Doctoral Thesis

Stockholm University School of Business

The Law Businessman™

Five essays on Legal Self-efficacy and Business Risk.
The Law Businessman™

Five Essays on Legal Self-efficacy and Business Risk

Fredrik Jörgensen
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To those who dare to dream.

To those do dare to act.

To Anna.

To my parents.
Acknowledgements

Writing a PhD thesis wasn’t something I had originally planned to do. Instead working with security policy seemed more attractive. The project I was invited to work on in 2001 on security policy in Central Asia at the Swedish Defence Agency, really made me realize that a PhD wasn’t such a bad thing to be since all the most original and industrious people there had one, or aspired to get one. However, business seemed much more dynamic than security policy, and also more productive. Businessmen try to create value for themselves and for others. I wanted to add to this noble ambition by writing about how to do more fruitful business. But institutions and politics didn’t leave me, so I ended up combining legal institutions and businessmen to see how businessmen can use the legal system to do better business.

Russia has always been a mystery within a riddle to me, but in an encouraging way. The mystery is not that Russia works the way it does, but how to improve it. Many feel that Russia is so different that results apply only to Russia. This is not the case. Russia is much more of a normal country than most think, yet it’s not a normal Western country. The best comparison is Italy – which also isn’t a normal country. One of the greatest lessons of researchers of transition is that when we turn our analytic tools to the transition countries, we end up learning more about our own countries and the prejudices we have about them.

I spent the first three years writing another thesis about corporate governance. And then in 2004 I made contact with scholars such as Peter Murrell who had done survey studies in the CIS and decided to write a completely different thesis based on surveys. It was this approach combined with my ideas about legal effectiveness based on the individual level that led me to write this thesis, now in your hand. The environment at Baltic and East European Graduate School at South Stockholm University was that of many Phd students in sociology, history, political science and business administration. Institutional theory was something that connected our disciplines. The question that hit me was: why didn’t anyone ask themselves the reverse question, instead of asking how institutions affect the economy – how do the end users of institutions’ perception of their own ability to use institutions affect their own use of these very institutions? And so I had to ask myself that question – how do businesmens’ perception of their own ability to use legal terminology in communication affect their risk behaviour when doing economic transactions? The notion was that it would be a good idea to start a new research approach that addresses the issue of corporate governance from the opposite side- the legal consciousness – and attempt to answer the questions that scholars in finance, accounting, law and finance, law and economics constantly stumble upon – businesspeople’s behaviour in relation to norms - rules and laws.

A greatest source of inspiration for writing this thesis has been those who think in new perspectives and dare to consistently believe in their findings. Those who venture to ask the questions that no one asked before, or maybe didn’t have the possibilities to answer. I have been fortunate to be able to combine many different sorts of resources to write this thesis owing to friends and colleagues from Russia, Sweden, the US, and Finland. It would be impossible to do it without your help. Soili Nystén-Haarala, I found a colleague that is interested in the same field of law and Russia, thanks for the conferences and meeting legal scholars. To Larisa Melnik, professor of sociology in St. Petersburg – thanks for finding the right people to work with and proofreading the survey.

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To supervisor and professor Bino Catasus – thanks for hanging in there and not giving up. Who knows what papers would have been written had we started cooperating earlier on e.g. accounting self-efficacy? To early supervisor and professor Cheick Wagué- thanks for helping me out when it was needed. Without both of you this thesis about legal self-efficacy might not have been in your hand today.

Thanks to my family who never failed to support my work with this thesis. Thanks to dad who knows how trying it can be to write a Phd thesis from his own experience. Thanks to mother who never failed to believe in me. Thanks to Anna who has kept me in good spirits. Without you there would definitely be no thesis on legal self-efficacy.

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1. Introduction to the Law Businessman

When public or private systems of risk reduction fail, business is at risk. How can businessmen manage risk when the legal system fails, as it did in most states of the Commonwealth of Independent States, including Russia, after the fall of the Soviet Union? The individual is capable of compensation for a loss of risk reduction with his or her perception of risk. The legal system is the most prominent and without much exaggeration the foremost system of business risk reduction. Businessmen can benefit greatly from taking the legal system into account when managing business risk – the ones who are comfortable using legal terminology are dubbed “law businessman”. Law businessmen take more business risks than does the average businessman.

The management of risk is a defining feature of any economy or society. As the German sociologist Beck (1998) demonstrates in his book Risk Society, economies and societies are not organized or created without taking risk into account, but rather in response to risk. Every economy has a solution as to how risk is to be managed. The idea that the management of risk, and not technology, is the defining feature of the development of societies over time is the key idea in Bernstein’s (1996) masterpiece Against the Gods: The Remarkable Story of Risk. It is captured in this passage:

The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature. Until human beings discovered a way across that boundary, the future was a mirror of the past or the murky domain of oracles and soothsayers who held a monopoly over knowledge of anticipated events.

Bernstein (1996 p.1)

As time passed, from medieval times to our own time, to which Giddens (1999) refers as “modernity”, society as a system developed institutions to mitigate business risk with the use of ingenious concepts.

1 The formation of the concept law businessman has been influenced by a relevant concept – the law merchant - the private code of laws which traders in medieval Europe used to trade more efficiently. This system led to the “Rise of the Western World” (Milgrom, P.R., North, D.C., Weingast, B.C. (1990) The Role of Institutions in the Revival of Trade: The Law Merchahng, Private Judges and the Champagne Fairs. Economics and Politics, 2)
such as the limited liability company, bankruptcy, credit rating agencies, insurance on property and life, the stock and derivatives market, hedging and credit default swaps, not to mention credit of all kinds, including trade credit, as well as risk management in all its forms. On the systems level, developed economies offer a never-before-seen set of mechanisms of risk management and reduction. Developed economies offer both high-quality public and private institutions of risk reduction for business as well as for individuals. Since risk reduction is absolutely essential to businesses it seems relevant to ask how much risk reduction public and private institutions of risk reduction provide in absolute and relative terms. Are law businessmen more efficient in reducing business risk than the actual private and public institutions of risk reduction themselves?

On the individual level, the mind’s ability to make decisions has not changed much since medieval or ancient times, as is apparent to anyone familiar with Shakespearean plays or Greek dramas. Human decisions are as fraught with imperfections, misbeliefs, heuristics (shortcuts) and lack of information as ever. One might hope that humans’ ability to make proper decisions would have evolved as much as legal systems, which have made these mechanisms of risk reduction possible. The Western governments that have created these legal systems have also evolved considerably with the gradual rise of democracy and the division of powers inspired by Montesquieu’s (1793) In the Spirit of Laws.

The role of the government as an institution for management of both manufactured risks (risks that derive from human activity such as business activity) and risk that derives from nature (i.e., non-manufactured risks, such as floods and earthquakes) is not very well understood. Moss (2002) explains in full detail the role of the US government as a risk manager for both types of risks. The government provides risk management, or rather risk reduction, in all aspects of life ranging from the regulation of food and drugs to the provision of armed forces designated to safeguard the nation and its constitution, and everything between these extremes. Primarily, the government provides stable institutions such as written laws, law enforcement, and a judiciary. Yet how much risk reduction is provided when these institutions are not stable and can in fact be manipulated? The government provides risk reduction in terms of deposit insurance for bank customers, disaster relief against natural disaster and even defence forces, medical assistance and fire fighters to help its citizens and their property when faced with destruction. Governments also provide regulation to reduce risk associated with nuclear plants and they often manage nuclear plants to provide energy for the needs of society. Moss’ (2002, p.1) definition of “risk management policy” is “any government action designed to reduce or to reallocate risk”. There are many more examples of the various government risk reduction or reallocation actions that governments carry out for citizens and business entities. It is fair to say that one of the primary functions of governments is the provision of risk management to citizens and businesses. But we do not know how much business risk they reduce in absolute and relative terms, nor in relation to the law businessman.

Institutions of risk reduction – public and private.

Institutions create predictable patterns of behaviour. Predictability reduces risk. North’s (1990) definition, “Institutions are the rules of the game in a society or, more formally, the humanly devised

2 Not all governments provide the protection that its citizens would like. In these countries the government itself was the worst enemy thinkable for many of its citizens. There are some notable exceptions. The Soviet Union is one, China under Mao is another, North Korea throughout its existence and Cambodia under Pol Pot is a fourth.

3 This is of course not always true, quality in government risk reduction differs from country to country and also over time. Some governments operate under an ideology that does not promote private enterprise. See e.g. the previous footnote. The suboptimal legal system in Russia is one reason for writing this thesis.
constraints that shape human interaction”, encompasses formal as well as informal institutions, systems and individuals. Public institutions of risk reduction include the legal system, law enforcement and the court system. Local or federal government organs are also public institutions of risk reduction to which businesses can turn to resolve conflicts. The laws and regulations are also part of the formal public institution of risk reduction. Private institutions of risk reduction include the law businessman/woman, lawyers, trade associations or financial-industrial groups, private security organizations and social or religious organizations. Private institutions of risk reduction also include strategies that do not include third parties. In situations of repeated trade there are also the trade strategies of relational trade and tit-for-tat. North (1990) underscores the importance of institutions in referring to “… the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World”. It is essential to understand the perceptual quality of institutions and that individuals' discernment of institutions, rules and sanctions plays a larger role for behaviour than do the inherent qualities of the institutions themselves (Opp, 1985; Denzau & North, 1994).

The institutions that provide risk reduction for systematic risks can be divided into two categories – public and private mechanisms of risk reduction. A definition of risk is relevant - risk is defined as “the probability of an adverse event multiplied by the extent of the damage caused” (Pidgeon et al., 1992). Business risk consists of two components, the objective risk, which can be measured over time, e.g. the risk of bankruptcy of a company – the business of credit rating agencies – and the individual's perception of dealing with risk, subjective risk. The foremost public institution of risk reduction is the legal system – written laws and the judiciary. Research on and evidence of the interactions of the public and private order is in short supply (Katz, 2000; Charny, 1990; McMillan & Woodruff, 2000). We know very little of how public and private mechanisms of risk reduction interact with or substitute for each other. The benefit of knowing this is that it might enable us to put private mechanisms to use where the public ones fail, as is the case in many countries across the world. Far from being a perfect substitute for the public order, private order mechanisms can make up for many of the shortcomings of the public order.

We know little about the effects of lawyers on transaction costs. The same holds true for trade associations. Trade associations provide excellent services to member companies, yet the effects of membership in them are not very well studied. Yet trade associations are a perfect example of a private mechanism of risk reduction (for a more elaborate discussion on this topic see Jörgensen 2008). Many authors discuss the beneficial effects of trade associations, but none measure their effects on the transaction costs of private contracts. So far we also know very little about the effect of risk perception on the granting of trade credit and on the use of sanctions against clients. One of the questions that this thesis attempts to answer is “What are the most effective institutions for risk reduction in Russia in the year of 2005?”

Public and private institutions of risk reduction are only half the story in achieving risk reduction: businessmen need to believe they can use them in order to do more lucrative business. At his disposal a businessman has a plethora of risk tools that he or she can use to do more business and accept more or longer-term trade credit to customers. The problem for businessmen and women in countries with weak legal systems is different. Djankov et al. (2008) demonstrate that the quality of debt enforcement correlates with per capita income and legal origin. Most developing countries grapple with weak legal systems and law enforcement. How can their citizens use the tools available to them and achieve successful risk management with the tool that they always have with them – their mind?
But businessmen generally do not like to use law and written contracts if they do not have to. In the
Soviet Union, businessmen and private enterprise were anathema to the communist concept of the
planned economy. But one does not have to turn to the USSR to find that businessmen shun the use of
law. Macaulay’s (1963) study of businesses in the US confirms that businessmen avoid the use of law as
long as it is possible. Businessmen shun legal disputes even though they might obtain a useful court
adjudications based on a signed contract. Instead of contracts, businessmen felt that they had orders,
which could be cancelled without much ado since it was a business custom to accept that trade partners
could cancel orders. Conflicts were dealt with on the phone. “One doesn’t run to lawyers if one wants to
stay in business because one must behave decently,” was the typical attitude. Businessmen as a rule resort
to using written contracts only if they have no more comfortable option. Written contracts were not
preferred over a handshake agreement, and if written contracts were made, they were considered
“orders” and people did not seem to care that many business contracts were unenforceable. In the Soviet
Union, state-owned enterprises ran most business transactions. There was not much room for private
businessmen. As a result the lack of experience of doing business in a legal system that provides the
foundations of the capitalist system – property rights, contracts, banks, trade credit, and other
mechanisms of risk management – hampered the development of business. The answer to the question
“Which are the more efficient in risk reduction for business – private institutions or public?” is,
unequivocally, private institutions.

A proposition in this thesis is that the private mechanisms of risk reduction – legal self-efficacy, lawyers,
and trade associations – are ahead of the public mechanisms of risk reduction – courts and law
enforcement – when it comes to providing risk reduction for businesses in Russia.

The legal system: the principal public mechanism of risk reduction

A common definition of a legal system is the formal institutions of written laws, the judiciary (courts)
and law enforcement. Yet the legal system is more than its written and formal components – the most
important measure of the effectiveness of the legal system is that of laypersons’ ability to use legal
terminology in communication with others when doing business. Luhmann (1981) considers all legal
communication in any environment as being performed within the legal system. This ability is captured
in the concept of “legal self-efficacy” (see definition and explanation on the next page). The legal system
is thus a system of communication of social expectations. He has an all-encompassing perspective on the
nature of law as communication. He suggests that the legal system is a system of communication that
constitutes its autonomy in treating law as an autopoietic, or self-reproducing, system of meaning and
communication rather than a set of institutional norms, practices or structures. Legal systems are
grouped in families. Every national legal system belongs to, most commonly, one legal family. Some are a
clear mixture of two systems. With the growing export and import of laws, not the least within the
European Union, in time there may be a convergence of systems. This is not likely to occur any time
soon as legal systems tend to display inertia, not to mention the populations that need to understand the
laws and regulations. But this convergence is on the level of formal institutions: what about the end
users of law and the law businessmen – are they becoming better at using legal terminology and thus
reducing business risks?

A legal family is a peculiar system for interpreting and enforcing the laws that have developed over time
and spread to more than one country. The five European legal families are: Common Law, originating
from England; Code Napoleon, which originates in France; Bürgerliches Gesetzbuch (BGB), which
originates in the unified Germany; the Scandinavian legal system, common to the Scandinavian countries; and the Eurasian legal family, used in the former Soviet countries with formerly communist legal systems. The legal families are subdivided into two general categories: common law and civil law. One of the main contributions of La Porta et al. (1997; 1998; 2000b) is that legal families have a significant effect on firm leverage and debt maturity across all four continents. This thesis confirms the La Porta et al. hypotheses on the effect of legal families on leverage and debt maturity. The field of comparative research on corporate governance received a new analytical framework that included law and finance with the help of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, La Porta, 1998). The operationalization of legal rights and families made possible a new type of comparison that demonstrated the impact of legal rules on external financing of firms. (Levine, 1998, 1999; Demirguc-Kunt et al., 1998). The measures of investor protection were shown to correlate with numerous factors that affect economic performance. LLSV initiated a legal approach analysing corporate governance systems by demonstrating the impact not only of legal rules on the external financing of companies but also of the legal families to which they belong and of legal reform (La Porta et al., 1997, 1999, 2000; Johnson et al., 2000). They later proxied legal origin with colonial impact on the social institutions of the recipient countries (La Porta, 1999b; Beck et al., 2000; Levine, 1999b). They have generally showed that common law is more conducive to external financing of firms than are the German, Scandinavian, French, and Eurasian legal families. Many of the Eastern European countries that face massive legal change during transition have tried to adopt an approach based on the LLSV results focusing on investor protection without much concern for other issues. As a result, reforms have failed to reach the desired results (Black et al., 2000, Glaeser, 2001). A one-eyed focus on institutions is not likely to be conducive to the successful development of external finance to companies in transition. Could the missing link in understanding legal efficacy be to include the end users of law, the businessmen, in order to understand the effect of law – legal efficacy in businesses across the world?

A proposition of this thesis is that unlisted firms change their leverage and debt maturity as creditor rights increase. It also confirms that legal origin is related to the level of debt and debt maturity. It also posits that creditor protection and institutional effectiveness are interchangeable when it comes to leverage and debt maturity.

**Legal self-efficacy**

Legal self-efficacy as the belief that one is capable of performing in a certain manner to attain certain goals is related to the more general theory of bounded rationality of Herbert Simon in several ways. Herbert Simon paved the way for behavioural economics, which challenged and still challenges the limited foundation of neoclassical economics inspired by Arrow and Debreu (1954).

The main proposition of this thesis is that it is the communicative aspect of the legal system – in terms of legal self-efficacy - that is the best measure of legal efficacy, and not its formal incarnation in terms of written laws and the judiciary.

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4For an introduction to the scholarly debate in comparative law on the differences of the legal families see Zweigert, K. & Kötz, H. (1998) or Coing (1986) or Blumberg (1993). The conclusion among comparative legal scholars seems to be that the dissimilarities between legal families can be found less in the substance of legal provisions, and more in the history of the law, the understanding of legal rules, legal processes and legal culture. For an introduction to the transplantation to the Russian legal system, which is part of the Eurasian legal system from other legal families, see Ajani (1995).
Legal self-efficacy is the key concept of this thesis. It is a marriage of self-efficacy, a known and tested concept of cognitive psychology, and the individual’s relationship to the use of legal concepts. According to the discussion in Torpman & Jörgensen (2005), individuals tend to accept legal communication if they believe they understand it and feel at ease with legal terminology. The most appropriate term in current research that connects the new theory of legal efficacy with current research in cognitive psychology is “self-efficacy”. People’s assessments of their own capacity to achieve specific tasks – their self-efficacy – strongly influences human motivation and behaviour. Self-efficacy has been found to be a much more consistent predictor of behaviour and behavioural change than is any other closely related expectancy variable (Weiner 1986, p. 17). Consequently, legal self-efficacy is an individual’s confidence in his or her ability to use legal terminology and in the acceptance of legal concepts as communication. Legal self-efficacy (LSE) is particularly relevant to the understanding and measurement laymen’s use of law. In using the term “laymen” we exclude legal professionals such as lawyers and judges, legal assistants, and others who have a direct or indirect professional relationship to the formal legal system. Laymen structure their business and other relationships through their personal and not infrequently inaccurate conceptions of abstract concepts, such as contract, debt, obligation, duties, private property rights, and immaterial rights. Familiarity with the concepts makes it more likely they will be used in communication and consequently law will be more frequently referred to.

The sources of legal self-efficacy are analysed in the fifth and last paper of this thesis. The findings of this paper suggest that sources of law, written sources and from persons such as acquaintances and/or colleagues, films and TV are conducive to legal self-efficacy. The results indicate that risk reduction can be achieved not only through legal human capital but also through behaviour related to information search and retrieval. Previous research on contractual assurance and risk reduction has focused on the improvement of legal institutions such as courts and legal texts to address the problem of contractual assurance. The present study takes the opposite approach, addressing the legal consciousness and behaviours of the end users of law. The policy implications are that managers can be taught to improve their legal self-efficacy or they can use risk-reducing behaviour to mitigate business risks.

A proposition of this thesis is that legal self-efficacy can be improved through personal experience, sources of law, such as books and journals, and through films and TV.

Legal self-efficacy is thus a perceived skill that can be learned through contact with sources of legal knowledge. This does not imply that it is necessary to become a lawyer, but rather that friends, relatives, and other sources of legal information impart legal self-efficacy. This thesis analyses laypersons in relation to legal self-efficacy – not professional users of law such as lawyers and judges.

**Legal effectiveness**

Legal effectiveness in literature denotes the effectiveness of the constituent parts of the legal system such as the courts and law enforcement. This thesis redefines this concept to imply the businessmen’s ability to use legal terms and their acceptance of law as a means of communication. Legal effectiveness thus a

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5It doesn’t seem implausible that legal consciousness is measurable in a standardized fashion across different economies and that its effects can be compared to the effect of other institutions of risk reduction. Although this thesis measures legal self-efficacy in one population at one time, the theoretical constructs behind the concept of self-efficacy (see the works of Bandura and tens of thousands of publications on self-efficacy) allows it to be standardized across countries.
function of the distributed acceptance of law as a way to structure business transactions. Legal effectiveness is a key concept of the thesis as it is closely connected to the key concept of the thesis.

The understanding of legal efficacy in previous studies is, with few exceptions, that law is effective when the professional and institutional services provided by lawyers, the courts, and the authorities can be acquired rapidly, accurately, and at low cost. In this perspective, the formal legal system is therefore associated with transaction costs to businesses.

The concept of legal effectiveness as legal self-efficacy is a reaction to previous theories of legal effectiveness based on the characteristics of external institutions such as creditor rights, speed of court rulings, and the effectiveness of law enforcement agencies (see e.g. Pistor, 2000; LLSV, 1997 and 1998; Botero et al., 2003; Buscaglia & Uhlen, 1997; Church et al., 1978). According to the form of definition used in these studies, law is effective when behaviour is in compliance with the law, and compliance is described as though it is achieved mostly according to an Austinian command backed by a threat model. This thesis attempts to find a more positive and creative definition of legal effectiveness that also does a better job of predicting the effectiveness of law: could it be that the individual him/herself is the best determinant of legal effectiveness?

