal advice and (2) whether a firm becomes involved in litigation before the courts as a means of resolving disputes with others.

## 5.1 Independent Variables

The independent variables evaluated by the models were selected to evaluate the impact that informal social institutions and other factors have on social demand for law among business firms in Tanzania. The following independent variables were included in the probit models:

- (1) *Customer network* – the percentage of the firm’s overall sales made to customers located in Dar es Salaam. This variable captures the degree of geographic or spatial distance within firm customer networks. The larger the percentage of overall sales made to local customers, the smaller the spatial distance within the firm’s customer network. The smaller the percentage of overall sales made to local customers, the greater the spatial distance. The theoretical framework described in Section 3 predicts that firms with customer networks characterized by low relational distance will be less likely to engage the formal legal system. Conversely, firms with customer networks characterized by high relational distance will exhibit a higher degree of demand for law.<sup>51</sup> As such, we expect a *negative* relationship between the customer network variable and the measures of demand for law reflected in the dependent variables.
- (2) *Firm size* – the natural log of the number of persons employed by each respondent firm. The data suggest a relationship between firm size and demand for law. A much greater percentage of medium and large firms

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<sup>51</sup> Because many of the respondent firms were unwilling or unable to share detailed aggregate information about their customer and supplier networks, the survey data does not permit effective probit analysis of the relationship between other network characteristics and the demand for law. Among these potentially relevant characteristics are: (1) the size of customer and supplier networks as measured by the number of a firm’s customers and suppliers; (2) the density of those networks as reflected in the percentage of sales made to the single largest customer or purchases obtained from the single largest supplier; and (3) whether the networks have a family dimension to them, i.e., whether the firm’s most important customers and suppliers are owned by relatives of the firm’s owners.



consulted an attorney and became involved in litigation compared to the micro and small firms in the survey sample. The data suggest that, all things being equal, larger firms are more likely to have more sophisticated transactional networks, including larger customer, supplier and creditor networks. They are more likely to have the financial resources to absorb the costs of engaging the formal legal system (e.g., attorneys fees, court costs, etc.). As such, we expect a *positive* relationship between firm size and the dependent variables.

- (3) *Trust in the legal system* – measuring the degree of trust the respondent firm manager has in the legal system. The conventional view is that, all things being equal, firms are more likely to engage the formal legal system if firm decision-makers perceive state-supplied laws and legal institutions to be fair and just. This view predicts a *positive* relationship between trust in the legal system and demand for law.
- (4) *Familiarity with the legal system* – measuring the respondent firm manager's degree of familiarity with the laws and regulations that affect the firm's business. It may be that the degree of legal literacy – one's awareness and understanding of the formal laws and legal institutions – affects whether one is likely to engage the legal system. This suggests a *positive* relationship between this familiarity and demand for law.
- (5) *Majority foreign ownership* – reflecting whether a majority of the firm is owned by foreign individuals or firms. The survey data suggest a relationship between ownership structure and demand for law. A greater percentage of foreign firms sought legal advice compared to domestic firms. A significantly greater percentage of foreign firms litigated compared to domestic firms. All things being equal, the data suggest a *positive* relationship between foreign ownership and demand for law.

## 5.2 Likelihood of Consulting an Attorney

A statistical model was estimated to evaluate the factors influencing the likelihood that a business firm in Tanzania will engage the formal legal system by consulting an attorney for legal advice. The probit results are reported in Table 5.

The coefficient on the customer network variable is significant at  $p \leq 0.05$  and has the expected negative sign. The result is consistent with the hypothesis that firms with customer networks characterized by high levels of spatial distance are more likely to engage the legal system by consulting an attorney for legal advice. The probit results indicate that a firm with half (50%) of its

**Table 5:** Probit results – likelihood of consulting an attorney.

Variable	Coefficient	Std. err.	z	p >  z
% of customers that are local	-0.023	0.010	-2.26	0.024
Firm size	0.535	0.184	2.91	0.004
Trust in the legal system	-0.573	0.558	-1.03	0.304
Familiarity with the legal system	0.704	0.337	2.09	0.037
Majority foreign ownership	0.593	0.481	1.23	0.218
Constant	-1.193	1.403	-0.85	0.395

Explaining the likelihood that a business firm will consult an attorney for legal advice.  $N = 92$ ; log likelihood = -36.19. Firm size is measured by number of employees.

customer base in Dar es Salaam is 23% ( $\pm 14\%$ ) more likely to consult an attorney than one with almost all (90%) of its customer base in the city.<sup>52</sup> As a firm begins to transact with a greater percentage of customers located outside of the firm's geographic base of operations, the probability that the firm will seek legal advice from an attorney increases.