Economic transactions and risk

Businessmen, as a rule, base their decisions on their own subjective risk calculations. Subjective risks are the risks that individuals discern in any given situation affected by bounded rationality, incomplete information, and possibly errors of calculation. Subjective risk consists of two distinctive elements – uncertainty and significance of consequence (Cox, 1967; Taylor, 1974). “Uncertainty about the outcome can be reduced by acquiring and handling information. Uncertainty about the consequences can be dealt with by reducing the consequences through reducing the amount at stake” as Taylor (1974, p. 54) explains. The difference is that an individual assesses a risk using subjective assessment, and the actual risk is calculated by objective analysis, e.g., by repeating situations over time, such as the likelihood that the engine of a new car will break down (which a car insurance company needs to know in order to price the car insurance correctly). Most businessmen rely on their subjective risk calculations in their daily assessments of risk. Their business decisions take society’s institutions into account in the equation of business risk equation.

Unquestionably, economic transactions involve risk. Whether an economic transaction will take place or not depends on at least two factors: the objective (systematic and unsystematic) risks involved in the transaction and whether the transacting parties are willing to take this risk; that is, their subjective risk propensity. The objective risks related to a certain customer are referred to as customer risk. Firm-specific risks are business – or unsystematic – risks. Market risks are systematic risks. Firms have to take both types of risk into account (Amit & Wernerfelt, 1990). Russia is considered a high-risk environment for business. Firms can reduce or increase risk in their own operations. Organizational theory suggests that managers structure their businesses to reduce uncertainty produced by environmental unpredictability (e.g., Burns & Stalker, 1961; Dess & Beard, 1984). The reason why managers can and will increase risk in dealing with external contracts is that they can do so to increase the risk of projects at the expense of owners. Owners, however, may also prefer higher risk in projects to

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6 See Austin (1954) for a treatment of the command backed by threat model.
increase the return on investments. Firms aim to reduce risk based on three motives: the agency motive, the cash-flow motive, and the rate-of-return motive. Low business risk allows firms to acquire factors of production at lower cost, operate more efficiently, or both (Amit & Wernerfelt, 1990). There is a trade-off between profitability and risk, however (Bettis & Mahajan, 1985). The main reason to increase risk found in empirical studies is that it increases cash flows (Amit & Wernerfelt, 1990).

**Legal self-efficacy allows for risk matching with objective risks**

The subjective and the objective risks involved can act as substitutes – if the risks are high, i.e., if the probability of success is low and the probability of losses high, the love of risk must be high, and conversely there little need for a love of risk to perform a high-probability transaction. This relationship is referred to as risk matching. High levels of objective risk can only be matched with an equal amount of subjective risk in order for a specific transaction to take place. Risk matching is a precondition of transactions taking place and is essential to the functioning of an economy. The problem with deteriorating institutions of risk reduction is that subjective risk needs to increase in order for business to be carried out. When the effectiveness of a legal system for reducing business risk declines, other institutions will take its place for risk reduction. When the institutions of contract enforcement fail in an economy, risk matching requires that the subjective risks increase in order for transactions to take place.

The most prominent institution of risk reduction is the legal system, through written law, the courts and law enforcement. Another way of stating the risk matching relationship is: when institutions of contract enforcement are of high quality, there is less need of legal self-efficacy for economic transactions to take place.

In the literature, "legal effectiveness" denotes the effectiveness of the constituent parts of the legal system such as the courts and law enforcement. This thesis redefines this concept to imply the businessmen's ability to use legal terms and their acceptance of law as a means of communication. Legal effectiveness is thus a “function of the distributed acceptance of law as a way to structure business transactions”. Legal effectiveness is a key concept in this thesis as it closely connected to the main theme of this thesis.

This thesis aims to fill a gap in previous research – that of a standardized concept that measures the individual’s relationship to law that is based on solid research evidence in cognitive psychology and that reflects the communicative nature of the legal system. The concept should be all-pervasive in its application, meaning it should be applicable in most if not all fields where humans are in contact with the legal system and there is risk. The measurement should also be autopoietic, i.e., a self-reported measurement such that the individual can use self-assessments in surveys. Most scientific endeavours that focus on individuals in relation to the law are done on the system level, often with the neoclassical assumptions in place; legal self-efficacy, on the other hand, allows researchers to step into behavioural business and economics and measure individuals’ legal consciousness in a standardized way. The concept has many uses in corporate governance, law and finance, law and economics, and legal sociology.

Risk matching transactions when objective risks are high requires high legal self-efficacy. Let us assume that the *de jure* sales, creditor and contract laws, as well as their *de facto* enforcement, are poor. Anyone who delivers goods on trade credit or lends money runs quite a significant risk of non-payment. Trade credit is the separation in time of payment and the delivery of goods and services. Most companies
receive an award trade credit to other companies and sometimes to individuals. Trade credit always entails a risk of default. Most business-to-business payments are performed using trade credit.

This situation is not dissimilar to that of post-Soviet Russia, where there was no previous experience of private property rights and solid contract enforcement due to the political experiment with Marxism-Leninism. These two pillars of the capitalist market provide for lowered objective risk. The question in the early post-Soviet years was whether law would have a place in the new market. Would Russians use the new Civil Code of 1995 to build a functioning capitalist economy, or would they revert to the networks and contacts approach of the Soviet years to do business?

Let us consider two basic transactions: firstly, that of a supplier delivering goods to a previously unknown client in another town. Payment should be made with the use of a 30-day trade credit to a bank account. There is risk to both parties in this transaction. The supplier runs the risk of non-payment, while the client runs the risk of goods that mismatch the order, are faulty, or are delivered late, or not at all. In this elementary situation there is a risk of contract enforcement on both sides; even if there is no written contract, they rely on de jure and de facto sales law as well as the law of contracts. Secondly, let’s consider the transaction in which a creditor, e.g., a bank, lends money to a debtor, e.g., a company. The creditor can use a pledge in the debtor’s property to lessen risk. Applicable creditor rights that mitigate the risk to the creditor are de jure and de facto credit law. The debt maturity and leverage may also be affected by the risk that a creditor accepts at a given price. Creditor rights are the legal rights accorded to a creditor that help him/her to recover borrowed funds. Debt maturity is a measure of the scheduled life of a loan. The higher the maturity, the longer the time until the life of a loan ends. Leverage is the use of debt financing. A company with much more debt than equity is generally considered to be highly leveraged.

**Legal self-efficacy as a catalyst of institutions of contract enforcement**

Legal self-efficacy is a catalyst of norms, or institutions, that regulate contract enforcement. Let us assume a third situation, which of contract enforcement through the use of trade sanctions. Trade sanctions can be direct, e.g., ceasing to trade with a client, or indirect, e.g., spreading rumours about a client, or mediated by a third party, e.g., a court of law. There are more than 11 different ways to enforce a contract, as demonstrated in the fourth paper in this thesis.

Norms, or institutions, can act as contract enforcement when a client is not acting according to social expectations. The use of second-party sanctions, such as imposing a fine on or halting trade with an enterprise, is all positively and significantly correlated to legal self-efficacy. The latter is common in so called relational trade (MacNeil, 1978, pp. 883–884) when there is no written agreement. The least costly and therefore most common of all sanctions is to stop trade.

Legal self-efficacy is also positively and significantly correlated to the use of a host of third-party sanctions, including the legal ones – filing a claim in court, reporting the enterprise to a local or federal government organ, business association, financial-industrial group, or social, religious, or other organization, or to a private security organization, or individuals or groups, with the intention of collecting debt (see the Fourth paper, “Legal self-efficacy and managers’ use of law”, Table 5, for a report on correlations).
A proposition of this thesis is that legal self-efficacy bolsters the use of contract enforcement.

Norms are considered obligations when there is a need for conformity and the social pressure to punish deviators is considered great (Cohen, 1976, p. 12). Social norms are the norms common to a population that regulate social and economic interaction. In this thesis they are used as norms that are not directly legal norms. For a more lengthy treatment see Huang P. and Wu H. (1994). The essential difference between a social norm and a legal norm is that the latter is written, promulgated, and backed by government legitimacy. Legal norms express the normative expectation of behaviour and the organization of society as expressed by the legislators and law enforcement agencies.

The individual’s relation to legal norms reflects his or her acceptance or internalization of these norms. The level of internalization may differ between different areas of law or even individual laws. Also the acceptance of legal norms should be considered to be situation specific. Internalized legal norms are closely related to emotions – non-legal sanctions of the individual upon himself in terms of shame, guilt, and remorse (Frank, 1987; Huang & Wu, 1994). The individual’s emotions are the sanctions that internal norms impose on the individual. This is helpful for enforcing second and third-party sanctions as well.

The use of sanctions is not always the use of law. Not all sanctions are strictly legal, only two: the threat of adjudication and adjudication of a conflict in a court are strictly formal legal sanctions. A person imposes first party sanctions by him or herself. Second-party sanctions are imposed directly to the other party, usually a client. Third-party sanctions engage a party outside a dualistic trade relationship to enforce a contract. Close-knit groups mediate sanctions via social norms, such as gossip. When strangers trade, law can mediate sanctions by invoking the contingent legal system.

Previous research has not specifically targeted norms that are conducive to all three forms of sanctions. This study is likely to be the first to use a reflexive trait that is in direct relationship to the legal system. For businesses it is valuable to be aware of legal self-efficacy as a personal trait that is related to the legal system, and is conducive to customer sanctions.

Efficient contract enforcement has long been recognized as vital for markets to function. Only recently, however, economists have begun to study different mechanisms of contract enforcement empirically. The breakup of the Soviet Union seriously disrupted trade patterns for most companies. New ties had to be made with domestic and foreign companies in order not to lose output. In this new scenario, it was hard for companies to find reliable trade partners, and many preferred to stay with the old ones. However, this impeded their adjustment to the market economy. Moreover, ultimately, in order not to perish companies need to expand their client base, or better, to grow and capture market share.

Russia is a special case in terms of credit information. There is little in the way of a system of developed credit information. Such a system would simplify the search for reliable customers. The respondents to the field study of this thesis claimed that they usually relied on “face control” to compensate for the lack of reliable information on customers. In case of total uncertainty, companies frequently rely on the system of prepayment, predoplata. This method of risk reduction plays an important role in the acquisition of new trade partners.

Sanctions, and therefore trade, function differently depending on the character of the parties’ relationship and their geographical proximity. The third study divides clients into four categories: family clients, business clients, clients in the same town, and out-of-town clients. The reason behind this
categorization is that it represents four sets of norms and risks (McMillan and Woodruff 2001). Family clients are governed by social norms as social networks can use social sanctions through gossip. Business clients are expected to be regulated by business norms, i.e., the courts. Courts are substitutes for social networks (McMillan & Woodruff, 2001). Clients in the same town are supposed to be regulated via the local law enforcement agencies and of course the local judges. Law enforcement agencies are most likely to work best when a seller and a buyer are in the same town and not in different jurisdictions. Pursuing claims on customers is harder in exterior jurisdictions. This is why the category of out-of-town customers is riskier than same-town customers. Bernstein (1992) demonstrates that diamond traders, a close-knit group, use their own methods of sanctioning involving an elaborate set of rules, complete with characteristic institutions and sanctions to handle disagreements among industry members. This means that private-order norms regulate trade better in close-knit groups than do public-order norms, such as the courts and law enforcement. The character of a trade sanction is dependent on the transaction at hand. We know from Williamson (1979, p. 239) that transactions vary in uncertainty, in transaction frequency, and in the degree of durable transaction-specific transactions. We can also add the variables relating to the players: geographical distance and “close-knittedness”. Contracts can also be enforced by a third party, such as an informal group, a second party, such as a trade partner, or a first party – the person that trades, namely, you, given that you engage in trade. There is also a type of contract that is self-enforcing, does not require third-party enforcement, and ceases to exist when one party so decides.8

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8The economic literature on contract enforcement has two extreme traditions with regard to the role of the courts in contract enforcement. The legal centralist school assumes that no-cost contract enforcement is in place and that the courts are readily available to expedite conflict resolution. The more realistically inclined school of self-enforcing agreements assumes that contracts between two parties are not enforceable through the courts (Bull, 1987; Klein & Leffler, 1981; Telser, 1980). The second, the theory of self-enforcing agreements, implicitly or explicitly assumes that contracts between two parties are not enforceable through the courts (e.g., Telser, 1980; Klein & Leffler, 1981; Bull, 1987). One type of agreement is the self-enforcing agreement or relational trade arrangements explicated by MacNeil (1978, pp.883–4). The contrary position to centralism – legal pluralism is more in line with the findings of this thesis. The critics claim “How is law distinguished in a pluralist view from other normative systems? What makes a social rule system legal?” (Potterell, 2006). Well, in everyday use, law is an institution like many other institutions whose value or power is what people charge it with, i.e., the social value that they give it.

Self-enforcing agreements between two parties remain in force as long as each party believes himself to make greater gains from keeping to the agreement than he/she would if they were to end it. A self-enforcing agreement has no third party. It ends when one of the players ends it, either by the other party violating the contract or one part merely ceding from it for any reason (Telser 1980:27). Self-enforcing (Klein and Laffler, 1981 and Telser 1981), contracts are usually referred to as implicit contracts (MacLeod and Malcolmson, 1989), or both (Bull, p. 1987). Law and transaction costs are intimately interconnected. By law it must be understood that not only the way laws are written and enforced, but more importantly how laymen interpret them. Every day in every country laymen have a relation to the legal system of their economy and this relation reflects decisions at risk. The legal system is the most elaborate public system of risk reduction and this thesis tells the story that the legal consciousness in relation to law, or rather legal self-efficacy has more impact on decisions at risk than do the perceived effectiveness of formal institutions both public and private.
The collapse of the Soviet Union and the Law Businessman

The collapse, reorganization, and restructuring of an entire economy seems like a good place to start to study the effect of economic institutions on economic and legal transactions, especially if that particular economy had abolished private-property rights and a capitalist legal system to supports them in return for a rigidly authoritarian command economy.

The economy of the Soviet Union was characterized by centralized planning, implemented administratively through the issuing of direct commands and far-reaching, detailed coordination directives. The state owned all or virtually all activity in industry, construction, transportation, and reproducible capital, as well as natural resources, research and development, mining, and construction. Further characteristics of the Soviet economic system were: hierarchical structure of authority; rigidly centralized planning of production and distribution; exhaustive price control; the lack of any legal alternatives to assigned (state-controlled) relationships; the control by overseers of norms and plans; and incentives geared towards meeting plans from the very top and not the economic consequences of decisions made at levels below the very top (Ericsson, 1991, p. 19). The Soviet Union disintegrated finally in December 1991 after the perestroika years (1987–1990) during which the system weakened from within. Internal as well as external forces led to the breakup of the USSR. The authoritarian economic system became too complex and the “Superman” or “Homo Sovieticus”10 was not as altruistic and collectivist as Trotsky (1924) had planned for. Glasnost and perestroika coupled with freedom of speech led to a rise in nationalist tensions and reports in the media on the shortcomings of the system. In 1991 a wave of revolutions swept across Eastern Europe which led to the final coup against the communist regimes of Bulgaria, Czechoslovakia, East Germany (which had already been set free in 1989), Hungary, Poland and Romania. The political and economic foundations of the USSR led to its demise.

The building of a legal system in post-Soviet Russia

The basic argument for legal reform in Russia was that new legislation needed to be put in place quickly and in a top–down fashion. No lessons were learned from previous failures in legal transplants from the experience of countries in Latin America (Gardner, 1980) and Trubek and Galanter (1974). Legal transplants are the “the moving of a rule or a system of law from one country to another” (Watson, 1997). Private production was restricted to family plots, arts and crafts, construction of private housing, and some professional and personal services (ibid p. 11). The central coordination required to manufacture and distribute over 24 million products was overwhelming (ibid. p. 15). The centralist idea of society – that the government should organize production and ownership – runs in direct opposition to the propositions of this thesis. In post-Soviet Russia Adam Smith’s invisible hand actively supports the price mechanism and coordinates trade on the most decentralized level possible. The Law Businessman – the title of this thesis – is the epitome of the businessman, with high legal self-efficacy, who is comfortable with the legal system and with the rights and protections it grants him in a free market where individuals’ efforts to maximize their own gains in a free market benefits society. The quantity and quality of law businessmen in present-day Russia is therefore both a precondition of and the effect of the free market including private property rights, which are the hallmarks of functional capitalism. The Law Businessman, owing to risk matching, can of course function very well in a situation of poorly functioning public systems of risk reduction such as the legal system. The Law Businessman is equipped to take more risks than are other businessmen. There is not gender bias in the term Law Businessman; she is just as well a Law Businesswoman. 40 percent of the respondents in northwest Russia were women.

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10 Trotsky, I. (1924) Literature and Revolution, about the ‘Communist man’, ‘man of the future’. ‘Man will make it his purpose to master his own feelings, to raise his instincts to the heights of consciousness, to make them transparent, to extend the wires of his will into hidden recesses, and thereby to raise himself to a new plane, to create a higher social biologic type, or, if you please, a superman.’

Legal transplants are more or less frequent in all jurisdictions. The “transplant effect” is the difficulties that an economy encounters when it receives foreign law – legal transplants – from other countries and legal families, due to the unfamiliarity of the new imported legal concepts. Law can be transplanted, but if the provisions are exported in an entirely new societal, economic, and legal context the provisions will not be understood or used the same way and will therefore not have the same effect as they did in the country of origin. This has a detrimental effect on the legal efficacy of the population. Legal efficacy decreases initially as a result of the transplant effect. The traditional definitions of legal efficacy are based on the population's obedience to the law – the lesser the gap between the letter of the law and the actions of the population, the higher the legal efficacy. When economic agents do not understand imported provisions of law, they feel estranged and will tend to revert to the previously used law in a particular area.

In the spirit of shock therapy\textsuperscript{12} and the Washington Consensus\textsuperscript{13}, supported by the IMF, it was necessary to quickly legislate for a market economy and the laws needed if not to be transplanted verbatim, then at least very much to be inspired by the West. It was assumed that Russian economic actors would rely on these new Western-style laws and build their markets around them, without taking into account their past experience of a system based on networks and personal relationships, without regard for law. It was assumed that the use of law was purely a matter of incentives (Murrell, 1997, p. 229). Privatization, as a result of this strategy, preceded legal reform, as did much of the redistribution of former state property in voucher programmes. The worst part of this was not how citizens were granted vouchers – which could be used to buy a stock in a state company (Ellerman, 2001), but rather how so-called oligarchs and government insiders stole billions of dollars’ worth of government property from its proper owners – the Russian people.

After the fall of Communism, Russia has been the leading country in terms of share of privatization. This process has been scandalous since the process of privatization was the most rapid and perhaps worst planned of all of the former planned economies. The dissatisfaction among the general population with the result of privatization is not to be underrated. Denisova et al. (2007) analyse an EBRD 2007 survey on popular support for a revision of privatization in 28 post-communist countries. Fully 80 percent of the respondents favoured some kind of revision, but total nationalization was supported by only one-third of the respondents. The main conclusions are that wealthy individuals are the most against a revision and those who have had negative personal experience of privatization are most in favour of a revision owing to a lack of fairness. Lack of human capital in terms of higher education also predicted support for a revision. Another survey of Russia’s population in 2006 found that 52 percent of respondents agreed with the statement “the majority of private assets in the country should be nationalized”.

\textsuperscript{12}Shock therapy was the process of quick privatization of government property in the former USSR, coupled with the sudden release of price and currency controls, withdrawal of state subsidies, and immediate trade liberalization. Jeffrey Sachs was the theoretical mind behind the shock therapy in Russia. Yegor Gaidar, the 35-year old prime minister under Yeltsin is considered the driving executive force behind shock therapy in Russia.

\textsuperscript{13}Naim, M. (1999) Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion? Working Draft of a Paper Prepared for the IMF Conference on Second Generation Reforms, Washington, D.C. The Washington consensus was a policy John Williamson gave in 1989 to a list of ten policy recommendations for countries willing to reform their economies. These recommendations are summarized in two tables of economic liberalization (p 19-20) and are very brief top to bottom cures. They do not take into account sociological variation in the target countries as such.
Russia has an inherent distrust of private property rights that can be traced back to medieval times and beyond. Whereas in Western Europe private property rights are considered indisputable civil rights and considered a natural part of the constitution of each country without any serious political challenge, Russia has never had private property rights as an elementary civil right. Property rights have instead existed at the whim of the government, were it Czarist or Communist, which could grant individual ownership rights to private property. Ownership rights could easily be retracted by the Czar or the Communist party with restricted right of appeal (Pomeranz, 2004). Moreover, these Western-style laws were based on the notion of cooperation between the state (assuming the state is neutral) and market actors. The driving force was assumed to be a newly awakened interest in private property and the interest in personal protection of it. For Russians to rely on law meant relinquishing established patterns of behaviour as well as power and control over transactions. The relationship of Russians toward law has been filled with antipathy (Krygier, 1990, p. 640). Since the lack of autonomy and neutrality of law reflected in the Communist party’s control over it made law into an instrument of control. Russian managers learned that who was involved and that networks could trump any law or written contract. As a result, law played a minor role in business in the USSR.

A salient feature of capitalist law-based economies is the possibility of engaging in impersonal anonymous trade. Law provides a certain set of assumptions of negotiation and default, with or without a written contract, in both business-to-business as well as business-to-consumer relationships.

Given the previous state-centred role of law in the USSR it was difficult to fathom that law could actually use to defend citizens’ private property against the state. Previously law had been an instrument of the state to extract what it needed from its citizens (Hendley, 1997). Given the suspicion with which ordinary citizens viewed the law and its relatively inconsiderable status in Soviet trade, the new commercial laws in the post-Soviet era endured a challenging start. There are many methods of social control – law and contracts is but one of them. The challenge for the Russian economy was whether a modern legal system would prevail despite the pervasive mistrust of the law as such and the newness of transplanted Western-style law.

When Russia emerged from the USSR in late 1991, most Russians who already were, or who would become, businessmen were not used to applying law when doing business, for lack of a capitalist legal system and lack of practice in doing business in a free market. In the early 1990s Russia was left with the remnants of the Soviet civil code (the new civil code was not promulgated until 1995) and a business establishment unfamiliar with the capitalist legal system. In many aspects, Russia was facing the same challenge as was the developing world, with a legal systems lacking formal representation of property rights, and massive importation of law from the West. This challenging situation is the reason why this thesis was written. How can businessmen take on business risk with a dysfunctional legal system and a lack of experience of relying on a capitalist legal system to manage business risk?

14 In present day Russia Putin on one hand adamantly promised that there will be no nationalization of companies and then on the other hand actively pursued nationalization policies, the Land Code of 2001 gave businesses an opportunity to buy the land they sit on, or lease it from the local government. There is a double policy of nationalization and widening the importance of ownership for businesses. The average businessman can therefore be expected to view his rights to his business and the land that it sits on with lack of expectation (Sonin 2003). The political risk of private property rights for businesses – foreign and domestic – is a fact of life in Russia.
Russian businessmen could not be expected to make an evolutionary leap in their minds overnight and use the full spectrum of the new civil code when doing business in the transition period. The task then was to find a connection between common risks that businessmen assume and the most prominent system of risk reduction – the legal system – in order to see if we could find a link between the legal consciousness and real-life business risks. If this relationship could be established we could find a way to solve the abovementioned problem of business-risk management in a country with a dysfunctional legal system and with businessmen who have momentary experience of using law to do business.

**Mistrust of property rights**

With the background of mistrust of the law and of property rights, overly zealous privatization and mistrust of central government, coupled with a dysfunctional court system, pandemic corruption and the resulting problems with contract enforcement, it is necessary to analyse the problem of whether law was effective in the new post-Soviet Russia – whether the law had a real and lasting place in business. Add to this the new legal transplant from the common law and the continental German legal system, other legal families, which was bound to estrange the population from its own legal system, and ultimately decrease legal effectiveness. Legal effectiveness, I argue, exists only when the end users of law can comfortably communicate using legal terminology, as opposed to the previous theory, which argues that it is when law is obeyed that it is effective. The effectiveness of law can be tested in relation to the previously described common transactions as described in situations one and two. In addition, we can test the effectiveness of contract enforcement verifying the effect of self-efficacy on common transactions of risk, such as trade credit.

**The law businessman should be hard at work in the third world**

Russia is not the only country with a challenging legal situation. Many if not most developing countries have problems not only with the protection of private property rights, but also with contract enforcement and a functional system for even starting a firm. For reference, please check the excellent World Bank website project doingbusiness.org, which compares 185 countries in terms of their ease of doing business, including legal conditions such as starting a business, registering property, enforcing contracts and resolving insolvency. There is ample evidence that higher transaction costs for business hurt the economy by reducing profits and making private enterprise unnecessarily burdensome. The Law Businessman has fewer problems dealing with red tape than do other businessmen. This is one of their reasons why he should be hard at work in the developing world.

An account of failed government provision of institutions of risk reduction was written by De Soto (2000). The risk management that is provided in the United States government as in the Moss’ example from the very beginning of the introduction, of the government as a manager of both man made and natural risks is not present in all countries. De Soto (2000) tells us the story of the developing world and the causes of its poverty. Since the nineteenth century, nations have been copying the laws of the West to give their citizens the institutional framework to produce wealth. They continue to copy such laws today, but it obviously does not work. Most citizens cannot use the law to convert their savings into capital. Why this is so and what is needed to make the laws work remains a mystery.\(^{15}\)

\(^{15}\)De Soto (2000) has taught us that one of the reasons why the West is ahead of the developing world countries, despite massive export of laws and that seemingly might improve domestic economies, is that the West is blessed with legally established and secure private property rights in standardized legal systems since the 18th century in Europe and the 19th
De Soto (2000) recounts many advantages provided by legally assigned private property rights, e.g., that they create committed and responsible citizens. He claims that extralegality, the informal sector of legally unrecognized property and its complementary extralegal jurisdictional institutions, is a universal phenomenon that was only achieved in the West in the 19th century. As he explains (p. 52):

... The reason capitalism has triumphed in the West and sputtered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system.

De Soto explains that the institutions that are so successful in the West do not work in the developing world because there is a lack of formal legal rules to manifest property rights. Property rights in themselves are a means of business risk reduction as they significantly decrease the risk of a person’s property being unjustly taken away from them. Means (1983) tells a similar story about the Colombian wholesale adoption, or legal transplant, of Spanish corporate law in the early 19th century in order to achieve an economic upturn. The result was that corporate law was unfamiliar to the population and as a result businessmen did not use the new corporate law, which created a lack of legitimacy in the legal system. When businessmen refrain from using law to reduce business risk, law is said to be ineffective. The law businessman could do a lot of good in countries where there is no functional system of representation of property rights. He could use his legal self-efficacy to claim his formally non-existing rights with the use of legal terminology and thus encourage these economies, which typically display a less developed system of public and private risk reduction, to take more business risk. The law businessman is not first and foremost a lobbyist; however, another possibility is that given the proper amount of lobbying power, he or she could use their political influence to establish private property rights on land.

The key concepts of this thesis are explained above and displayed in relation to each other on Table 1 on the next page.

The organization of this thesis

A table organizing the key concepts of the thesis is followed by the contributions of the thesis to literature in the domain. In the theory section, Luhmann’s theories on law as communication and legal efficacy, as well as the theory of public and private mechanisms of risk reduction, are accounted for. The theory section ends with a discussion of decision theory. Methods, research design, and articles are discussed in the third section. The fourth section contains brief paper summaries for the reader who is in a hurry. Section five contains the conclusions and contributions of the law businessman. The thesis ends with a statistics appendix and a list of references.

century in the US. The single most important source for external funding for a new entrepreneur in the US is a mortgage on his or her home. The failure to produce legal entitlements is one of the reasons not only why the developing world is behind the West, but also why Russia is behind the West. Foreigners in Russia could not own land, and companies could only lease land on which their factories are positioned until 2001 (The Russia Journal 25th of April 2004). According to De Soto (2000) property spawns a multiplier effect that produces composite economic growth. De Soto argues that this function of property was renowned most thoroughly by Marx, and provided the basis for the Marxist critique of capitalism. Capitalism however, has been the salvation of the lower classes of society, exactly opposite to what Marx stated. When the lower classes can have legal entitlements to their property they can enter into the capitalist society and benefit from material opulence. This lesson was learned by the West during the Industrial Revolution and is being learned by the Third World today.
### Table 1: Relationships between key common concepts

<table>
<thead>
<tr>
<th>Level</th>
<th>Public order</th>
<th>Private and public order</th>
<th>Private order and financial concepts</th>
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<tbody>
<tr>
<td><strong>System/Macro</strong></td>
<td>Legal system/family</td>
<td>Legal norms</td>
<td>Social norms</td>
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<td>Legal transplants</td>
<td>Transplant effect</td>
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<td><strong>Meso</strong></td>
<td>Courts</td>
<td>The Law Businessman</td>
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<td>Trade associations</td>
<td>The Law Merchant</td>
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<td><strong>Individual/Micro</strong></td>
<td>Law enforcement</td>
<td>Legal efficacy</td>
<td>The Law Businessman</td>
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<td>Trade sanctions</td>
<td>Legal self-efficacy</td>
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<td><strong>Financial concepts</strong></td>
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<td>Leverage</td>
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</table>
1.1 Purpose of thesis

The purpose of this thesis is to introduce legal self-efficacy as a concept that is not only a measure of subjective risk but also as the best measure of legal effectiveness. Supplementary purposes include the demonstration that legal self-efficacy, as a part of private order mechanisms of risk reduction, is more efficient in reducing business risks than are public order systems of risk reduction using the granting of trade credit as a measure of business risk.

An equally important aspect of the purpose is to validate that legal self-efficacy works both for risk matching objective risk and as a booster of the activation of 11 different trade sanctions against business clients.

Another purpose is to find the causes of legal self-efficacy and yet another is purpose is to analyse whether legal self-efficacy can be improved with the use of personal experience as well as sources of legal knowledge, such as books, journals, films and TV.

The final purposes are to validate that unlisted firms change their leverage and debt maturity as creditor rights increase, and to confirm that legal origin is related to the level of debt and its maturity as well as to verify that creditor protection and institutional effectiveness can be substituted for each other when it comes to leverage and debt maturity.
What is especially striking and remarkable is that in fundamental physics a beautiful or elegant theory is more likely to be right than a theory that is inelegant.

Murray Gell-Mann

2. Theoretical background

This section discusses three areas of theory: Luhmann’s theories on law as communication and legal efficacy, the theory of the public and private mechanisms of risk reduction, and decision theory.

This thesis proposes that individuals endowed with legal self-efficacy – “Law Businessmen” – are more prone to take business risks than are other businessmen. Law is effective when end-users are comfortable with using law when making business decisions. When law is effective it reduces business risk. This perspective is novel since it views the legal consciousness of the individual as an independent variable that explains risk reduction in business. Most business and legal scholars consider businessmen’s legal consciousness as an exogenous variable that does not influence decisions involving risk.

The perspective that the thesis uses is closest to that of legal sociology which, as a rule, rejects the notion of legal centralism that “the only true law is the law made and enforced by the modern state” (Woodman 2008). The individual co-creates his or her perception of the laws and the legal system. The law is, like many other institutions, an institution whose value or power is what people charge it with.

Legal self-efficacy implies that laymen are comfortable with the use of legal terminology in all situations, including business decisions and communication with clients and suppliers. This idea is related to Luhmann’s view of law as communication and to Hirschman’s (1970) view of customer loyalty as a function of individuals’ estimation of their ability to communicate with a certain supplier. Laymen are loyal to the use of law as communication if it is a channel of communication that functions well. According to Hirschman’s concept of exit-voice-loyalty, consumers are loyal to a product if they feel that they can communicate with the supplier through the product (Hirschman 1970). The most valid approximation of legal efficacy in a population ought to be closely related to legal self-efficacy as the law has an effect in society only if legal communication is accepted as the law, with its inherent meanings and expectations (Torpmä and Jörgensen 2005).


2.1 Luhmann on the legal system

The thesis employs Luhmann’s theory of law as communication in its empirical studies on legal self-efficacy and in its conceptual study on legal efficacy. Luhmann presented a comprehensive theory of the legal system as an autopoietic system and of law as means of communicating social expectations. This section presents Luhmann’s theory of law as a theoretical perspective. In the next section we elaborate on the theory of the firm as a nexus of internal and external contracts. This is followed by a discussion of De Soto’s findings about the role of informal norms and the lack of a standardized legal registration as a cause of the backwardness of the developing world. The examples support the arguments on legal self-efficacy as a mechanism of the formal legal system.

According to Luhmann (1988a) systems are by definition cognitively open but operationally or normatively closed. Luhmann’s (1990, p. 121) definition of law uses “the possibility of conflict for a generalisation of expectations in temporal, social and substantial aspects” (Luhmann, 1990, p. 121). This definition is quite different from a standard definition, e.g., “the set of laws of a particular country and the way that they are used”, which includes jurisdiction but excludes the more ephemeral and the applicative aspect of law included in the Luhmann definition. The function of law is “the exploitation of conflict perspectives for the formation and reproduction of ... generalized behavioural expectations” (Luhmann, 1988b:347). As Luhmann (1990, p. 111) describes, the decision not to use the legal framework for handling affairs of everyday life is a decision within the system. The legal system includes all acts or failures to act that are selected by reference to its mode of operation. The legal system is responsible for thresholds and discouraging effects (Luhmann, 1981, p. 234). In order to understand this view of the legal system we need to explore Luhmann’s position in regards to the self-reproductive nature of law and the reflexive nature of the creation of law.

The legal system is a functional subsystem of society (Luhmann, 1982, p. 122). The independence of the legal system from society is a significant necessity but not an end in itself (Luhmann, 1990, p. 112). The legal system is open for cognitive information but closed for normative control. Luhmann’s position is that the legal system does not adapt to new norms that derive from outside the system, but rather only norms from inside the legal system can transform it. In light of breaches of institutionalised expectations such as violations of legal norms, the legal system counter-factually reaffirms those expectations (in the dualistic code lawful/unlawful) in accordance with its conditional programme on its own internal conditions (Luhmann 1989). The problems of the legal system can only be mended from within the system, as “No functional subsystem is able to solve the core problems of another system” (Luhmann, 1990, p. 121). This is a wide definition of the legal system – wherever it is possible to use the legal system is where the legal system is prevalent.

Luhmann (1982, 1993) considers the systems of politics and the economy as functionally differentiated from law. While the legal system is tied to the political system, e.g., through elections, as well as to the economic system, e.g., via property laws that are regulated in the constitution, social subsystems remain independent of one another in their respective modes of operation (Luhmann, 1992b). Luhmann (1990) divides the users of the legal system into
professional users and end users, “clients”. The clients are the lay businessmen, citizens and others who are not professional users but still represent the vast majority who are subject to the laws emanating from within the legal system. But in order to use law they have to be aware of the legal problem and define the situation accordingly. They also have to commit themselves to advancing legal claims or at least to communicate them. They participate in the legal system using its system reference to give meaning to their activities.

2.2 Luhmann on law as communication

“The legal system consists of all social communication that is formulated with reference to law”

Luhmann 1982 p.122

Luhmann suggests that the legal system is a system of communication that constitutes its autonomy in treating law as an autopoietic, or self-reproducing system of meaning and communication, rather than a set of institutional norms, practices or structures.

…the law differentiates out within society as an autopoietic system on its own, by setting up networks of function-specific communication which in part gives words a narrower sense, in part a sense incomprehensible for non-legal communication, in part adding coinages of its own (for instance liability, testament), in order to make the transformations needed by law communicable. Whether thallium is necessary in the production of cement and what consequences this has is not a specifically legal question. It may however be the case (or else not) that an environmental law develops that gives this question additional legal relevance.

Teubner (1988, p. 340.)

Luhmann has an all-inclusive standpoint on the nature of law as communication. Law is not limited to legal application in a contracted sense (Luhmann, 1982, p. 123). All communication that invokes law takes place inside the system to the degree that it is communicated or individuals anticipate communicating about law. The legal system includes correct or incorrect, lawful as well as unlawful, behaviour. The identity of the legal system hinges on this very disjunction. The legal system is not confined to communication within legal procedures, but it also includes the communication of daily life to the extent that it involves legal queries. Individuals are free to invoke or not to invoke law; the right to “juridify” a situation or conflict or not to “juridify” is every individual’s own choice. Law is in itself a causa passiva which on its own cannot make a choice. This sovereignty Luhmann refers to as invocation sovereignty. The legal system is available if the individual chooses to invoke its normative function. The use of law can include or avoid the use of the courts.
Luhmann’s theory suggests that legal modification can only occur because of changes within the legal subsystem itself: “law can regulate its own regulation, and thereby also regulate, legally, alterations in the law” (Luhmann, 1989). From Luhmann’s perspective, then, the construction of certain legal norms, as well as the extent and manner to which they change or are responsive to change, are conditioned by the legal system itself.

The nature of the legal system as a cognitively open yet operationally closed system is a precondition of legal transplants. Any legal system can adopt new laws from other legal systems using its own autopoietic structure of self-change. This usually occurs through legal experts who recommend the transplanting of exact pieces of law. Law is thus copied piecemeal from one legal sphere and transformed to fit into another system on the conditions of that legal system. The autopoietic characteristics of the legal system are maintained, despite change from the outside, from another legal system.

Luhmann (1989) refutes the supremacy of law’s relative autonomy and argues the interrelationships of different subsystems necessitate transformations into their respective codes of operation. Luhmann writes that the “legal system also depends on and has effects on other systems in its social environment” (Luhmann, 1994b). The legal system, as a “differentiated functional system within society,” also contributes to the replication of society as a whole (Luhmann, 1989). Although, Luhmann argues, modern law is at the level of its own operation completely autonomous and closed.

Luhmann’s view that law is effective when it is used to communicate social expectations – the “law as communication” perspective – is fruitful in that it allows for analysis of the everyday use of law by laymen. The problem of legal transplants is that they tend to estrange the population from the law that they used to know and that they cause a rupture with respect to the previous legal terminology and the underlying principles of how the law works.

2.3 The legal system and legal transplants

The familiarity and comfort that a population of end-users of law feels with the present legal concepts can be undermined by a) introducing alien legal concepts that do not fit into the receiver legal system, b) decreasing the relative utility of using legal terminology in communication when contracting in business, e.g., relative to other systems of social control, or just plain c) decreasing the legitimacy of using legal terminology in communication due to a decrease in the legitimacy of the legal system.

Mindless legal transplants to a receiver jurisdiction can lead to the effective development of all three of the abovementioned factors undermining legal self-efficacy. Closely related to the failure that consists of citizens losing their confidence in the legitimacy of their own legal system and subsequent avoidance of using legal terminology making references to it is an estrangement from the legal system. When laymen feel estranged from the legal system they start using other systems of social control. To this end we need to familiarize ourselves with the theory of legal transplants in order to understand the mechanism of the process of these threats to legal self-efficacy.
The definition of legal transplants by the most prominent scholar in the field, Alan Watson, is “the moving of a rule or a system of law from one country to another” (Watson, 1974). His thesis is that transplanting is the most fertile source of legal development (Watson, 1993, p. 111). Legal transplants have tended to take place historically as a consequence of initiatives of the receiver system (Ajani, 1995). This was certainly the case for Russia as well as all countries of Central and Eastern Europe in the early 1990s (Ajani 1995, p. 1). Russia has imported law from the West throughout its existence. The Russian legal system has roots in the Germanic legal family, only after the Russian Revolution many of the Germanic traits were abolished, but not entirely.

The process of legal transplantation is an ever ongoing process, and Russia, like most countries, borrows ideas and laws from other countries. It would seem that a brief introduction to the nature of legal transplants is in order here. The following summary gives the necessary tools for understanding legal transplants, and why they are sometimes successful but most of the time not. An example is the process of standardization of laws, e.g., the IAEA’s rules in its member nations (Jörgensen, 2008b).16

Legal transplantation is a hazardous project: the likelihood of failure is usually much higher than the chances of success.17 Academic debate on this matter has not rested much. One extreme position can be summarized as “all laws are legal transplants – the only way for law to evolve is through transplants”. According to Alan Watson, “legal transplants, the desirability and practicality of borrowing from another legal system” are the essence of comparative law in its practical conception, offering the prospect of making improvements to one’s own legal system. (Watson, 1978, p. 317–318) Watson concludes that “successful borrowing could be made from a very different legal system”, such as one at a different stage of development or with a different political structure, and that:

What … the law reformer should be after in looking at foreign systems [is] an idea which could be transformed into part of the law of his country. For this a systematic knowledge of the law or political structure of the donor system [is] not necessary, though a law reformer with such knowledge would be more efficient. Successful borrowing could be achieved even when nothing [is] known of the political, social or economic context of the foreign law.

The other extreme is Pierre Legrand (1997, 113–114) who claims that legal transplants are impossible at a fundamental theoretical level, because of the inability of legal rules to “travel across

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16 The author has, in a project outside of this dissertation for the Nuclear Power Inspectorate of Sweden, yet closely related to it, analyzed the process of legal transplantation of nuclear legislation to Russian Rostekhnadzor - Federal Service for Ecological, Technological and Nuclear Supervision. Russia is a permanent member of the United Nations and also subscriber to the Treaty of Non Proliferation is subject to a host of standards that regulate nuclear safety, issued by the International Atomic Energy Agency.