The coefficient on the firm size variable is significant at the  $p \leq 0.005$  level and has the expected positive sign. The larger the firm, the more likely the firm is to consult an attorney for legal advice. The probit results indicate that the median large firm is 24% ( $\pm 12\%$ ) more likely to consult an attorney than the median small firm. The marginal difference in probabilities is starker at the lower end of the size spectrum. The median small firm with 20 employees is 37% ( $\pm 22\%$ ) more likely to consult an attorney than the median micro-enterprise with 3 employees.

The coefficient on the familiarity variable is significant at  $p \leq 0.05$  and has the expected positive sign. The results suggest that the more familiar a firm decision-maker is with the laws and regulations that affect their business, the

<sup>52</sup> The predicted probabilities reported here were estimated using the CLARIFY software developed by Michael Tomz, Jason Wittenberg and Gary King. The software uses stochastic simulation techniques to calculate quantities of interest suggested by statistical models, here the predicted probability that a business firm in Tanzania will seek legal advice from an attorney or litigate disputes in court. A 90% confidence interval is reported for all quantities of interest. See Michael Tomz, Jason Wittenberg and Gary King, *Clarify: Software for Interpreting and Presenting Statistical Results* (5 January 2003), available at: <<https://web.stanford.edu/~tomz/software/clarify.pdf>>; and Gary King, Michael Tomz and Jason Wittenberg, *Making the Most of Statistical Analyses: Improving Interpretation and Presentation*, 44 *American Journal of Political Science* (2000), 341.

more likely they are to consult an attorney for legal advice. All else being equal, a firm where the management is “very familiar” with the relevant laws and regulations has a 0.88 ( $\pm 0.13$ ) probability of consulting an attorney. By contrast, a firm where the management is “somewhat unfamiliar” has only a 0.44 ( $\pm 0.27$ ) probability of consulting an attorney.

The coefficients on the trust and foreign ownership variables are not statistically significant. One unanticipated result here, however, is that the sign of the coefficient on the trust variable is negative, suggesting that, all things being equal, firms with lower levels of trust in the legal system are more likely to consult an attorney than those with high levels of trust. One possible explanation is that firms that distrust the legal system consult attorneys to minimize the chances of being adversely affected by the perceived injustices within the system should they come in contact with it. In other words, attorneys are perceived as a buffer between the firm and the system.

### 5.3 Likelihood of Litigating in Court

A second probit model was estimated to evaluate the factors affecting the likelihood that a business firm in Tanzania will become involved in litigation with other firms or individuals. The probit results for this model are reported in Table 6.

Once again the coefficient on the customer network variable is significant at  $p \leq 0.05$  and has the expected negative sign. The result supports the hypothesis that the greater the degree of spatial distance within a firm’s customer network, the more likely the firm will become involved in litigation before the courts. The lower the degree of social distance within transactional networks, the more likely firms will eschew the formal legal system to resolve disputes. The

**Table 6:** Probit results — likelihood of litigating in court.

Variable	Coefficient	Std. err.	<i>z</i>	<i>p</i> >   <i>z</i>
% of customers that are local	-0.023	0.089	-2.62	0.009
Firm size	0.293	0.197	1.49	0.137
Trust in the legal system	-1.126	0.611	-1.84	0.065
Familiarity with the legal system	0.466	0.380	1.23	0.219
Majority foreign ownership	1.920	0.468	4.11	0.000
Constant	-1.598	1.270	-1.26	0.208

Explaining the likelihood that a business firm will become involved in litigation.  $N = 92$ ; log likelihood = -24.18. Firm size is measured by number of employees.

estimation results indicate that a firm with half (50%) of its sales made to local customers is 18% ( $\pm 16$ ) more likely to become involved in litigation compared with firms that make almost all (90%) of its sales to local customers. As a firm begins to transact with a greater percentage of customers located outside of its geographic base of operations, the probability that the firm will become involved in litigation increases.

The coefficient on the foreign ownership variable is significant at the  $p \leq 0.005$  level and has the expected positive sign. The probability that a foreign-owned firm will become involved in litigation is 0.52 ( $\pm 0.23$ ). By contrast, the probability that a domestic firm will become involved in litigation is only 0.04 ( $\pm 0.06$ ). All things being equal, a foreign-owned firm is 48% ( $\pm 22\%$ ) more likely to become involved in litigation in Tanzania than a firm with Tanzanian ownership.

The coefficient on the trust variable once again is not statistically significant. Neither are the coefficients on the firm size and familiarity variables. Contrary to expectations, however, the coefficient on the trust variable is negative. This suggests that, all things being equal, firms with low levels of trust in the legal system are more likely to litigate, a result that is counterintuitive but interesting. This result may reflect the fact that, in many developing countries, business firms may choose to take their disputes to court precisely to take advantage of systemic corruption and inefficiency, particularly firms that can afford to bribe. Firms either win in court or have cases against them dismissed because they pay bribes – recall that the survey results indicate that a majority (56%) of the respondent firms believe that it is either “always” or “frequently” necessary to pay a bribe to win in court in Tanzania. Short of outright victory in court, firms may also bribe to have hearings delayed or files lost to forestall the disposition of cases filed against them. In some instances, firms engage in “preemptive strikes” by initiating lawsuits so that emerging disputes become bogged down in the court system.