17 This discussion about legal transplants has been influenced by the discussion in Forsyth (2006).
jurisdictions … unencumbered by historical, epistemological, or cultural baggage”. Legrand takes Watson’s statement that the transplanting of legal rules is “socially easy” and subjects it to close scrutiny. But first, he takes a step back from the issue of whether legal transplants are feasible, by examining precisely what is to be “transplanted” or “displaced”: “laws”, or “legal rules”. A “rule is necessarily an incorporative cultural form … supported by impressive historical and ideological formations”, with a meaning or interpretation that is also socially and culturally embedded (Ibid., 114–116; see also Jerome Hall, 1980, p. 197)\textsuperscript{18} From here, Legrand’s argument develops as follows:

\begin{quote}
... [T]here could only occur a meaningful ‘legal transplant’ when both the propositional statement as such \textit{and} its invested meaning – which jointly constitute \textit{the rule} – are transported from one culture to another. Given that the meaning invested into the rule is itself culture-specific, it is difficult to conceive, however, how this could ever happen. … [A] crucial element of the ruleness of the rule – its meaning – does not survive the journey from one legal system to another. … Thus the imported form of the words is inevitably ascribed a different, local meaning which makes it \textit{ipso facto a different rule}. As the understanding of a rule changes, the meaning of the rule changes. And, as the meaning of the rule changes, the rule itself changes.

(Legrand 1997, 116-17)
\end{quote}

Legrand implies that a rule can of course be transplanted, but it will have lost its cultural, historical and legal context and it will not be understood in the same way in the new legal context. He states that at worst, a rule borrowed from one legal system to another can be “a meaningless form of words” (ibid., p.120). Legrand in essence states that laws can be transplanted, but legal rules cannot, since they are deeply culturally embedded. Transplanted laws can sometimes be considered “legal irritants”. This term was invented by Günther Teubner as a middle position between Watson and Legrand. He claims that some laws are easier to transplant and will be accepted, while others will be rejected. He uses the EU Consumer Protection Directive, which involves adaptation of the continental “good faith” principle to British contract law, as an example (Teubner, 1998, p. 11, 17). Good faith is a phenomenon of distinctively continental European character. Good faith was founded in the broader framework of German production and “Rhineland capitalism”. Good faith is firmly rooted in the specifics of German cooperative traditions that operate through its entire system. As a result, the transplant of the “good faith” principle was a failure in Great Britain, since it was not understood in Britain, lacking the wide acceptance needed for the principle to gain ground. The principle ended up irritating British legal culture considerably. There are countless examples of legal transplants throughout history. The most renowned work on the failure of legal transplants is about the endeavours of American lawyers who participated in legal assistance programs designed to reform Latin American legal education and legal systems (Gardner 1980). Legal transplants can occur inside a legal system, where a law, or idea, is borrowed from one sphere to another, but the most common legal transplant occurs from what the legislators in one system, usually a

developing country, wish to improve in their legal system by borrowing from a country that is considered successful in a particular field. Financial law is commonly borrowed from the United States\(^{19}\) and commercial law is borrowed from Germany\(^{20}\). Several commercial laws have been transplanted to Russia from Germany. The Russian legal system was built on the foundations of the German legal system: it was after 1922 that the heavily German-influenced civil law was obliterated to make place for Soviet law. More than a few nations have copied Swedish consumer protection law, social law, and health regulations in the 20th century.

Legal transplants can work – when the population adopts the new legal concept and uses it. The likelihood of this occurring increases when laymen are not only comfortable with the new legal concept but the concept fills a gap in the business vernacular. Legal transplants are relevant to legal self-efficacy in their effect on the comfort and familiarity that end users feel with legal terminology. A foreign concept that is transplanted to a receiver country has little chance of success since the culture-specific meaning built into the concept and the infrastructure that it works in may not harmonize. Legal concepts are like flowers that have grown in a fauna over hundreds if not thousands of years, the population grow accustomed to them and treat them as they were a property of the population. When a new flower is transplanted into new soil it may not be understood or used at all. Legal transplants can threaten legal self-efficacy unless they are successful and become useful concepts that are in demand by end users. Yet new law is needed in new economic circumstances, as in the case of Russia and the Commonwealth of Independent States, in which new laws, often legal transplants, were a necessity to permit the transition to a market economy.

The smaller the cognitive gap between laymen and legal concepts the more effective is law. Firms function in a legal environment regulating all commercial contracts, internal and external. The next section analyses the nexus-of-contracts view of the firm that includes contracts, skills and incentives, that has been advanced by Reve (1990).

### 2.4 The firm as a function of internal and external contracts

To understand the role of legal self-efficacy as a *perceived* skill in the context of the firm, it is helpful to refer to Reve’s (1990) theory, which combines skills, incentives and contracts. Legal self-efficacy has a given place in the firm as it affects external contracting, which is one of the core tasks of a firm. The Reve theory also adds life to the nexus-of-contracts theory, which can seem very abstract. Legal self-efficacy is a perceived skill that has direct impact on the firm’s contracting. Since contracts are a core concern of any firm, we can appreciate the significance of a perceived skill that affects risk in contracting behaviour from this perspective also.

The nexus-of-contracts view of the firm has been refined by Reve (1990), who has identified skills and incentives relevant to all contracts undertaken by firm. Williamson’s transaction-cost theory implicitly and explicitly relies on the contract in its search for the best governance mechanisms to coordinate economic transactions. The three critical dimensions for

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\(^{19}\) The United States is the world leader in stock markets with more than 50 percent of the world’s capital stock market capital.

\(^{20}\) Germany’s civil law – Bürgerliches Gesetzbuch (BGB) has exerted unrivalled influence on the civil law of most legal systems in continental Europe.
characterizing transactions are uncertainty, frequency of transactions, and the degree of durable transaction-specific transactions (Williamson, 1979, p. 239).

Let us first build on the assumptions of the theory of the firm. The theory and its assumptions are inspired by Reve (1990) who combines the behavioural and economic aspects of the firm by describing the firm as a function of contracts, skills and incentives. The major governance mechanisms in any economy are the market or the firm (Coase, 1937), with intermediary forms such as long-term bilateral relations (Williamson, 1979).

The definition of the firm according to Reve’s typology is:

A. Firm = f(contracts)

B. Contracts = f(skills, incentives)

Market transactions are governed by the price mechanism and by definition take place outside the firm. Market transactions include bilateral relations such as franchising, joint ventures, licensing, co-branding and other types of coalitions and long term agreements. The internal governance of a firm is that of hierarchy as defined by Williamson (1979). Internal governance is characterized by internal contracts that take place within the hierarchy of the firm. The two differ not only in terms of the setting of the transaction, but also in terms of the skills and incentives that are used.

C. Firm = f(internal contracts, external contracts)

The nexus-of-contracts view condenses the organization to viewing the firm as a proficient package of skills and incentives. Internal contracts should be limited to the core skill set of the firm, due to the high administrative costs involved (Reve, 1990, p. 137).

Core skills are, e.g., technology, know-how, design skills, or highly asset-specific knowledge in a very limited field or any distinctive capability that endows a particular business with a competitive advantage over its rivals.

D. Internal contracts = f(core skills, organizational incentives)

This thesis focuses on the role of risk mitigation in external contracts. The external contracts can be further defined as:

E. External contracts = f(complementary skills, interorganisational incentives)

The concept of “complementary skill” is used in the composition of organizational teams where each member has a different set of skills from the other members. Complementary skills are of medium-asset specificity. Interorganisational incentives are not applicable to internal contracts, only to external contracts. The interests of managers are determined by interorganisational incentive systems that may not fully align with the interests of the organization as a whole.
F. Firm = \( f(\text{core skills, organizational incentives, complementary skills, interorganisational incentives}) \)

The perspective of the manager is that of a person who safeguards the private property rights of the firm through the use of core skills in which legal self-efficacy plays a significant role. The strategic core is the *raison d’être* of the firm, defining its economic justification in an industry. The strategic core includes core skills, among which are organizational heuristics, and culture (Reve, p. 140). The strategic core also includes site specificity, physical asset specificity, human asset specificity and dedicated assets, i.e., specialized investments (Reve, p. 140).

The position of this thesis is that law permeates business life every day and is omnipresent. It coincides with the Luhmann position that the decision to use or not to use law is a decision made *inside* the legal system. Every formal contract is subject to the legal system. For Russia, however, the legal system, as embodied in the courts and in company law, plays an important part in the country’s transformation into a market economy. The external legal system, in terms of, e.g., the courts and business law, is not disconnected from legal self-efficacy. Not all external contracts can be measured and metered every day. This is especially true for relational contracts, which develop over time, or contracts for which the results are difficult to evaluate on any given day.

It is important to understand the perception-related quality of legal self-efficacy – that is, that individuals’ discernment of institutions, rules and sanctions plays a larger role for their behaviour than do the inherent qualities of institutions themselves (Opp, 1985) Legal self-efficacy is also a measure of how much an individual has internalized legal norms. Internalized legal norms are closely related to emotions – non-legal sanctions of the individual upon himself in terms of shame, guilt, and remorse. (Frank, 1987; Elster, 1996) The emotions of the individual are the sanctions that internal norms impose on the individual. This is significant for enforcing second and third-party sanctions as well. Norms enjoy a scale economy, i.e. a person who has internalized norms will be willing to pay a price in order to ensure that other people, while they may not internalize these norms, at least adhere to them (Cooter, 1996). It is therefore less costly to transact with a person, or a firm, who uses similar norms, as there will be no need to teach them or enforce them. An individual can communicate legal norms in various forms; a typical one is the use of contract, or oral communication with a client. Legal norms can also be communicated in oral communication with customers and clients. Typically, a manager who has internalized legal norms is comfortable using them in the course of business. The implications are that legal self-efficacy has an emotional side – that of self-punishment when legal norms are breached. It is also significant for written and oral communication with clients. A businessman who has a high level of legal self-efficacy finds it less costly to communicate with other likeminded businessmen. Legal self-efficacy can therefore help make law a focal point when doing business.

In this section we have learned from Hirschman (1970) how laymen are loyal to law as a channel of communication when they feel they can communicate with it – law can be both the medium and the message in the communication of social expectations. The legal system, according to Luhmann, is cognitively open but operationally closed, but at the same time it is omnipresent – everywhere where a decision is made to use or not to use law the legal system is present. Law is in
itself a *causa passiva* which on its own cannot make a choice. Every individual has the ability to invoke law at will. Law is effective when it is used in business decisions.

Watson (1993, p. 111) claims that transplanting is the most fertile source of legal development. He also claims (Watson, 1978) that transplants can be successfully performed from systems that are very different to the receiver system. Experience does not support this claim by Watson. When tracing the origins of law one often finds out that the origin is from another country. Most likely all legislations have borrowed law from foreign jurisdictions. Legal transplants are common, but not always successful. Le Grand (1997) claims that legal transplants are impossible at a fundamental theoretical level, because of the inability of legal rules to “travel across jurisdictions … unencumbered by historical, epistemological, or cultural baggage”. This type of legal transplant is a *legal irritant*. The success of legal transplants to Russia and other countries is somewhere between those two extremes.

Social norms are relevant to the failure of law in two ways (Galligan, 2003, p. 4). Firstly, they tend to undermine law as a distinct means of social regulation. Transplanted law risks being misunderstood by laymen depending on how well the transplant fits into the legal system framework already in place. The depiction of law as an external and irrelevant norm undermines respect for law. When law is considered unimportant, it is not likely to be internalized and gain added relevance for social use, such as trade. Another way that social norms are relevant to legal failure is where they conflict with the content of current law. When social norms compete with law, or contradict the law, and social norms win, this is cause for legal failure (Galligan, 2003) which we recall from De Soto and Mean’s accounts of failed legal transplantation in the developing world, including Colombia.

The section closes with a summary of the Reve (1990) typology, which places legal self-efficacy as a perceived skill relevant to the external contracts of the firm. Reve develops the nexus-of-contracts view of the firm to include incentives and skills in order to make the theory more complete. The combination of the nexus-of-contracts view of the firm and the Luhmann view of law as communication renders the firm a nexus of contracts as a function of skills and incentives, where contracts are a means of communication with external parties.
One doesn’t discover new lands without consenting to lose sight of the shore for a very long time.

Andre Gide

If you’re not a risk taker, you should get the hell out of business.

Ray Kroc

2.5. Public and private mechanisms of risk reduction

Businesses across the world use mechanisms of risk reduction, public and private, in order to manage business risk. Public mechanisms of risk reduction for business are not limited to written law, the courts and law enforcement. A public mechanism that reduces risk for business could also be a predictable and efficient bureaucracy that helps business manage and register property rights, e.g., intellectual property as well as physical property such as land. There are plenty of other examples, e.g., predictable and efficient accounting standards and tax regulation as well as export and import regulation. All of these factors play a role as public mechanisms of risk reduction. In this thesis we limit ourselves to measuring the effect of the courts and of law enforcement, but we recognize that all public mechanisms of risk reduction play an important part in business risk management. Moreover, businesses live in an intricate world where not all risks are easily separable. Most businessmen do not consciously analyse business risks as an inherent and recurring part of their business – instead they use their gut feeling and quick calculation. Business risks are multifaceted in complex world.

Private mechanisms of risk reduction are likewise not limited to lawyers, trade associations and legal self-efficacy, which this thesis covers. In order to reduce risks, businessmen often use strategies to minimize transaction and enforcement costs, such as relational contracting – if a conflict arises in the trade relationship, one or both parties end trade without further action. Other strategies include spreading rumours to other businesses about parties in breach. In families, social sanctions tend to work well. Any breaches of contract between you and your brother or uncle are more likely to be settled without the use of third parties from outside the family. The nature of sanctions depends on the “close-knitness” and physical proximity of the party in breach as well as the contractual terms of the trade relationship.

The legal systems in transition countries have developed quite rapidly, with a massive amount of new laws being issued constantly, with the result that the formal legal system has lost legitimacy. A decreasing effectiveness of the courts and law enforcement has been a common phenomenon, as even before the transition period they were seen as the instrument of political power. The questions that this thesis addresses relate to the individual as the source of measurement of the
effectiveness of the legal system when the legal system fails. The individual is the unit of research. The individual’s risk reduction capabilities are contrasted with the risk reduction provided by the legal system. This thesis uses the latest research findings in law and finance, law and economics, and legal sociology to find out if there is an alternative way to provide risk reduction among individuals beyond what is already known. This approach is novel in that it contradicts previous research efforts that have solely measured the effects of external institutions on economic performance. The thesis compares the impact of public vs. private-order mechanisms in order to test the efficiency of the concept of legal self-efficacy. Public-order mechanisms of risk reduction are, e.g., the legal system, which includes the courts, law enforcement and judges. Private-order mechanisms of risk reduction are, e.g., individual psychological characteristics, trade associations and lawyers.

Public and private-order mechanisms of risk reduction supplement each other. They do not replace one another. Internal institutions of risk reduction entail the psychological characteristics of the individual. The legal system, the courts and law enforcement are external institutions of risk, as are lawyers and trade associations. The comparison of the different mechanisms of risk reduction is based on transaction costs – the lower the transaction costs of a transaction the more efficient it is. The comparison is made between the systems based on one of the most common of all business transactions – trade credit.

Lawyers and trade associations are belong to the private-order mechanisms of risk reduction. Lawyers are transaction-cost engineers (Gilson 1984). They aid businessmen in reducing transaction costs and business risks when structuring transactions. Commercial lawyers help structure business in a more efficient and less costly manner. Previous research by Hendley et al. (2001) indicates that in the Soviet days lawyers performed menial functions in firms. This legacy has to some extent spilled over to the post-Communist era. Trade associations provide assistance to member companies in many ways, depending on the character of the particular association. They can provide legal support as well as conflict resolution services (the Stockholm Chamber of Commerce’s Institute of Arbitration is popular amongst Russian and Chinese businesses as a forum for of out-of-court settlement). Membership in a trade association can be conceptualized as social network capital. The private mechanisms of risk reduction are commonplace, yet there are few reported measurements on their risk-reducing effect on contracts.

2.6 What we do not know about public and private mechanisms of risk reduction

Despite a torrent of research on law and finance that uncovers the effects of legal families, legal effectiveness and the characteristics of creditor law throughout the world, not one study (to the author’s knowledge) has attempted to attack the issues of risk reduction, business sanctioning behaviour, corporate governance or external finance of firms by using the businessmen’s legal consciousness as an explanatory variable. The law and society research tradition studies legal consciousness and attitudes to the legal system, and is represented most notably by Ewick and Silbey (1998), who have found that individuals can decide to engage, avoid, or resist law in their
communication with other people. Scholars of law and economics or law and finance have not attempted to measure the effect of this aspect of legal consciousness on economic performance.

Businesspeople’s legal consciousness as a persistent predictor of business-risk reduction is not well researched. Many other psychological phenomena found in the realm of cognitive psychology, such as risk aversion, locus of control and extroversion/introversion, have been used to explain businesspeople’s risk behaviour. Few or no studies have used legal consciousness as a predictor of business risk with a persistent statistically valid result. We previously know of no trait that can be referred to as the legal consciousness of individuals that can be learned and taught – that we can in other words adapt in order to improve the legal consciousness of businessmen and women.

Legal effectiveness, as a measure of the effectiveness of the public order, is well known. Many researchers have provided their own definitions of legal effectiveness, often used to explain economic performance. Likewise, legal effectiveness has been used as a concept to explain the reception of foreign legal concepts to a new population of end users of law. Both uses of legal effectiveness are in want of a new definition that is based on the individual in order to better explain business transactions in relation to the legal system.

Research and evidence on the interactions of the public and the private orders is in short supply (Katz, 2000; Charny, 1990; McMillan & Woodruff, 2000). We know very little of how private and public mechanisms of risk reduction interact with or supplant each other. The benefit of knowing this is to find out how private mechanisms can be put to use where the public mechanisms fail, as is the case in many countries across the world. Far from being a perfect substitute for public-order mechanisms, private-order mechanisms can make up for many of shortcomings of the public-order mechanisms.

Sadly, we know little about the effects of lawyers on transaction costs. Previous researchers have stated that they do not know how to measure these effects. Gilson (1984) stated “A truly empirical approach to measuring the impact of a commercial lawyer’s participation seems impossible for a number of reasons. It is unlikely that we could find data covering both a sample of transactions in which a commercial lawyer did participate and a control group of transactions that were accomplished without a lawyer.” Jørgensen (2008) demonstrates that there is a straightforward way to measure the effect of lawyers on transaction costs.

The same holds true for trade associations. Trade associations provide excellent services to member companies, yet the effects of membership are not very well studied. Yet trade associations are a perfect example of a private mechanism of risk reduction (for a more elaborate discussion on this topic, see Jørgensen 2008). Many authors discuss the beneficial effects of trade associations, but none measure their effect on the transaction costs of private contracts.

In sum, we know quite a lot about the effects of the public mechanisms of risk reduction on business transactions thanks to the plentiful research on law and finance, yet we know sadly little about the effects of private mechanisms of risk reduction. And we know hardly anything at all about the effect of individuals’ legal consciousness on business transactions. As a result we also know very little about the comparative effect on transaction costs of the two categories of mechanisms – public and private.
Scholarship in law and finance, law and society, and legal scholarship would benefit from a concept that captures legal consciousness and that is globally applicable to measure the effect of legal consciousness on economic transactions, in order to find new ways to improve legal effectiveness, contractual assurance, reduction of risk in business transactions, sanctioning of behaviour, external finance of firms and the reception of foreign legal transplants to an economy.

2.7 Private order mechanisms of risk reduction

The private-order mechanisms of risk reduction dealt with in this thesis are individuals’ legal self-efficacy, lawyers and trade associations. Lawyers, particularly commercial lawyers, are economic as well as legal actors; they interpret the legal system and communicate with laymen. They are essential private-order actors as they help navigate the public-order legal system. Trade associations are chosen since they represent the collective effort of an industry to coordinate interests. All these three mechanisms play a role as reducers of business risk. In the section below, we will cover lawyers and trade associations; legal self-efficacy has already been covered previously, and will also be treated after this section as well.

2.7.1 Lawyers

Not much is known about the role of Russian lawyers in the provision of contractual support to firms. Hendley et al. (2001) find that lawyers are marginalized within the enterprise. Lawyers focus on established, routine tasks, such as labour relations or drafting form contracts, rather than on shaping enterprise strategies in the newer areas created by the transition, such as corporate governance or securities law. She further points out that the failure of in-house lawyers to emerge as agents of change in Russia reflects a continuation of their low status during the Soviet era and the lack of professional identity among these company lawyers. In Soviet times, lawyers played a minor role in business (Hendley 1999). The mechanisms of trade were placed mainly outside of the firms in the central planning committees and inside the Communist party. After the breakup of the Soviet Union, however, the need for lawyers increased, and they now serve to coordinate firm transactions, among other things. In Russia, lawyers are an advantage, yet they are not quite as indispensable as are lawyers in the United States. No more than about half of the cases in courts are unrepresented by legal counsel (Hendley et al., 1999). This is evidence that lawyers play a greater role in structuring business outside court than inside it, in Russian business. Hadfield stresses that lawyers are carriers of legal human capital. In her context “legal human capital” refers to the shared knowledge accumulated within the legal profession – the expertise of judges, lawyers, legislators, and law professors (Hadfield, 2007). Lawyers do have the potential to act as agents of transformation in economies that undergo reform (ibid.).

Commercial lawyers create value by constructing transactional arrangements that reduce insecurity (ibid.). Lawyers are engaged in developing approaches to private ordering that
minimize transaction costs (Felstiner et al., 1980–81). Lawyers reduce transaction costs by bridging businessmen’s cognitive cap when structuring transactions. They also function as contractual support for businessmen in legal recourse. Commercial lawyers do more than just law; they are at least as often involved in financial, accounting and business matters. Their function is also symbolic, in the sense that if laymen have confidence in commercial lawyers, they are more likely to take more risks, as they know that they can rely on their commercial lawyer for contractual support, both by structuring the deal, and as a legal counsel in court.

When there is a commercial conflict, the choice of norms to solve the conflict depends on a variety of factors, such as the efficiency and effectiveness of the norm (Felstiner et al., 1980-81; Engel, 1984). The lawyer’s role can be interpreted as that of a mediator between social and legal norms, between private-order norms and public-order norms. As such the lawyer becomes very valuable in a changing legal climate. The managers in our survey value lawyers more highly than judges as agents of conflict resolution. A client who knows how to use legal terminology will be more likely to be able to communicate with a lawyer and will not be screened out. Porat (2000) argues that if judges, being the most important part of the court system, deviate from their function, all sorts of compensation must then be carried out by private order. I argue that lawyers are one very palpable substitute for that, as this analysis demonstrates. Lawyers and trade associations have the same purpose of furthering the interests of their clients and members. Trade associations are a curious feature of the private order. Some large trade associations provide quite a few services to their members, while many provide just the very basic ones.

2.7.2 Trade associations

Trade associations pool resources for the benefit of their members and can be seen as an uncertainty-reducing device. An example of a private order is the trade association, which facilitates contracts under uncertainty. Trade associations do four things: a) they coordinate information about their members, b) they apply sanctions against members when necessary, c) they often act as forum for conflict resolution, and d) they can promote the interests of their members in society, e.g., by lobbying, etc. The vast changes in trading patterns that have occurred in transition countries have forced firms to find new clients and networks. These networks differ in their degrees of openness and competition (Grabher & Stark, 1997). Guilds, throughout history, created rules for transactions, with multilateral enforcement (Greif & Weingast, 1994).

The main raison-d’être of trade associations is the provision of contractual assurance and trade partners for its members. Trade associations coordinate information and serve as norm standardisers. Firms that have a special interest can form trade groups, which will uphold prevalent business norms. Trade associations provide information about their industry to others and can represent their industry to the government through lobbying. They can serve as expert advisory body to government in conjunction with the creation of new legislation. In addition to this, trade associations coordinate sanctions to members in breach of association norms. They

21There are various forms of trade associations, some which are very strong in all of these areas, and the other extreme, which performs virtually none of the functions above except granting membership to its members.
also coordinate information between members. In short, they provide several useful services to their members.\(^{22}\)

Membership in a formal organization can, among other things, formulate the law in ways advantageous to its organization’s members (Macaulay 1979). Some people belong to organizations that are regularly counselled by lawyers and others about their legal problems (Wasby, 1970). Trade associations help raise firms’ confidence in trade, especially if the association offers contractual support, to solve conflicts. Another function of trade organization is to disseminate information about contractual breaches and coordinate the community’s reaction to breaches. Trade associations and networks lower the cost of information gathering, resulting in better-informed manufacturers. Both business and social networks are significantly associated with trading locally, which suggests that geographic immediacy makes reputation easier to communicate. Fafchamps and Minten (2000) conceptualize membership networks as social network capital.\(^{23}\) They find that such networks have a strongly positive effect on trade. They divide social networks into three categories – relationships with other traders, which help economize on transaction costs; relations with individuals who can help in times of financial difficulties and insure traders against liquidity risks; and family relationships, which reduce efficiency, as opposed to the former two groups. They also find that the density of interpersonal relationships is significantly related to trust and information flows. One study finds no evidence that courts or trade associations support long-distance trade. Firms that believe that courts are effective are more likely to trade locally, and those who are members of trade associations are more likely to sell to distant buyers, but these results are not significant.

Pyle (2005) found that the marginal value of business associations increases when the parties are in different cities. The role of business associations in promoting the flow of information is sensitive to the degree of local competition in the members’ markets. McMillan and Woodruff (2001) found that neither courts nor trade associations support long-distance trade. Those who believe in the efficiency of courts are more likely to trade locally. On the other hand, another study found that business associations play only a marginal role in helping enforce contracts and spread information on prospective customers’ ability to pay (Hendley et al., 2001). Trade associations have many roles that reduce uncertainty for their member enterprises: they coordinate information about suppliers and clients; they report contractual breaches; and some even provide contractual support in case of a conflict with a client. All of these roles can be useful for an enterprise that decides to provide trade credit to a client.

The results strongly support Coase’s proposition that private contracting is more efficient than third-party contracting. One might be tempted to believe that the private order can do without the public order, but this is not the case. However, in this post-Soviet environment private-order institutions in line with the “New Law Merchant” (Cooter, 1994) win the day, in particular with regards to the versatility of lawyers who prove to be effective with all client groups. The most successful private-order mechanism for the provision of trade credit is the lawyer. Among Russian businesses, lawyers are an underestimated and underused resource as regards contracts.

\(^{22}\)While trade associations provide many different functions to their members, courts can provide far less services. This is an example of the richness of private order in comparison to public order.

\(^{23}\) For a brief introduction to social capital, see p. 1-3 in Fafchamps, M., and Minten, B., (2000).
The Law Businessman, i.e., a businessperson who has legal self-efficacy is the second winner in the private order. Confidence in one’s ability to use legal terminology has a strong and significant impact on private contracting in post-Soviet Russia. The framing of conflicts in legal terminology channels conflict resolution into legal means and allows for easier communication about legal sanctions with customers. It is no surprise that the Law Businessman, i.e. legal self-efficacy and the confidence in lawyers’ ability to solve commercial conflicts are positively correlated, as the lawyer is a professional user of legal norms. Human legal capital in terms of legal self-efficacy has significant impact on private contracting. The compound effect of the Law Businessman and of general public confidence in lawyers as a medium of private contracting sends a clear signal that legal norms and private-order mechanisms serve private contracting very well.

The study supports Hendley, Murrell and Ryterman’s (2001) observation that trade associations play only a marginal role in helping enforce contracts. Trade associations have a weak effect on local trade only and no effect on other groups of clients. The findings of Fafchamps and Minten (2000), that trade associations have a strongly positive effect on trade, are not supported. McMillan and Woodruff (2000) find no evidence that trade associations support long-distance trade. This study supports Pyle’s (2005) observation that the marginal value of trade associations does not increase when the parties are in different cities.

The policy implications are that programs for improving individuals’ trust in their own ability to use law can be at least as effective as efforts to improve formal legal institutions. The role of lawyers as mediators of transactions and interpreters between legal language and laymen’s communication is evident. It is therefore easy to agree with Jeffrey Sachs in that Russia needs more lawyers. It also needs more law businessmen who have a high level of legal self-efficacy. The findings in this paper warrant future research on the impact of legal self-efficacy and lawyers on other economic transactions, such as money-lending and borrowing between firms and banks in various comparative national contexts.

The private and the public order interact and influence each other. Lawyers, trade associations and legal self-efficacy are part of the private order of most if not all economies on the planet. They interact with the public order to provide a full set of mechanisms of risk reduction.

2.8 Public-order mechanisms of risk reduction

Some researchers seem to think that private enforcement is inferior to state enforcement of contracts, since private enforcement is more costly, creates competition of violence, is more difficult to monitor and often inhibits changes in economic institutions that could increase efficiency (Frye, 1997). Others seem to think that private substitutes to law can take the place of legal arrangements and create an environment conducive to economic growth (Cooter, 1996). Katz (2000) stresses that, nevertheless, public-order institutions are needed to provide public legitimacy for well-functioning private-order norms. Efficient public-order norms give legitimacy to private-order norms and efficient private-order norms can serve as examples of norms that
the public order can adopt. Private and public order can complement each other, but they cannot entirely replace one another.

2.8.1 Courts

Courts serve as guides to the interpretation and dissemination of legal standards to society. The strongest impact of the courts on the general population of enterprises is that of norm communication, which communicates what expectations should be associated with breaches of contract. The vast majority of firms are never sued, nor do they tend to engage in suing other firms. The results of this survey show that Russian managers consider that the courts function rather well. Many scholars agree with these findings (Pistor, K., 1996; Hendley, K., 2001; Hendley et al., 2001; Hendley et al., 1997). They also show that private firms deem suing another private firm to have reasonable prospects. They refrain, however, from suing state enterprises due to court bias. When Russian managers compare judges and lawyers in the role of agents for the resolution of commercial conflicts, lawyers come out ahead – see Figure 2, below.

The innate characteristics of the courts matter for enterprises, in both positive and negative ways. Previous research has shown that the most important features of courts are fairness and honesty, as opposed to their efficiency or ability to enforce decisions (Raiser et al., 2003). Powerful economic interest groups steer weak firms away from the justice system (Glaeser et al, 2002). The inequality of influence over government institutions has a strong negative impact on weak firms’ use of the legal system (Hellman et al., 2004). This can imply that weak private firms are less likely to sue a large state company for unpaid trade credit.

Measuring perception of the courts’ effectiveness, controlling for court use, is the most effective way to assess court impact on trade credit (Johnson et al., 2001). Perception of the courts’ effectiveness has previously been shown to have a positive significant effect on the granting of trade credit to clients. The courts have also been shown to have a direct impact on banks’ lending to enterprises, whereas their effect on trade credit is less significant (Shvets, 2005). Other effects of the perception of the courts have been shown, such as a significantly positive effect on the level of trust shown in new relationships between firms and their customers (Johnson et al., 2002). One study found that court effectiveness has a significant impact on local, but not on

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24 These results are corroborated by the findings of Frye, T (2002).

25 This paper shows that trust among businesses is higher where confidence in third party enforcement through the legal system is higher. It also found that a variable capturing the fairness and honesty of the courts was more closely correlated with trust than the courts’ efficiency or ability to enforce decisions.

26 The authors point out that when justice is subverted by powerful economic interest groups, other businesses tend to turn away from the justice system, with negative consequences for the whole economy. In many countries, the operation of legal, political and regulatory institutions is subverted by the wealthy and the politically powerful for their own benefit. This subversion takes the form of corruption, intimidation, and other forms of influence.

27 Kornai, J. and Rose-Ackerman, S. (eds) provide a preliminary investigation of the determinants of enterprise perceptions of the quality of the courts in the BEEPS, taking into account the role of interest groups and capture. The paper shows a consistent pattern in which the inequality of influence over government institutions has a strongly negative impact on assessments of public institutions that ultimately affects the behaviour of firms towards these institutions. The data suggest that the inequality of influence of weak firms not only damages their trust in these institutions, it also affects the likelihood that they will use and provide tax resources to support such institutions.
distant, trade (McMillan & Woodruff, 2000). Perceptions of Russian courts seem to not diverge very far from actual performance.

Russian courts require 37 steps before the recovery of a disputed debt. It takes 281 days to recover a debt, and the price is on average 13.4 percent of the debt. By comparison, in Sweden, there are 30 steps required before the recovery of a disputed debt, and the average recovery time is 508 days, the cost 31.3 percent of the debt. In the US, there are 32 steps, the recovery time is 300 days, and the cost 9.4 percent of the debt (Djankov et al., 2003) The comparison reveals that the Russian court system is not far behind Western countries when it comes to the formalities of debt recovery through the courts. In sum, Russian courts do function; however, there are serious flaws that deter private and weak firms from using them. It could be the case that it is businesspeople’s mistrust of the courts that deters them from using them.

Figure 2. Lawyers vs. judges: efficiency in solving commercial conflicts

<table>
<thead>
<tr>
<th>Lawyers</th>
<th>6.5</th>
</tr>
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<tbody>
<tr>
<td>Judges</td>
<td>4.8</td>
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2.8.2 Law enforcement in Russia

The primary agencies of law enforcement are the police – formerly known as militsiya, now known as politiya, after a police reform in 2011 – and the internal troops known as OMON (Special Purpose Mobile Unit). Both serve under the Ministry for Internal Affairs. The police reform led to a centralization of law enforcement agencies; they are now funded from the federal budget (Russia Today, 18 March 2011). Law enforcement agencies in post-Soviet Russia leave much to be desired. They have been reported to be underpaid and outnumbered (Hoffman, 1997). Their place is often taken by private armies and protection rackets. There are five recognized powers in Russia today: the executive power, the legislative power, the judicial power, the mass media and the bandits. The police are reported to have problems confronting a krysha, which literally means “roof.” As a slang word, krysha refers to a criminal protection racket, such as a gang that extorts money from a store owner. Many businessmen report that the use of a krysha is the only way to enforce a contract. Shopkeepers view private protection organizations primarily as a substitute for state-provided police protection and state-provided courts (Frye and Zhuravskaya, 2000). The research on law enforcement in Russia has focused on the general picture, researchers often painting a sad picture of the law enforcement agencies. Corruption is usually mentioned as one of the reasons for this. In a situation of debt recovery, law enforcement acts upon a court order only, and not preventively. Survey studies that measure the impact of law enforcement are in short supply. Most reports conclude that law enforcement agencies in Russia leave much to be desired.
Out of a large number of private and public mechanisms of risk reduction we have chosen three private mechanisms – trade associations, lawyers and legal self-efficacy – and two public mechanisms – courts and law enforcement – to test their effect on business contracting. Russia is a special case when it comes to the lifespan of these mechanisms, due to its recent break from the planned Soviet economy where trade associations and lawyers played a lesser if any role at all in contracting, which makes them quite a recent phenomenon and their effect particularly interesting to study. Legal consciousness in the form of legal self-efficacy was also a very curious effect to study. It was interesting to study the relative effect of trade associations and lawyers in comparison to the public mechanisms of the courts and law enforcement, which were also in place in the Soviet era, but which now serve under a renewed penal and civil code – the rules of the game have changed significantly.

We will now turn to the mechanisms of decision. Human decision making is fraught with various imperfections, which are useful to be aware of in relation to this present account of legal self-efficacy and decisions involving risk.

Nothing is more difficult, and therefore more precious, than to be able to decide.

Napoleon Bonaparte

2.9 The Mechanisms of Decision

In this section we look at previous research on the psychology of decision-making and see how this thesis contributes to it. The results of Jörgensen (2010) “Legal Self-efficacy and its Latent Causes: Human Legal Capital and Access to Information.” (the final paper in this thesis) are then discussed and its contribution assessed in light of previous research. In the subsequent section, Business Risk Reduction through the Use of Law, we look at previous research on sanction behaviour and the use of business sanctions, legal and non-legal.

The foundation of the anatomy of a decision, as described in neoclassical decision theory, uses the following assumptions:

1. A well-structured and specific goal to be achieved
2. Full information about the set of alternative means to achieve the goal
3. Full information about the consequences of each choice
4. Bayesian calculation of the best choice (probability of event*gain/loss of that event)
5. Assessment of the alternatives
6. Choice of the best alternative to meet goal criteria

A challenge to this notion of the nature of the decision was set out by Simon (1957) in his seminal work *Models of Man.* This work modifies the neoclassical model of human decision by adding more realistic limitations to this idealistic model of man. The term “bounded rationality”
was coined by Herbert Simon. Simon points out in *Models of Man* that most people are only moderately rational, and emotional and irrational in the residual part of their actions. Bounded rationality has been defined as actions that are “intendedly rational, but only *limitedly* so” (Simon, 1957). Torsten Veblen (1919, p. 73) characterized economic man to be

“…a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift about the area, but leave him intact.”

Unlike *economic* man, attributed with hyperrationality (i.e., perfect information about choice alternatives, perfect Bayesian calculation abilities, and perfect foresight of the consequences of all alternatives) Simon’s *administrative* man has bounded rationality – with limits in formulating and solving complex problems and processing, i.e., transmitting, receiving, storing and retrieving information (Simon, 1957). Apart from these inadequacies *administrative* man is *boundedly* rational, but not irrational (Simon, 1978). If it were not for bounded rationality all economic exchange, including all transactions, could be efficiently organized by complete contracts (Williamson, 1981, p. 553). Williamson recognized the powerful implications of bounded rationality and included it as one of two behavioural assumptions in transaction cost analysis. The other is that humans exhibit some degree of opportunism (ibid.). Enforcement of these contracts would be unnecessary if agents displayed no signs of opportunism, since every promise would be kept and remain valid. The impossibility of this renders the absolute majority of contracts *incomplete*.

Administrative man, short of being able to maximize his economic opportunities like his distant cousin economic man is left with “satisficing” (a portmanteau of *satisfy* and *suffice*) which is a strategy in decision-making that attempts to meet the first and best criteria of adequacy rather than find an optimal solution to a problem. Simon, who coined the word, pointed out that human beings lack the cognitive resources to maximize economic opportunity. People cannot usually imagine all the alternative ways to solve a problem, and cannot know the relevant probabilities of outcomes, let alone calculate the best of the alternatives. Humans can seldom evaluate all outcomes with adequate precision, and our memories are weak and unpredictable.

Since the organism, like those of the real world, has neither the senses nor the wits to discover an “optimal” path—even assuming the concept of optimal to be clearly defined—we are concerned only with finding a choice mechanism that will lead it to pursue a “satisficing” path that will permit satisfaction at some specified level of all of its needs.

Simon 1957:270–71

Simon proposes that economic agents employ the use of heuristics to make decisions rather than a strict rigid rule of optimization. Heuristics, in more precise terms, are strategies using readily available through loosely applicable information to control problem-solving in human beings and machines (Pearl, 1983). Calculation costs are high and there may be other parallel activities that require decisions. Economic agents that make decisions seek to achieve given goals within defined limits, such as “turnover”, “market share”, “maximum loss”, etc. These alternatives are readily measurable.

Further explorations of the bounded rationality of man have performed by Daniel Kahneman and Amos Tversky (1979), the originators of prospect theory. They demonstrate that humans are boundedly rational in numerous experiments where the probabilities are given in each calculation
of alternatives. The theory describes human decision processes as consisting of two stages, editing and evaluation. They reveal that human thinking is dependent on the phrasing of a problem. They also demonstrate individuals’ loss aversion. The problems encountered in prospect theory do not exclude managers, as managers’ decisions are impeded by the foibles of the heuristics of human decision-making not unlike all men and women. Mintzberg (1975) has preoccupied himself with analysing the roles of the manager.

Jörgensen (2010) is concerned with the analysis of the effect of legal self-efficacy as a managers’ complementary skill to maximize the utility of a firm’s external contracts. In its essence legal self-efficacy is a person’s belief about their own ability to use legal terminology, yet this belief can be considered a skill. Legal self-efficacy has an impact on the manager’s external contracts with suppliers and customers. It therefore has an impact mainly on the negotiator role of the manager. The manager has several different roles in the firm. Mintzberg (1975, p.57) identifies ten manager roles, which can be divided into three areas: interpersonal, informational and decisional. The decisional roles are: the entrepreneur, the negotiator, the disturbance handler and the resource allocator.

Legal self-efficacy as a complementary skill for use in external contacts concerns the manager’s role mainly as a negotiator but also as an entrepreneur and disturbance handler. The resource allocator role concerns hierarchical relations within the firm and is therefore beyond the scope of this study. In the entrepreneurial role the manager seeks to develop his unit and to adjust it to shifting circumstances in the environment. The negotiator role is an integral part of a manager’s job as he is the only one in his unit with the influence to consign organizational resources and he is also the only nerve centre for information required for essential negotiations. The disturbance handler role captures the involuntary response to outside high-pressure disturbances of his business. Even good managers cannot foresee all contingencies and must therefore be able to handle crises once in a while. The resource allocator role reflects the manager’s authority to assign resources in his organizational unit, not external contracts.

External contracts include suppliers and clients, as well as outsourcing of various services and production. Successful external contracting maximizes the utility of the firm in terms of low-cost acquisition of supplies, and higher sales. When it comes to focusing on the core skills of the firm, legal self-efficacy can aid in outsourcing the non-core tasks of the firm to subcontractors. The external contracts can be of both frequent and infrequent nature. The frequent contracts can be programmed. Programmed decisions can be thought of as repetitive and routine. They are decisions for which there is a definite procedure for handling that does not need new thought each time the decision occasion occurs.

Habit is the most general, the most pervasive of all techniques for making programmed decisions. The collective memories of organization members are vast encyclopaedias of factual knowledge, habitual skills, and operating procedures. Closely related to habits are standard operating procedures. The

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28 The term complementary skill is from the Reve (1990) typology as a skill key to external contracts; interorganizational incentives are the other set of functions needed to achieve successful external contracts. More will be explained about Reve’s (1990) typology in the next section about theory.