The trust variable sign may also capture a feedback effect: firm managers who become embroiled in litigation may walk away from the experience with a negative view of the legal system. In any country, litigation tends to be an unpleasant experience for all parties concerned, winners and losers alike. As such, the attitude of a firm manager toward the legal system today (as reflected in the responses to questions about trust) may be a product of the firm’s past involvement in litigation. This may be particularly true for large firms, where the data suggest both a greater likelihood of becoming involved in litigation and a stronger tendency to view corruption as necessary to win in court.

## 6 Conclusion

The demand for law is a critical link in the causal chain connecting commercial law reform and economic growth in developing countries like Tanzania. For business-friendly reforms to be effective, they must produce the intended response from the relevant social constituencies – entrepreneurs, firm managers and other private sector actors. Unless reformed laws and legal institutions prompt these actors to change behavior – to take more risks, enter new markets, make new investments or expand the scope of business activities – there will necessarily be a gap between reform goals and observed results.

Private sector demand for law is shaped both by (1) supply-side variables relating to the perceived quality of formal state legal institutions and (2) demand-side variables relating to the nature of informal marketplace institutions. The consensus view of law and development focuses primarily on the supply side: if the state in developing countries implements business-friendly law reforms, the resulting increase in supply-side quality will produce the desired outcome of market expansion and economic growth. This article sets out to question this model by bringing the demand-side of the equation into sharper focus.

Quality supply does not necessarily create its own demand. The survey data described and analyzed in the preceding sections support the conclusion that demand-side variables matter in shaping patterns of social engagement with the legal system. This analysis suggests further that demand-side variables matter more than the perceptions among private sector actors of legal system quality.

The nature and extent of the business networks developed and maintained by firms are the primary determinants of demand for law. Spatial distance within networks matters. Firms with more geographically dispersed supplier and customer networks are more likely to consult an attorney for advice and to become involved in litigation compared to firms that primarily transact business within their home region. Even controlling for firm size and ownership structure, the network variable is statistically significant and has the expected sign in both probit models estimated above.

Firm size and ownership structure also matter. Larger firms and foreign-owned firms are more likely to engage the legal system. They transact within the type of business networks that give rise to higher levels of demand for law. Compared to smaller firms, the data show that large firms tend to have a larger number of customers, fewer local customers and suppliers, more geographically dispersed customer base, relationships with customers that are not as long-lasting, and fewer family ties to transacting partners. They are more likely to

have made recent significant investments and are more likely to maintain a physical presence outside of their home region by opening upcountry offices.

Foreign firms also are more likely to exhibit demand for law compared to domestic firms in Tanzania. Compared to domestic firms, the data show that foreign-owned firms tend to be larger, have more geographically dispersed supplier networks, and have relationships with customers that are not as long-lasting. They are more likely to maintain a physical presence outside of Dar es Salaam by opening upcountry offices. They are more likely to have recently made significant investments and borrowed from creditors.

The results of the probit analysis support the conclusion that spatial distance within business networks affects demand for law among firms in Tanzania, that larger firms are more likely to seek legal advice from attorneys, and that foreign-owned firms are more likely to become involved in litigation. The probit analysis also suggests that these demand-side variables have a greater effect on demand for law than perceptions of supply-side quality. The consensus view suggests that credibility of the formal legal system in the eyes of private sector actors greatly affects whether they choose to engage the formal legal system instead of relying on informal alternatives to structure transactions and resolve disputes. Although this view makes logical sense, the probit results show that perceptions of trustworthiness are not a statistically significant determinant of demand for law. Demand-side variables thus appear to matter more than the credibility of the legal systems in countries like Tanzania that have struggled with improving supply-side quality.