29 Interpersonal roles include the role as a figurehead, leader and the liaison role. The informational roles include those of the monitor, disseminator and spokesman.
only difference between habits and standard operating procedures is that the former have become internalized – recorded in the central nervous system – while the latter begin as formal, written, recorded programs. Standard operating procedures provide a means for indoctrinating new members into the habitual patterns of organizing behaviour, a means for reminding old members of patterns that are used so infrequently that they never become completely habitual, and a means for bringing habitual patterns out into the open where they can be examined modified and improved.

Simon, 1977, p. 50

Non-programmed decisions require thought and consideration. The decisions related to legal self-efficacy are of both kinds depending on the situation at hand. The majority of decisions taken in a firm are of a routine character. This thesis concerns mostly routine decisions with regards to the external contracts of the firm. The nature of legal self-efficacy is both subconscious and conscious. The nature of the decision at hand will decide to what extent a law businessman will use his or her legal self-efficacy to solve a business problem. External contracting can be both of a routine nature and of a specific nature. Legal self-efficacy is used as a coherent part of an individual’s decision-making heuristic. Considering that one of the salient features of a business is the multitude of standard operating procedures and programmed decisions, legal self-efficacy does have an impact on external contracting. The law businessman is the embodiment of the concept of legal self-efficacy.

2.10 Decision biases

Humans are by no means perfect calculators of risk. We are subject to a host of systematic miscalculations such as wishful thinking, optimism, overconfidence and availability bias, to name a few. There are several beliefs that can be attributed to repeated erroneous human miscalculation; some of the most common are anchoring, belief perseverance, availability biases, optimism and wishful thinking, overconfidence, affect, and similarity. Most businessmen possess mental faculties to calculate risks such as creditor risks in relation to lending money to clients, or to banks’ lending money to clients. Doing business is to a large extent trading in private property rights, which in the progress of deals includes protecting one’s

30 People often start with some initial value, often arbitrary and adjust from it. People do not adjust enough; the anchoring has a significant effect (Kahneman and Tversky 1974).
31 This phenomenon derives from evidence that when people have formed an opinion they cling to it too much and for too long, they do not adjust to reality (Lord, Ross and Lepper 1979).
32 The availability of an event in time and experience can affect a person’s assessment of probabilities, e.g.a person that has recently been in a car accident has a higher than normal wariness of cars (Kahneman and Tversky 1974).
33 People tend to cling to unrealistically optimistic views on their future prospects and abilities (Weinstein 1980).
34 People are overconfident in their judgments. People are also not well equipped with calibration when estimating probabilities. Events that they are certain to occur 80% of the time occur only 20% of the time (Fischhoff, Slovic and Liechtenstein 1977).
35 The affect heuristic concerns feelings of good and bad. Affective responses to a stimulus occur rapidly and automatically; note how quickly you sense the feelings associated with the stimulus words gold or cat.
36 The similarity heuristic leads us to believe that ‘like causes like’ and ‘appearance equals reality’. The heuristic is used to account for how people make judgments based on the similarity between current situations and other situations or prototypes of those situations.
own private property rights. When the systems of risk reduction do not provide the proper reduction of property risk, the businessman is left to his or her own devices in terms of the protection of private property rights.

2.11 Businessmen’s relationship to the law

The individual can decide to engage, avoid, or resist law in communication with other people (Ewick & Silbey, 1998). Empirical evidence indicates that business is not structured through law but through social relations. Macaulay and Ellickson’s studies describe how businessmen avoid the use of law: they prefer to use the usual handshake and not involve lawyers. Bernstein (1992) and Axelrod (1984) describe how reciprocity and reputation function as mechanisms of efficient trade – norms that can only work in close-knit groups or in situations where reputations can be monitored.

As a rule businessmen strive to avoid the use of law. If a handshake is enough, this is good. Businessmen strive to avoid the use of the legal system, since it is a third party and costly to use by parties in a conflict. Farmers, for example, prefer to settle their differences between themselves (Ellickson, 1991) as do businessmen (Macaulay, 1963). Strategies of risk reduction include the Axelrod tit-for-tat game used in relational trade. Relational trade is characterized by the lack of any written agreement; it can end at any moment. The punishment for deviation is the termination of trade (Macneil, 1985). The rationality is that whenever a breach occurs, trade halts. The precondition of this type of trade is repetition of transactions. When there is a contract between parties, and also when there is no contract, the legal system has standardized rules that than can be referred to and used as recourse of conflict resolution.

Law is contingent on conflict. Managers may choose to activate law or refrain from it. Law shapes the individual’s expectations, calculations of action and understandings (McCann & March, 1995). Lindenberg (1990) stresses the role of “framing effects” – the preferences and action space available to a manager depend on the way a situation is framed. In many disputes people may pick between several different types of norms (Felstiner & Sarat, 1980-81). The framing of conflict in legal spectacles is in itself contingent on an acquaintance with legal concepts. Familiarity with basic legal concepts makes communication using law possible. Luhmann (1981) considers legal communication in any environment, by anyone, to be performed inside the legal system. The legal system is thus a system of communication of social expectations. Luhmann has an all-encompassing perspective on the nature of law as communication. Luhmann suggests that the legal system is a system of communication that constitutes its autonomy in treating law as an autopoietic, or self-reproducing system of meaning and communication rather than a set of institutional norms, practices of structures.

2.12 Determinants of risk calculation

Previous research has identified three individual characteristics as likely determinants of risk behaviour: risk preferences, risk perceptions, and risk aversion (Sitkin & Pablo, 1992). Risk preference implies an individual’s enjoyment of the challenge that risks bring about. Risk
perception is defined as a decision maker’s calculation of the risk essential to a situation. Risk perception can be divided into three parts: 1) the decision-maker’s classification of situations, 2) calculating estimates of the extent and controllability of risks, and (3) confidence in those estimates. Risk aversion is usually referred to as an individual’s risk-taking tendencies. Every decision-maker has his or her own set of frames of problem-perception risk calculation. Self-efficacy has a significant effect on the individual’s risk assessment (Krueger & Dickson, 1994; Locander & Hermann, 1979). It is this individual calculation that is the foundation of the individual’s decision to engage in a certain behavioural pattern or not (Dowling & Staelin, 1994).

Human decision-making is fraught with imperfections. Yet most decisions display at least partial rationality. The way in which decisions are framed is a factor in decision-making. The framing of a decision in legal terminology increases the likelihood of risk reduction by means of the legal system. The repeated successful framing of situations of risk in a legal framework allows for more risk in subsequent decisions involving risk. The Law Businessman is able to reduce business risk by framing situations in legal terminology in every situation, despite decision biases and imperfections. The theoretical perspectives of the present thesis are presented in the following section.
What we observe is not nature itself, but nature exposed to our method of questioning.

Werner Heisenberg

3. Methods, research design, and paper outlines

The five research questions are addressed using one empirical survey study, one study with the use of data sets, and one conceptual paper. The research focus of each paper is elaborated in more detail in section 8.2, Table 2, as well as in chapter 9, which contains a brief presentation of each paper. All participants in the studies were businesspeople. This chapter presents the methods used in the field research for this thesis. A brief account of the research journey is included. The separate articles are also presented. In chapter 10 the results of the studies are reported and summarized, which is followed by a discussion.

3.1 General research approach

As was pointed out in the introductory chapter, the aim of this thesis is to explore the effect of legal self-efficacy on businessmens’ decisions involving common business risks. In order to reach this aim a survey study was devised, which resulted in three papers (papers 3, 4 and 5). A conceptual study (the second paper) was written that provides some of the theoretical underpinnings of the survey studies. A quantitative study (the first paper) based on panel data was included to provide a piece of traditional law and economics that underscores the established paradigm of the correlation between law, transaction costs and capital structure in companies.

3.2 Methods

The ontological perspective (perception of reality) of the researcher usually guides him or her into doing research that fits his or her research approach. The two approaches are different and are applicable to different kinds of research problems. A quantitative approach is related to a positivistic research approach – a deterministic view of the world. Quantitative research aims to establish causal relationships between certain sets of variables. The aim is generally to create a model that predicts certain relationships between variables, dependent and independent. The analysis of qualitative data, on the other hand, is undertaken to understand and interpret certain phenomena. A research question is not necessarily made prior to the commencement of the study. Some researchers think that quantitative research is more objective than qualitative
research. I personally see them as complements to one another, in line with Firestone (2005). The research question should determine which approach is used, not the other way around.

Assumptions about science can be divided into two dimensions – subjective and objective. The objective world, such as financial data, the valence of atoms or the properties of a chemical compound, contains objectively measurable facts. Using positivist epistemology the scientist establishes relationships between these facts and draws conclusions about their interrelations. Relationships are considered at face value.

While according to the alternative way of understanding social reality, individuals create their own world – it is subjective reality that determines the individual’s actions. The subjectivist approach to science is epistemologically anti-positivistic and ontologically nominalist; i.e., it denies the existence of universals – things that can be exemplified by categories and their interrelations.

Subjective perceptions of objective reality are another scientific perspective based on the individual’s psychological conditions. The perspective of positivistically inspired research is that what cannot be measured does not exist. Much quantitative research in law and finance has focused primarily on finding correlations between financial variables and legal institutional variables. This thesis makes an attempt to fuse objective reality with subjective perception and make predictions about risk behaviour.

3.3 Research approach of papers I and II

The first paper is based on a positivistic quantitative approach using OLS regressions that identifies correlations between changing creditor protection and leverage. The second paper is conceptual in nature. It argues for a new definition of legal efficacy that is based on the individual and his and her perception of their own ability to use law. Previous definitions of legal efficacy as solely based on institutional measures are argued against. This paper provides the theoretical starting point of the subsequent survey investigations.

3.4 Research approach of papers III, IV and V.

When a researcher wishes to investigate phenomena that occur naturally in a population, as opposed to secondary data, which can be manipulated, surveys are useful (Rigsby, 1991). The collection of survey data allows for exploration of variables; yet, because there is a difficulty in establishing cause–effect relationships in survey research, this method is used to establish how variables covary and under what conditions. Researchers use control variables to minimise alternative factors that explain correlations between variables. A proper theoretical framework functioning as a context of the investigation presents previous research and facilitates theoretical connections between the included variables.
3.5 Limitations

The samples from the surveys are not based on true random samples, but rather convenience samples. This can impede the generalizability of the results. Another problem can be that research on cognitive biases implies that people who score high on performance tests underrate their performance and those who score low overestimate their performance relative to others (Krueger & Mueller, 2002), which could affect data. This observation is supported by a small test consisting of six questions on actual knowledge of current merchant law that was performed in the survey, in which it was found that legal self-efficacy does not match actual knowledge of law. The test is reported in the third paper – “The Law Businessman”.

Other limitations to the interpretation of the results are the possibility of spuriousness. Spuriousness is the risk that the correlation between two variables is caused by a third variable. The inclusion of control variables can counteract this possibility. Had the test been redone, two variables, risk aversion and a brief IQ test, would have been used as controls to reduce the possibility of spuriousness. Age can contribute to under or overestimations of self-efficacy (Marakas, Mun & Johnson, 1998). It should be noted that other studies of self-efficacy – see for example Pajares (1996, p. 548) – do not include variables of risk aversion or IQ tests. Jurecska et al. (2011) demonstrate that IQ and self-efficacy can correlate, but that this can be culture-dependent.

3.6 Choice of sample and respondents

The selection of respondents in three cities in northwest Russia was based on the principles of a sufficiently large heterogeneous sample. The correctness of statistics depends to an extent on the size of the sample: the larger the sample, the lower the risk of large errors. Large samples are as a rule more accurate than small samples. Economic and practical circumstances limited the possibility of using random and probability-sampling methods. It cannot be stated that the sample is representative of the population of businesspeople in the northwest. The aim was to get a sample large enough to allow us to draw some conclusions with regards to businesspeople in northwest Russia.

3.7 Methods and research design

The survey was carried out by the author and his three Russian students among 246 enterprises between March and May of 2005 in St. Petersburg, Pskov and Kaliningrad in northwest Russia.77 The respondents were found among random samples of businessmen (146) in several trade fairs at Lenexpo and at the Petersburg Sports and Concert Complex in St. Petersburg, and among random samples of businessmen in Kaliningrad (50) and Pskov (50). We approached CEOs and

77My gratitude to Vyacheslav Eropkin in Pskov, and Olga Belova and Elena Osipova in Kaliningrad for assistance with collecting the surveys. I would also like to thank the Swedish Institute and Inga-Lill Norlin for two generous grants supporting the data collection in Russia.
top managers of each firm at trade fairs and directly at their offices. The response rate was 50 percent or above. The internal response rate of the questionnaires themselves was 80 percent or above. The sample is a mixture of a convenience sample and a random sample, in that it was random in terms of choice of respondents within the group of businessmen, but that the sample quantity is not quite sufficient for it to be considered a pure random sample.

3.7.1 The enterprises

Enterprises were represented from ten different industrial categories. Firms were from 5 to 7000 employees in size, with average firm size of 44 employees. The average time span of firm activity at the point of the survey was 9.5 years. Twenty-eight percent of the respondents were female, 72 percent male. Seven percent of the firms were registered on a stock exchange, while 8.3 percent were at least partially state-owned. Among the firms, 18.1 percent were open stock companies (OAO), and 30.3 percent were closed (ZAO), while the remaining 51.9 percent were of other legal structure or undisclosed. The mix between industry and services was 60–40, representative of the Russian economy as a whole. The distribution of companies was as follows: 0–10 employees: 26.5% (67); 11–30 employees: 27.6% (67); 31–100 employees, 24.3% (59); >101 employees: 12.6% (31); > 500 employees: 9% (22). The distribution of firm size has not been verified as representative of northwest Russia, but it is most likely not very far off.

3.7.2 The concept construct of legal self-efficacy

Self-efficacy is a measure of an individual’s self-estimation in a particular field. The formulation with “legal” in conjunction with “self-efficacy” is my own and has not to my knowledge been published in any academic journal or book prior to my first publication in 2006.38 The same holds for accounting self-efficacy, which is mentioned but not tested in this thesis.

Domain-specific self-efficacy, such as work self-efficacy, has a broader connotation than legal self-efficacy (Schyns, Paul, Mohr & Blank, 2005). Self-efficacy should be considered a person-in-context variable pertaining to an individual’s belief in his or her capability to perform well in a given situation or encounter (Cervone et al., 2004, Sadri & Robertson, 1993). Self-efficacy should not be treated as a general trait. In management studies, there is a tendency to use general self-efficacy as a disposition or trait – this reduces the explanatory power of the concept (Bandura, 1997). On the other hand, Judge and Bono (2001, p. 80) claim that generalized self-efficacy is “among the best dispositional predictors of job satisfaction and performance.”

The two statements “I am confident in using legal terminology” and “I know the legal system very well” both reflect the notion of being versed in the legal system and communicating with law. These two questions were chosen as they were deemed to best embody legal self-efficacy. The structure of the questions on self-efficacy is very similar to those of other studies as presented in Pajares (1996, p. 548). When surveying teaching efficacy Bandura (1993) phrased questions like this: “How much can you...?” completed by various teaching-related tasks – e.g., 1 (nothing) to 9 (a great deal), in “influence the decisions that are made in your school?”

38The only place where I have come across it in Google searches is in connection with Street Law’s Corporate Diversity Pipeline Program, see http://www.streetlaw.org/.
intervals of 1]. Answer options were 1 (nothing) to 9 (a great deal). And when Pajares and Miller, (1994) surveyed mathematics problem-solving self-efficacy they phrased the question as follows: “How confident are you that you could give the correct answer to the following problem without using a calculator?” [followed by 20 algebra or geometry problems – e.g., “Simplify: -6(x + (-4y)) + (-5)(3C - y)"], where the answer options were 1 (no confidence) to 6 (complete confidence) in intervals of 1. Shell et al. (1989) tested self-efficacy for writing skills using the question: “How confident are you that you can perform each of the following writing skills?” [8 skills presented – e.g., “correctly spell all words in a one-page passage”] using a scale from 0 to 100 where the student writes the number.

Pajares (1996 p. 547) argues that there is plenty of empirical evidence that specific self-efficacy questions better predict specific behaviour that do general measures of self-efficacy, since self-efficacy is specific for every field. Bandura (1986) cautions researchers to rely on general self-efficacy measures when trying to predict specific behaviours. It is safe to conclude that the measures of self-efficacy follow the standards used by previous researchers.

The full set of questions in both Russian and English can be found in the statistics appendix at the end of the thesis. Six of these questions are presented below, to give the reader an idea of the nature of the questions.

**I am confident in using legal terminology**

<table>
<thead>
<tr>
<th>I do not agree at all</th>
<th>I fully agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

**I know the legal system very well**

<table>
<thead>
<tr>
<th>I do not agree at all</th>
<th>I fully agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

There was also a brief test consisting of four questions to test legal proficiency in current Russian trade law. This test is printed in the fourth paper in the thesis. The measures of trade credit granted to customers and distance to customers used Likert scales. Large firms use legal sanctions more than do small firms, due to availability of resources to sue business partners. They also, as a rule, have larger volumes of business, and also less personal business, which all contribute to the increased likelihood of court adjudication.
The measurement of willingness to grant trade credit was done in a similar fashion with examples such as the questions below.

To what extent does your firm give trade credit to customers located in the same town?
To what extent does your firm give trade credit to customers in its social network?
To what extent does your firm give trade credit to customers found through its business network?
To what extent does your firm give trade credit to customers located out of town or abroad?
The answers to these questions are given somewhere between the two extremes “not at all”, to “always as much as they ask”.

The statistics appendix at the end of the thesis provides more information about biases in the firm sample. It also contains all of the questions, in both English and in Russian, used for the thesis, categorized by paper.

3.7.3 Statistical methods

Pearson correlations were used as the statistical method for this thesis. Pearson requires normal distribution and non-skewness of variables. Post-publication tests of distribution normality were done and it was discovered that two variables for sanctions in Jørgensen and Svanberg (2009) did not pass the skewness test. One reason for the skewness of these two variables was a low response rate for those two sanctions. This does not change the results of the paper other than the fact that we cannot draw any conclusions regarding these sanctions. For a full description of the statistics, please refer to the statistics appendix in the end of the thesis.

Controls for company size and court use were performed for Jørgensen (2008) to cancel out effects of firms’ granting of trade credit based on their legal activity. As a rule, large firms spend more resources on court adjudication owing to their greater resources, greater amounts of impersonal business, and larger volumes of business. In Jørgensen (2010) there is one control for company size and attitude toward protection from the nationalization of one’s own enterprise, to cancel out the effects of large firms since large firms are more likely to be nationalized than are small firms.

3.7.4 Research journey

This PhD project started as a full-time project funded by the Baltic Sea Foundation. The initial project idea was to study corporate governance in Eastern Europe with the use of datasets from Amadeus. This track continued and included law and finance studies in cooperation with Thomas W. Hall, which resulted in three publications, one of which is included in this thesis. In 2005, I thought there was a need for an additional source of data and research method. Few studies have been published involving Russian businesspeople, their legal consciousness and their attitudes to law. I had just come across the concept of self-efficacy and found it worthwhile to combine it with legal consciousness to form legal self-efficacy and test it on common business risks. Surveys using Likert scale questions were chosen as the proper instrument. The surveys
were carried out in northwest Russia in the spring of 2005 with the help of two generous grants from the Swedish Institute. In 2007 I took a break from my PhD project and took on a consultancy project with the Swedish Radiation Safety Authority to evaluate a bilateral legal aid project on nuclear law with the Russian counterpart Rostekhnadzor (Jörgensen 2008 c). The idea of this project was to provide Swedish expertise in nuclear legislation to Russia as support for its rewriting of nuclear safety legislation. There were no clear legal transplants in the sense that a Swedish law was transferred to Russian law; instead, two Swedish experts commented on drafts by Russian nuclear experts. This project was useful for both understanding how laws are made in Russia, and how they are obeyed by the end users. My professional involvement in the field of legal aid and academic background of publishing a paper on legal transplants and legal efficacy (the second paper in this thesis, Torpman & Jörgensen, 2005) opened my eyes to the good idea of combining academic knowledge with practical experience. More than this, the experience gave me insight into how certain laws, in particular highly technical laws, are really written – by a group of experts. The purpose of the written law and the reality of how, say, nuclear material is handled in Russia do not always have much in common. I also realized that Russia is the perfect place for testing the effectiveness of law – with all its development and non-development, from 1917 until today.

3.7.5 Choice of dependent factors

The choice of dependent factors such as the use of law, provision of trade credit, and business risks, in the form of the risk of privatization and customer risk, were chosen because they represent very common risks for almost all businesses across the globe. The risk of privatization was chosen since Russia has a notably hazardous record on the protection of private property rights in relation to government – particularly as regards the Russian Revolution and the subsequent disrespect for private property rights. All dependent variables are interval variables.