These findings carry with them certain implications for law reform initiatives in developing and transition countries and suggest avenues for further social science research:

## 6.1 Explaining Reform Failure

An emerging consensus among scholars and policy makers is that law reform programs in developing and transition countries have largely failed to achieve their intended goals.<sup>53</sup> In noting the “mixed results” of law reform initiatives in

<sup>53</sup> See *supra* note 48 and accompanying text. See also Hammergren (2014), *supra* note 1, pp. 48–54; Joseph M. Isanga, “Rethinking the Rule of Law as Antidote to African Development Challenges”, in David K. Linnan (ed.), *Legitimacy, Legal Development and Change* (Burlington, VT: Ashgate Publishing Company, 2012), p. 62 (“almost two decades into the rule of law experiment, only a few countries in [Africa] can claim to have really made any significant gains on the economic front”); and Jensen and Heller (2003), *supra* note 23, p. 3 (discussing “the

Central and Eastern Europe and the former Soviet Union, Daniel Berkowitz and his co-authors concluded that, “[w]hile nobody has yet stood up and declared the death of the second law and development movement, there is broad consensus that the impact of legal reforms efforts has been at best limited.”<sup>54</sup>

The demand for law variable offers one possible explanation for the observed gap between the theory and practice of law reform in developing and transition countries. Even if the governments of these countries improve legal system quality by properly designing and effectively implementing reforms, the characteristics of existing informal market institutions may cause low levels of demand for law to persist. Where demand for law is low, the private sector will remain largely disconnected from the formal legal system. If the private sector fails to engage the legal system or mobilize the law to its advantage when making market decisions, even the best laws and legal institutions may have limited impact.<sup>55</sup>

## 6.2 Path Dependence

It may take time to realize the economic benefits of law reform in developing and transition countries because of the persistence of inefficient informal market institutions. This persistence captures what the new institutional economics terms “path dependence.” Within the analytical framework posited by the new institutional economics, pre-existing social institutions operate to constrain the range of opportunities and effectively limit choices available to market actors. Markets decisions are shaped and limited by existing institutional constraints.<sup>56</sup> Actors modify their behavior to take advantage of available opportunities,

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widening gap between theory and practice, or to the disconnection between stated project goals and the actual activities supported”).

<sup>54</sup> Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect*, 47 *European Economic Review* (2003), 165.

<sup>55</sup> See Brian Z. Tamanaha, *The Primacy of Society and the Failures of Law and Development*, 44 *Cornell International Law Journal* (2011), 209 (culture matters to the relationship between law and development).

<sup>56</sup> See North (1990), *supra* note 37, p. 358 no. 2 (“instrumental rationality is not the correct behavior assumption”). See also Lauren B. Edelman and Robin Stryker, “A Sociological Approach to Law and the Economy”, in Neil J. Smelser and Richard Swedberg (eds.), *The Handbook of Economic Sociology* (2nd ed., Princeton, NJ: Princeton University Press, 2005), pp. 527–551. Bounded rationality is a central assumption of the behavioral law and economics movement. See, e.g., Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 *American Law and Economics Review* (1999), 117 (“human preferences and values are constructed, rather than simply elicited, by social situations”).

thereby conforming behavior to the institutional constraints they face.<sup>57</sup> The result is reinforcement and replication over time of the existing institutional framework.

Because of this path dependence, informal institutions “that are culturally derived will not change immediately in reaction to changes in the formal rules.”<sup>58</sup> The result is a “tension between altered formal rules and the persisting informal constraints.”<sup>59</sup> Even where the formal institutions would provide more efficient outcomes, path dependence may continue to lock actors into the pre-existing framework.<sup>60</sup> In his study of business networks, Raja Kali noted the persistence of networks despite inefficiencies, even in the presence of legal reforms.<sup>61</sup>

Where transacting communities are characterized by low relational distance, the norms, routines and practices within pre-existing transacting networks will prevail over formal legal institutions in continuing to structure behavior. Business actors will continue to choose the informal institutions, resulting in low levels of demand for law. If the pre-existing informal institutions that structure market behavior within the private sector are less than efficient, even introducing the right, efficient formal rules via law reform may not enhance the prospects for private sector growth.

Policy makers in developing and transition countries, and scholars who study the relationship between law and development, should account more explicitly for the nature of informal market institutions when contemplating or evaluating law reform. Reforms should be designed so that there is a tighter fit between formal legal institutions and informal market institutions. The closer the fit, the more likely private sector actors will engage the legal system. The greater the extent of engagement, the more likely the reforms will produce the desired outcomes. Designing reforms in this way requires knowledge and understanding of the relevant institutional environment, and this requires a closer examination of the environment through empirical social science research.<sup>62</sup>

<sup>57</sup> See Clague (1998), *supra* note 38, p. 204 (social actors “simplify their decision making by employing rules of thumb rather than continuously optimizing all dimensions.”).

<sup>58</sup> North (1990), *supra* note 37, p. 45.

<sup>59</sup> *Ibid.*

<sup>60</sup> See Schauer (2003), *supra* note 47, p. 272 (“legal systems may also be especially prone to path dependence”) (footnotes omitted).

<sup>61</sup> See Raja Kali, *Endogenous Business Networks*, 15 *Journal of Law, Economics and Organization* (1999), 633.

<sup>62</sup> See Barak D. Richman, *Firms, Courts, and Regulation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 *Columbia Law Review* (2004), 2367.



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