3.7.6 The assumptions of legal self-efficacy in a corporation

Individuals endowed with legal self-efficacy are Law Businessmen. Only individuals can make decisions; however, in many cases other individuals – groups – can influence a decision made by an individual. The survey methodology used for this thesis did not measure the factors that impact the decisions of groups but only those of individuals. This could be conceived as a methodological shortcoming if one assumes that only groups make decisions in enterprises. Many businessmen make decisions with regards to trade credit and trade sanctions, without consulting other people in the organization. Other factors that can affect decision-making about, e.g., trade credit include: the prevalence of credit history data or computer models that calculate creditworthiness. Organizations in their entirety can be considered to be “corporate law businessmen” if the corporation as a whole behaves as a law businessman. The corporate law businessman will perhaps be the subject of another study.
3.7.7 The use of law and sanctions

The Jörgensen and Svanberg (2009) paper is titled “Legal Self-efficacy and Managers’ Use of Law”. There are 11 sanctions that are tested in terms of legal self-efficacy, two of which are legal in the strict sense – *pretenzia* (the written threat of going to court) and the actual adjudication of a commercial conflict in court. The authors do not claim that all sanctions are legal in this sense, despite the title of the article. The point is that sanctioning behaviour, legal and extra-legal, is boosted by legal self-efficacy.

3.7.8 Weaknesses of method

In retrospect the design of the studies in this thesis could have been amended with a comparison with the application of standardized general self-efficacy questions, which would have allowed for a comparison between the legal self-efficacy measure and a measure of general self-efficacy, as proposed in Chen et al. (2001). The studies would have had improved measurements if measures of risk aversion and of mental capacity, such as a brief IQ test, had been included. That would have allowed for a more diversified analysis of legal self-efficacy, and also for controlling for effects that could be hidden in the data. Hmieleski et al. (2008) report that optimism and environmental dynamism have an effect on entrepreneurial self-efficacy. It is not unlikely that other personal traits as well as environmental factors can have an impact on legal self-efficacy.

Another possible improvement in the research design could have been to use a second population of respondents in another country, such as Sweden or Germany. Attempts were made to include these countries, but time and resource constraints impeded them. Also, it would have been useful to test perceptions and the use of more specific law applied to business, such as accounting, credit and IP law, in order to focus more on their effect on business risk. It would have been useful to test more types of business risks other than the granting of trade credit and the use of sanctions, e.g., investment planning and – Why not? – typical business risks such as export and import, currency risks and the risks involved in establishing a foreign subsidiary.

3.8 Paper outlines

Four of the five papers included in this thesis have been published in peer-reviewed journals and a book, and one is under review by a peer-reviewed journal. All of the papers focus on the interaction of law and business, approaching it from different angles. The first paper uses panel data from financial reports on European companies. The second paper is purely conceptual. The third, fourth and fifth papers test the validity of the concept of legal self-efficacy based on survey data gathered in northwest Russia in 2005.

Table 2 on the next page presents all five papers including their title, research question, research design, key concepts and main insights.
<table>
<thead>
<tr>
<th>Article</th>
<th>Main research question(s)</th>
<th>Research design</th>
<th>Key Concepts</th>
<th>Main insights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Variation and Capital Structure: Comparing Listed and Non-Listed Companies</td>
<td>What measure of legal efficiency best explains leverage and debt maturity?</td>
<td>GLS correlations applied to panel data.</td>
<td>Legal efficiency. Creditor rights.</td>
<td>Measures of transaction costs in bankruptcy found by empirical investigation benefit from not just focusing on law on the books, but also on the time, cost, and the likely disposition of the assets.</td>
</tr>
<tr>
<td>Legal Efficacy: Theoretical Developments Concerning Legal Transplants</td>
<td>What is the optimal way of measuring legal efficacy? How do legal transplants affect legal efficacy among laypersons in a jurisdiction?</td>
<td>Conceptual paper.</td>
<td>Legal efficacy. Legal transplants.</td>
<td>The best measure of legal efficacy is a distributed one based on laymen’s ability to communicate with the use of legal terminology, as opposed to previous definitions based on obedience to law.</td>
</tr>
<tr>
<td>Legal Self-efficacy and Managers' Use of Law</td>
<td>How does legal self-efficacy affect sanctioning of clients in relation to other mechanisms of risk reduction?</td>
<td>Pearson correlations applied on survey data.</td>
<td>Legal self-efficacy, client sanctions.</td>
<td>Legal self-efficacy is strongly positively correlated to the use of all categories of sanctions.</td>
</tr>
<tr>
<td>Legal Self-efficacy and its Latent Causes: Human Legal Capital and Access to Information</td>
<td>What are the sources of legal self-efficacy?</td>
<td>Pearson correlations applied on survey data.</td>
<td>Legal self-efficacy. Internal and external sources of information.</td>
<td>Legal self-efficacy, access to, and the search for, internal and external information concerning business risks each bring significant reduction of business risk in two separate but interrelated channels.</td>
</tr>
</tbody>
</table>
4. Brief paper summaries

As a service to the reader who is in a hurry five abstracts of the papers are presented. They serve as a very brief introduction. At the end of the thesis there is a brief summary, conclusions and discussion.

4.1 The first study

Using panel data derived from recent financial statements, we examine the relationship between changing creditor protection and leverage (and debt maturity) in a number of emerging market countries located in Central and Eastern Europe. We examine unlisted firms, which are more likely than listed companies to face credit constraints. Our main hypothesis is whether unlisted firms change their leverage and debt maturity as creditor rights increase. We confirm this to be the case at both the country and the firm level; our findings are robust to alternative econometric specifications and inclusion of country-level and firm-level controls. We also find that legal origin is related to the level of debt and debt maturity. Another finding is that creditor protection and institutional effectiveness can substitute for each other when it comes to leverage and debt maturity.

4.2 The second study

This study challenges the traditional notion of legal efficacy, which states that law is effective when behaviour is not in accordance with law. In this article a new effectiveness concept is developed. The study demonstrates how the poor functioning of legal transplants can be explained using our new approach to legal application and legal efficacy. The study lays the theoretical foundation and provides motivation for legal self-efficacy as a concept, that both enable the proper valuation of legal consciousness in relation to both contractual behaviour as well as reception of foreign laws – legal transplants. On a meta-level legal self-efficacy is a measure of the acceptance of current law as a means of communicating social expectations. As such it is a measure of the acceptance of the legal system as a valid and functioning part of society.
4.3 The third study

This empirically validates the effect of legal self-efficacy on the granting of trade credit on a sample of 246 managers in three towns in northwest Russia. The study demonstrates that, in terms of legal self-efficacy and lawyers, private institutions provide for better contractual assurance than do the public institutions of the courts and law enforcement agencies. Legal proficiency is demonstrated to have neither an impact on transactional behaviour nor any correlation to legal self-efficacy. This finding is in itself a signal to policy makers that legal proficiency alone is not enough to either provide contractual assurance or serve as a foundation for the establishment of legal self-efficacy.

4.4 The fourth study

This study demonstrates that legal self-efficacy has a strong and significant impact on the sanctioning behaviour of Russian businesspeople. Legal self-efficacy – and legal proficiency – or, the self-estimation of legal proficiency, has a significant impact on sanctioning behaviour, whereas legal proficiency does not. Legal self-efficacy mediates risk reduction for businesses. The psychological causes of sanctioning behaviour are not well researched.

4.5 The fifth study

This study presents and empirically validates a model of business risk, legal self-efficacy and behaviour. The model demonstrates how legal self-efficacy mediates risk reduction directly and indirectly via two types of behaviour. These behaviours are an internal and an external search for information pertinent to the situation at hand. The internal information search renders relational or tit-for-tat trade as the most effective risk reducing behaviour. The external search that mediates risk reduction involves finding information from print media, non-print media and human sources. The empirical findings of this study and the subsequent construction of a model can serve as a businessperson’s guide to risk reduction. The reduction of business risk can be achieved through two channels – one direct and one indirect. The indirect channel is also referred to as framing, as it includes a search for information that
frames the risk in a set of alternative courses of action. These alternatives are processes involving two stages of risk assessment and risk evaluation before an action is taken.
The strongest arguments prove nothing so long as the conclusions are not verified by experience. Experimental science is the queen of sciences and the goal of all speculation.

Roger Bacon

If…the past may be no rule for the future, all experience becomes useless and can give risk to no inference or conclusion.

David Hume

5. Conclusions and contributions from the Law Businessman

This thesis opens with statements by Moss (2005) and Bernstein (1996) on how the management of risk is a defining feature of any economy or society. The main unit of analysis of this thesis is the individual’s perception of his or her ability to use legal terminology. In this thesis we studied the effect of legal self-efficacy on decisions involving risk for 246 Russian businessmen only to find that legal self-efficacy does have an effect on these decisions. Legal self-efficacy is defined as a kind of distributed legal efficacy, which is the best measure of how efficiently law reduces risk in an economy. The study of risk in relation to law and business is a project with much promise, as business is inherently risky and law is all about reducing risks.

The thesis launches the idea that the effectiveness of law hinges on laypeople’s’ self-perception in relation to legal terminology. One interpretation of the effectiveness of law is its potential to reduce business risk. In legal studies and among economists, legal efficacy has previously been considered to be the result of the quality of formal institutions of law. This thesis applies a reversal of the perspective on legal efficacy as something that is produced by external institutions of risk reduction, to the affirmation that risk reduction is produced more effectively by the internal institutions of the legal consciousness of the individual.
Keeping in mind that the enforcement of private property rights is possibly the most important feature of the business and legal systems of every economy, the idea that legal efficacy hinges on the individual’s acceptance that the enforcement of private property rights is a function of the individual’s legal consciousness, or legal self-efficacy. We recall De Soto’s statement that the developing world is lacking in a formal system of representation of property rights. When laymen in the developing world acquire sufficient legal consciousness to claim their property rights, it could potentially lead to a more even distribution of wealth in these economies. But most importantly, when farmers in China, Brazil, and Indonesia use land that they cannot formally claim, without a formal title to “their” land they cannot obtain a loan on the property. This lack of formal ownership keeps millions of entrepreneurs from developing their business and increasing business productivity, which ultimately keeps the developing world in shackles.

The consequences of the affirmation of the idea that the effectiveness of law depends on the laymen’s legal consciousness are that legal institutions are to be considered not merely as products that are consumed by “actors”. But also that the actors create their own reality and it is this reality that is each and every “actor’s” reality that matters most not only for the consumption of institutions, but for their very production. Every man and woman lives in his or her own universe of self-perception. This universe has a greater impact on their business risk decisions than do the characteristics of the external products, or institutions. Institutions do not create people; people create institutions. People fill legal institutions with their own meanings, be they correct or incorrect.

The consequences for institutional scholars are that the receiver side of institutions plays a greater role than has hitherto been acknowledged. And perhaps the view that laymen are receivers is part of the problem. They are co-creators of their universe and as a consequence their own universe is what makes institutions meaningful. When law is used, consciously or unconsciously, as a factor in decisions involving risk, law is effective. And one point of this thesis is that this legal efficacy has a greater impact on decisions involving risk than do the external institutions. In this context it is possible to refer to the legal consciousness and the concept of legal self-efficacy as an internal institution, and this finding is in itself a novelty.

The ideal of legal efficacy as a question of legal consciousness on the individual level, the finding that an internal institution has a larger impact on business risk decisions, and the concept of legal self-efficacy are all new ideas. This notion runs contrary to legal centralism. Legal centralism implies that “the only true law is the law made and enforced by the modern state” (Woodman, 2008). From a legal centralist standpoint
“law is and should be the law of the state, uniform for all persons, exclusive of all other law, and administered by a single set of state institutions (Griffiths, 1986). Thus, according to legal centralism, “customary laws and religious laws are not properly called ‘law’ except in so far as the state has chosen to adopt and treat any such normative order as part of its own law” (Woodman, 2008). The contrary position, legal pluralism, is more in line with the findings of this thesis. The critics claim “How is law distinguished in a pluralist view from other normative systems? What makes a social rule system legal?” (Cotterell, 2006). Well, in everyday use, law is an institution like many other institutions whose value or power is what people charge it with, i.e., the social value that they give it.

Another novel concept of the thesis is its approach of dividing mechanisms of risk reduction into two – public and private – and testing legal self-efficacy as a private mechanism in comparison with the other mechanisms on some common business risks. It is in the comparison between different mechanisms of risk reduction that we can assess the true value of legal self-efficacy. The private mechanisms of lawyers and trade associations were compared along with legal self-efficacy to the public mechanisms of the courts and law enforcement. Legal self-efficacy came out ahead in almost all tests. Risk is omnipresent in all societies and economies. All societies and economies use public and private mechanisms of risk reduction to reduce business risk.

The thesis makes propositions in its introduction that it addresses through the research questions, which are stated in Table 2 in section 5.8. The main research question from the first paper is “Which measure of legal efficiency best explains leverage and debt maturity?” The paper demonstrates that the best measures of legal efficiency are the ones based on a firm’s actual transaction costs and not those in the law books. This holds true for both listed and non-listed companies. Listed firms hold less debt than do unlisted firms, presumably because the more dispersed ownership and higher requirements of information to the stock market are functional mechanisms of corporate governance. An auxiliary research question related to whether legal origin is related to the level of debt and debt maturity is answered in the affirmative. A third research question, which is answered in the affirmative, is whether creditor protection and institutional effectiveness can be substituted for each other when it comes to leverage and debt maturity.

Corporate governance in Russia and in many other former CIS countries is in a far from optimal state. We find that the major source of external funding to Russian firms is trade credit and that legal self-efficacy has a significant effect on the granting of trade credit. In a system where it is difficult to find affordable bank credit, legal
self-efficacy has an impact on capital structure. When we employ a wider definition of corporate governance that includes the issue of disciplining customers, we find that legal self-efficacy has a significant impact on sanctioning customers, which improves accounts receivable thus improving liquidity. Legal self-efficacy has an impact on the firm’s external contracts.

The second and third questions, “What is the optimal way of measuring legal efficacy?” and “How do legal transplants affect legal efficacy among laypersons in a jurisdiction?” were answered with a proposal of a new definition of legal efficacy as individual legal efficacy in relation to previous notions of this concept. The usefulness and versatility of the concept is demonstrated in its wide application to the problems of contracting in society. When we base legal efficacy on the level of the individual and his or her application and understanding of law, the notion of legal efficacy becomes as wide as it possibly can be. We use the Luhmann notion of the extension of the legal system to the decision to use or not to use the legal system in every possible decision where it could be applied and consider the non-use of legal terminology as the failure to use a legal way to solve a problem – and the failure of the legal system.

By widening the scope of the legal system to its everyday application by end users in every possible decision, we avoid the notion of law as an esoteric instrument used only by legal professionals. The effectiveness of the legal system is the extent to which it is used or avoided by the millions of laymen who make up society in their day-to-day conducting of their business. The extensive application of this new perspective on legal efficacy is demonstrated to be useful in the understanding of as seemingly remote concepts as private ordering of society, the effectiveness of legal transplants, contractual assurance, corporate governance and the reduction of business risk.

The fourth and fifth research questions, “How does legal self-efficacy affect business risk in relation to public and private mechanisms of risk reduction?” and “Does client category have an impact on the effect of legal self-efficacy on business risk?” were answered in the affirmative; private-order mechanisms of legal self-efficacy and lawyers are more efficient in mediating private contracts in Russia today. The consequences of this result are that risk reduction for firms of all categories is best provided by individuals’ legal consciousness, which can be developed by improving, and increasing sources of legal information, as reported in Jörgensen (2010). Lawyers are an underestimated part of private-order mechanisms of risk reduction.
The law businessman paper (Jörgensen, 2008) has demonstrated the value of private institutions when the public ones fail. Because when businessmen need to do business, they will use the mechanisms of control mediation that work, and not the ones that should work. In response to the question “Which governance mechanism best coordinates the disparate plans and interests of the various individuals who make up society?” and to Adam Smith’s notion of the invisible hand of the market that will lead to the optimal allocation of all resources to their utmost and superlative ends, this thesis demonstrates the significance of private institutions in terms of the legal capital of the individual and the lawyer as a proponent of risk reduction in private ordering. Human legal capital in the form of legal self-efficacy is shown to better mediate contracting in terms of trade credit than public institutions. The lawyer, also referred to as a transaction cost engineer, is also shown to mediate private contracting in terms of trade credit. The lawyer is also regarded as a better mediator of commercial conflicts than are the public institutions of commercial law and the courts. Trade associations are found not to mediate contracting. There were conflicting findings about their effect in previous research.

The concept of legal self-efficacy is a complement to the currently most known theories in law and economics, such as the Coase theorem, and ideas from behavioural law and economics, such as the endowment effect. Legal self-efficacy enables the individual to feel that he or she can use legal terminology to control outcomes in the firm’s external contracting. It can be taught to businesspeople to improve their contractual abilities. Individuals endowed with legal self-efficacy can be dubbed law businessmen, or law businesswomen.

The response to the question inspired by Williamson and Smith is then that the private-order institutions, in terms of businesspeople’s legal self-efficacy and lawyers, mediate contracting ahead of the commercial courts and law enforcement agencies. Or to be more precise, private legal capital, in terms of businessmen and lawyers, outdo public legal capital, in terms of commercial courts and law enforcement agencies, and the private network capital of trade associations. This observation suggests that human legal capital has unemployed potential for explaining contractual behaviour in general, and financial transactional behaviour in particular.

It is an established fact that very few people make decisions on the basis of clear data and probability calculations, regardless of the situation. People neglect normative rules and make decisions based on their gut feeling. The descriptive theories of Simon (1976) suggest that people suffer from bounded rationality and a lack of imagination in coming up with alternatives to solutions of problems, difficulty with assessing probabilities of events, problems with interpreting probabilities.
(Kahneman, D., & Tversky, A., 1979). Among the tools that can be used to improve decision-making are, e.g., computers and computer models. Numerous studies of businessmen as well government agencies suggest decision-support technologies, i.e., procedures developed for the generation, evaluation and selection of alternatives, have had only limited impact on decision-making practice and quality (Brown et al., 1992). Government decision-making has also been subject to considerable activity in terms of decision support; yet decision-makers rarely use modern decision-support technology (such as computer support) to help them make up their minds (Brown, 1987).

The sixth research question, “What are the sources of legal self-efficacy?” was found to be various sources of legal information, such as friends, movies, and magazines with legal content. Legal self-efficacy was found to be a parallel to Hirschman’s original idea that customers become loyal not through repetitive trading with a supplier, but through their feeling of confidence in their ability to communicate with a supplier. When businessmen felt confident in the use of legal terminology, legal self-efficacy was found to mediate the use of a host of sanctions against defaulting customers. The legal proficiency of the individual businessman was tested to verify its impact on sanctioning behaviour. There was no correlation between the two, and the reason behind this was speculated to be that the choice made by the individual is not a conscious choice. The hypothesis that behaviour is not conscious or calculated is supported by a growing psychological literature. The leading paradigm maintains the position that behaviour is mostly under conscious control (Bargh, 1989). Yet there is growing confirmation that behaviour is selected through habitual processes in which attitudes, thoughts and behaviour are activated without consciousness or awareness, which invites the interpretation of our results in terms of automatic stereotype activation.

The conclusion is that an individual’s choice whether or not to interpret a situation in a legal perspective is made on the basis of automatically produced perceptions and feelings, despite the fact that the ultimate decision appears to be conscious. Even when the individual adopts a calculative judiciousness for his/her choice the pre-processing of information is routine to a large degree. An automatic influence on the individual was especially effective when the individual was not aware of the potential for any such non-conscious influence (Herr, 1986).

Legal self-efficacy was tested on a set of business situations related to external contracts of the firm, such as the perceived risk of nationalization and customer risk. They were found to correlate through a direct and an indirect channel. The indirect channel mediates risk in five steps: risk framing, internal information search, external
information search, risk assessment and risk evaluation. Internal information was: previous experience with filing a complaint against an enterprise with the antimonopoly committee, and forcing a company to pay a financial penalty. External information was access to the legal journals and to the newspapers Rossiskaya gazeta, Ekonomika i zhizn', Sobranye zakonodatel'stva RF, and Vestnik Vyshego Arbitrazhnogo Suda. The other sources, in terms of impressions and knowledge, respectively, of external information, are foreign movies, domestic movies, and soap operas on TV, newspapers, books, my friends, and my colleagues. These sources of legal information mediate risk reduction separately. Legal information from many different sources contributes to legal self-efficacy. The direction of the correlation between sources of legal information and legal self-efficacy cannot be determined. It cannot be ruled out that legal self-efficacy has a positive effect on access to these sources of legal information. The two different factors legal self-efficacy and sources of legal information most likely mutually reinforce each other. The conclusion is that there is a direct positive effect of the various print, cinematic and social sources of legal information available to the population on the level of risk-taking in some business decisions.

Legal self-efficacy is conducive to risk mediation through improved skill in searching for legal information among external sources. Risk mediation through the indirect channel occurs through the interaction of legal self-efficacy and the search for internal and external information relevant to business risks in external contracts. The internal information search shows that legal self-efficacy positively correlates to two types of sanctions: filing a complaint against an enterprise with an antimonopoly committee and legal self-efficacy, and forcing the enterprise to pay a financial penalty. The external information is a combination of three elements of written sources of legal texts and other sources in terms of impressions and knowledge, as well as that of external information in terms of foreign movies, domestic movies, TV soap operas, newspapers, books, friends, and colleagues. These internal and external sources of information were then found to be positively and significantly correlated to the two business risks – the perceived risk of nationalization and customer risk.

The mechanism behind the relationship of legal self-efficacy and the search for legal information internally is likely the result of the internalization of legal norms in the sense used by Luhmann and Berkowitz, Pistor, and Richard, “for the law to be effective, it must be meaningful in the context in which it is applied so citizens have an incentive to use the law and to demand institutions that work to enforce the law” (Berkowitz et al, p. 166). In other words, the risk model is a confirmation that law and legal sources are a significant source of risk reduction and that law does play a role in business. It is also a sign that when technology does not seem at this point to
help us make decisions involving risk, legal self-efficacy can help, through both a direct and an indirect channel.

The seventh question, “How does legal self-efficacy affect sanctioning of clients in relation to other mechanisms of risk reduction?” was answered in the affirmative. Legal self-efficacy had a stronger impact on the use of sanctions than did the perceived effectiveness of institutions. This raised the question why the individual’s concept of himself as a competent user of law is so important to his/her decision to use law? Why is one’s opinion of oneself more important to this decision than perceived institutional effectiveness? This question seems to not have been raised before as the effect of self-efficacy has not been previously tested. The answer to this question can be that self-efficacy as the individual’s perception of his or her ability to act is much closer to the framing of a decision than is any courthouse or the law text regulating business. In any given situation, a person’s self-efficacy moderates his or her behaviour better than the effectiveness of external institutions.

The thesis uses a nexus-of-contract perspective on the firm in order to focus on the pervasiveness of the contractual nature of the firm. Legal self-efficacy is found to be a complementary skill with which managers maximize the utility of contracting with parties external to the firm. Legal self-efficacy is thus found to be an instrument for contracting on the market as opposed to it being a skill to be used inside the hierarchical structure of the firm.

Given the relative ineffectiveness of legal institutions in Russia, our results regarding the use of law seem illogical in one respect, namely that a person may choose to apply a legal perspective even though he or she recognizes that legal institutions are inefficient if the person feels highly competent in using law. The latter should not in itself determine motivation to use law, for despite good legal knowledge and ability, a poorly functioning court could ruin the attempt to determine a relationship by legal means. Persons cannot rationally calculate the outcome of legal use if poorly functioning legal institutions are ignored. Consequently, the choice to use law appears to be a decision more driven by the application of an individual’s identity to a situation than a rational calculation.

This study has assumed that the more confident a person is about using legal terminology for defining and communicating issues, the more prone the person will be to do so. The assumption stems from Hirschman’s (1970) classical work on loyalty, which has formed the basis of a considerable amount of theory on customer loyalty and service quality. According to Hirschman’s original idea customers become loyal not through repetitive trading with a supplier, but through their feeling
confident in their ability to communicate with a supplier. Thus, what people believe about their ability to communicate through a channel or a set of concepts constitutes loyalty towards the supplier, but notably in this respect, loyalty also to the communication channel and the set of concepts they use. Similarly, the legal efficacy concept developed by Torpman & Jörgensen assumed that law is effective when it forms the basis of social expectations (Torpman & Jörgensen, 2005). When people feel confident using legal terminology for communication they will tend to communicate legal meaning, and when other people communicate with them through legal concepts they will tend to respond using legal terminology. They will not reject the idea of referring to law, although they may reject the legal statement and propose another legal interpretation of a relationship that is more favourable to them. This idea of referring to legal application as rejection or acceptance of communication stems from Luhmann’s communications approach to the legal system.

The communications framework leads to productive conclusions. While the conventional approach to the study of legal transplants’ inadequate effectiveness, particularly the “transplant effect”, has claimed that the formal institutions of the receiving country are the impediment to effective law; this study has found that that claim is questionable. Not even when the tendency to approach a court of law is treated as the main form of legal application could the classical approach be supported by the data of this project. On the contrary, the hitherto untreated features of legal application, i.e., individual’s self-descriptions, form a better predictor of legal behaviour. This fact raises the following questions: Why is the individual’s conception of himself as a competent user of law so important to his or her decision to use law? Why is one’s opinion of oneself more important to this decision than perceived institutional effectiveness?

The legal origin theory as promoted by LLSV predicts that a country’s legal origin influences its laws, regulations, its level of external finance, contract enforcement and the security of private property rights (La Porta, 2008). The verdict is that common law jurisdictions come out ahead of civil law countries an all accounts. LLSV make the claim that legal origin alone is the prime cause behind all of these benefits. This thesis argues against the LLSV legal origin as a single factor explaining the business environment of a country. The legal origin of a country can have an influence, but it omits the influence of the receiver-end factors, such as legal self-efficacy. For example, this thesis shows that legal self-efficacy is a better determinant of external finance (in terms of trade credit) for companies in Russia than is the appreciation of the effectiveness of legal institutions. This fact alone shows that legal consciousness has a key influence on the external financing of companies apart from the legal
family explanation. This finding is in stark contrast with the results of LLSV (2000), which argue that the significant differences in access to external finance are due to creditor protection laws.

Most all scholars of corporate governance agree that there are countrywide differences, while the debate continues regarding the relevant dimensions of difference and how to best explain them. The initial papers published by LLSV regarding the link between law and finance spurred a debate as to the depth and breadth of the link between legal family and the level of companies’ external financing. One might be inclined to agree with Aguilera et al. (2009) that the legal origins theory is “inaccurate, incomplete, and important”. Pistor (2009, p. 1648) argues that the theory suffers from three distinct drawbacks: (1) the extrapolation fallacy, (2) the transmission problem, and (3) the exogeneity paradox. There are more drawbacks in that the theory only looks at one side of the problem – the institutional side – and ignores the end users of these institutions. Just because a country reduces the amount of steps required to register a company from 21 to 19 does not imply that businesspeople in the country are doing better business. We know sadly little about how they feel about these 21 or 19 steps, or how they grapple with the red tape of doing business. In essence all these steps are rules or laws to which a law businessman most likely would have a less tense attitude than would a non-law businessman. The same goes for the amount of steps it takes to enforce a contract, or the other eight categories of measures of the Doing Business project. The Doing Business project

This thesis has demonstrated that legal self-efficacy can supplement the theory of legal families as proposed by LLSV, by adding factors from the reception side of legal institutions. One of the inherent problems of the theory and its subsequent World Bank empirical research project, Doing Business, is the total rejection of any factor that is not a measurable external institution. As mentioned in the beginning of this thesis, the relationship between the players and the rules is not static and is also bound to be related to national characteristics and factors such as Hofstede’s (2001) cultural dimensions, locus of control and risk aversion. There is no shortage of measures of psychological evaluation of businessmen. The legal origins theory and Doing Business suffer from these obvious shortcomings and one could expect the psychological assessment of businessmen to be included in order to obtain a theory that better captures the complex relationships between law and business and law and finance, in particular external finance.

Technology does not at this point lend itself to improve the methods and measures of risk reduction, leaving it up to us to accurately assess risk in business situations.
Consumer behaviour research has long focused on the situation of purchases in relation to risks, and information search related to this specific situation (see, e.g., Bettman, 1970, 1971, 1973, 1975, 1979). The models related to this consumer research lend themselves to further modification for use in connection with business risk. The model of Cho and Lee (2006) was modified to explore the connection between legal self-efficacy and perceived risk related to a firm’s external contracts.

5.1 Contribution to domain literature

This thesis introduces legal self-efficacy – an autopoietic concept that can be captured in the question “How comfortable are you with the use of legal terminology?” The scientific context of self-efficacy is rooted in cognitive psychology (Bandura 1981). The purpose of this concept is to fill a void in previous research on the relationship between the individual and the legal system from the perspective of risk that exists in many fields of research owing to the omnipresence of law in the economy. The relationship between the individual and the legal system carries significant impact on laymens’ decisions involving risk in business contracting and in the application of property rights, as well as in the primary application of legal concepts in everyday life. An important characteristic of legal self-efficacy that sets it apart from other measurements of subjective risk is that it is a) autopoietic, i.e., self-referential, meaning that the respondent makes a self-evaluation of his or her ability to communicate using legal terminology, and b) it measures the communicative aspects of law and therefore its effectiveness according to the thesis that law is effective when it is in contact with society, and lastly, c) it is a measurement of subjective risk strictly in relation to the legal system. This opens up a whole range of possibilities to explore individuals’ relationship to the all-embracing aspects of the legal system and to the many situations in business.

Legal self-efficacy is tested empirically to verify that it is conducive to taking business risk. Unlike risk aversion – the common concept in economics that is concerned with individual’s relationship to risk – it is a standardized measurement of the individual’s relationship to their self-evaluation of their own ability to use legal terminology. The main proposition of the thesis is that legal self-efficacy is the best measure of legal efficacy since it is a measurement of the distributed legal efficacy of a population.

It also enables businessmen to take more business risk than do the public mechanisms of risk reduction such as law and the judiciary. The thesis claims
that legal self-efficacy, as an inherent part of private mechanisms of risk reduction, works better than the public mechanisms of risk reduction, such as written law and the judiciary. It also claims that legal self-efficacy boosts the use of other institutions of contract enforcement. Legal self-efficacy enables Law Businessmen and women to do business in environments of high objective risk by employing risk matching.

The findings of this thesis have implications for several domains of research, including: legal doctrine, law and finance, law and economics, and legal sociology, and also indirectly in areas where rules are used and analysed in relation to economic outcomes such as accounting and behavioural accounting. The research fields of corporate governance are a set of fields for which this thesis has implications. Law and development as well as development economics are other fields for which there are research implications.

Legal self-efficacy is also a measure of legal efficacy in that law serves as a focal point of social expectations in communication between people of all walks of life. For legal scholars, legal self-efficacy provides a concept that can be used to analyse the end user perspective on law and its consequences for the acceptance or rejection of law as a means of communication. According to the conventional approach in legal doctrine, law is effective when it is complied with. It is ineffective when it is breached (Austin, 1954; Ingram, 1983). The law and society school has often defined compliance as a question of coercion. Law is complied with if there is effective law enforcement. Thus effective law and law enforcement have been identified as being practically the same thing. According to this perspective law is something that needs to be obeyed – law is more or less tantamount to coercion.

This previous definition is in stark contrast with the new definition of legal efficacy, which relies on the Luhmann view that law is effective when it is in contact with society, and that it is used as a means of communicating social expectations. This definition is close to that of the economists Berkowitz et al. (2003), “for the law to be effective, it must be meaningful in the context in which it is applied so citizens have an incentive to use the law and to demand institutions that work to enforce the law.” Typically business scholars who apply themselves to uncovering the effects of the laws, judiciaries and legal families on the economics of the world spearhead the field of the interaction of law and business. The insightful comment of Berkowitz et al. is a rare insight into the usefulness of legal concepts and the legal system among economists. The law and finance literature is aflush with findings of the effect of legal families on firms’ financial structure. The literature of corporate governance is concerned with the legal systems and mechanisms that curb opportunistic behaviour.
among owners, board members, managers and investors. Legal self-efficacy as a concept has potential for the field of research on corporate governance since it can be used to analyse the relationship between businessmen and the legal system, and of their subjective risk in relation to the legal system. For maximizing profit, owners may wish to employ managers who are willing to take not just any risks, but risks in relation to the opportunities of the legal system. Managers who are Law Businessmen can also navigate more wisely in relation to current legislation and communicate more easily with commercial lawyers in relation to various objective business risks.

Legal sociology is the study of how individuals relate to the legal system and how this affects their behaviour. Previous theory on legal sociology has provided a typology of how individuals relate to the legal system – rejection, proactive use, and avoidance (Ewick & Silbey, 1998). Legal self-efficacy contributes to the field of legal sociology by providing a tried and tested concept with a theoretical background that can be applied to test individuals’ legal consciousness and the resulting effects on their behaviour. The level of internalization of legal norms can be used to measure the acceptance of law in general or in relation to specific sub-areas. The concept of legal self-efficacy is excellent to analyse the effects of legal transplant and the “transplant effect”.

Legal self-efficacy provides the fields of corporate governance with tool that uses a combination of personality characteristics and law – the perhaps most important institution that corporate governance is concerned with. The field of corporate governance has plenty of system explanations using system variables. With legal self-efficacy, it is possible to further analyse managerial behaviour in relation to a firm’s external contracts, such as lending, borrowing, subcontracting, clients and customers. Legal self-efficacy gives researchers a tool to understand more deeply managers’ perceptions of contracts in relation to law than has hitherto been done through the use of systems, ownership and financial variables.

Legal self-efficacy has a potential in the field of law and economics – defined as the application of economic methods to the analysis of law, in which economic concepts are used to explain the effects of laws, to assess which legal rules are economically efficient, and to predict which legal rules will be promulgated. Scholarship in law and economics is typically neoclassical and system-oriented in its approach. Legal self-efficacy opens a door to further research on the individual’s relationship to the legal system, and on his or her assessment of the law’s communicative capacity across legal systems. The effect of legal system families and other characteristics can be studied in order for legal efficacy to be analysed across jurisdictions. Legal self-
efficacy has the potential to challenge the LLSV tenets based on system variables and neoclassical theories, by using individual-level subjective risk measurement of legal self-efficacy, which is directly relevant to this task. There could be efforts made to find correlations between legal self-efficacy in a population and the legal family to which it belongs. The same could be done with accounting self-efficacy across jurisdictions.

To the field of institutional economics, which per definition (Friedman 1987) embraces bounded rationality, learning and evolution, legal self-efficacy is an example of the individual’s relationship to a specific formal institution and of the effects of risk aversion and communication that the particular institution enables. In essence a host of institutions, and self-efficacy in relation to them, can be used, in addition to legal self-efficacy. The major economic concept of micro-behaviour, such as investment, spending, saving, tax return, innovation and various consumer choices can be analysed in relation to various institutional self-efficacy measurements such as taxation, elections, and government spending. Investment self-efficacy, savings self-efficacy, spending self-efficacy, tax self-efficacy, and innovation self-efficacy are examples of concepts that ought to be tested to see how we can gain an understanding of economic behaviour among both ordinary laypeople as well as businessmen. Legal self-efficacy is but one of the many possible institutional self-efficacies that institutional economists could apply, if they were to venture into the realm of behavioural economics and employ measurements of subjective risk.

Accounting rules can be considered a subset of legal rules. The field of accounting is a field of professional users of law in a business context – i.e., accountants are professional users of law in the context of accounting. Laymen’s understanding of accounting rules is a field on which this thesis should have implications. Laymen’s accounting terminology self-efficacy may have a similar effect on the risk they take in their accounting practices. Legal self-efficacy has the potential of becoming a useful concept of subjective risk in behavioural accounting research (BAR). The concept might be remolded into accounting self-efficacy, which would have slightly different connotations. A survey on Risk Perception Literature in Behavioural Accounting and Behavioural Finance (Ricciardi, 2004) reveals no attempts in the field of behavioural accounting in the employment of accounting self-efficacy. The concept could open up new possibilities to analyse the consumption and perception of accounting information and how it leads to decisions involving risk, e.g., investment decisions.

Transition studies and development economics can use the insights of this thesis into the effectiveness of private vs. public mechanisms of risk reduction and use the lessons learned in the thesis for devoting research attention to the need for risk
reduction for businesses. The lack of a legal system for representation of property rights as described by de Soto can in part be counteracted with the advent of Law. Businessmen who use the possibilities that do exist, however scarce, to defend their legal entitlements to their property. Legal self-efficacy is ideal for individuals’ and businesspeople’s ability to assert their property rights.

Legal self-efficacy is a contribution to the field of risk research in psychology and decision science through the work of authors such as Paul Slovic (2000) and Kahneman and Tversky (2000), who were among the first to recognize the fact that there is subjective risk in business and economics. Stated more clearly, “The objective odds are either lowered or heightened depending on the persons experiences, inclinations toward risk taking, and the particular circumstances surrounding a given situation” (Roszkowski, 2001, p. 244). The research fields of risk research in psychology and decision science have employed several measures of subjective risk, such as risk aversion, sometimes expressed as “love for risk”, or “risk propensity” or “loss aversion”. Legal self-efficacy is more specialized than these more general measurements.

Legal self-efficacy is in itself a versatile tool for scientists to employ for studies on the individual level, in the research fields of corporate governance, law and finance, law and economics, behavioural accounting, institutional and behavioural economics, law, law and development, risk research, and legal sociology. Legal self-efficacy sets itself apart from other concepts and measurements of subjective risk in that it is autopoietic; it is also a measurement of subjective risk in relation to the legal system, and it measures the communicative aspects of law – essentially legal efficacy. It has versatility as a tool for policymakers in analysing the effect of new legislation on a given population. The potency of the concept lies in its limitations on the individual’s relationship to the legal system and to risk, as both risk and the legal system are universal.

The strand of literature that uses the neoclassical definitions of legal efficacy with the logic that the better the quality the de jure as well as de facto creditor rights are, the more money creditors will lend. The common law legal system seems to be best at this, the Scandinavian and German legal system (Bürgerliches Gesetzbuch) tie for second place, while Code Napoleon and the former Communist states linger last. Neoclassical scholars use system variables of external institutions such as creditor rights, speed of court rulings, and effectiveness of law enforcement agencies (see, e.g., Pistor, 2000; and LLSV, 1997, 1998; Botero et al., 2003; Buscaglia & Uhlen, 1997; Church et al., 1978; Mahoney et al., 1985) to get system results as do most work by economists in the field of law and economics.
The thesis adds to the domain of the literature using the neoclassical systems approach to law and economics in that it reveals that creditor rights and institutional effectiveness are substitutes for one another when it comes to leverage and debt maturity. Also, it is among the first to show robust solid empirical evidence that these firms’ leverage and debt maturity change as creditor rights increase. The study reveals, according to theory, that legal origin is related to the level of debt and debt maturity.

In business studies and economics, law and the legal consciousness is treated as an exogenous factor, usually taken for granted, meaning that law is peripheral to the business that is being conducted. This is evident in most teaching and in most journal papers. In its present state, economics suffers from inadequate explanations of economic behaviour; not only the recent economic crises in the US 2008 and European debt crisis, but common behaviour such as decisions involving risk, e.g., the many types of investments and decisions that a typical company does.

For business studies, legal self-efficacy is a way of addressing the problem of contracting from a psychological perspective, in, e.g., risk, or corporate governance studies. Business scholars do not, as a rule, analyse the psyche of respondents and use it an explanatory variable. There are many applications for legal self-efficacy in, e.g., accounting, as the legally regulated system of recording and summarizing business and financial transactions, and analysing, verifying, and reporting the results. Accounting as both practice and theory is in essence a haven for analysing the effect of understanding and perceiving regulation.

Accounting self-efficacy is the answer to the question “How comfortable are you with the use of accounting terminology?” Accounting self-efficacy (ASE) as a subset of legal self-efficacy holds much promise for accounting scholars in analysing the consciousness of accounting practitioners as an explanatory variable for, e.g., the understanding and use of accounting concepts and information as a means of managing an organization. Other possibilities include the consumption of accounting information from, e.g., annual reports: What role does ASE play in the perception of accounting information? ASE holds promise as a tool for analysing both the consumption and use of accounting terminology and information. Other possible applications of analysing the effect of legal self-efficacy are the multitude of corporate governance relations between owners and management. Corporate governance studies have to my knowledge not included legal consciousness, despite the fact that corporate governance as a field of research is founded on the view of the firms as a nexus of contracts.
The field of law and economics has many applications for analysing the legal consciousness of the players. The legal consciousness of players has not been thoroughly analysed by law and economics scholars. One of the classical problems of law and economics is the problem that Coase brings up – also known as the Coase theorem – concerning the externalization of costs and the usefulness of contracting without a third party, which has not been analysed. The reluctance to engage in contracting between parties and instead turning to a third party, e.g., adjudication by a court, is another possible contribution of legal self-efficacy to the field of law and economics. The study of efficient breach is another interesting application of legal self-efficacy. What role do legal self-efficacy and legal proficiency play for parties who do or do not use efficient breach of contracts?

The field of legal studies can use legal self-efficacy as a tool for true legal efficacy based on the individual's legal consciousness. Legal consciousness is apparently off-territory to legal scholars in business law. The field of criminology is not foreign to studies on the legal consciousness. Neither are the fields of sociology and legal sociology. Legal sociology can use legal self-efficacy as a measure of the acceptance of law among respondents.

For institutional scholars, legal self-efficacy, or self-efficacy in relation to other institutions can be used to analyse individuals’ perceptions of institutions. Law is one of the most powerful institutions in society. Institutional scholars do not tend to stress that people give institutions their value and role in society. Institutions seem to live a life of their own, where people are not in the equation. Legal self-efficacy demonstrates that the individual’s perception of his or her own ability to use the institution of law has a larger impact on risk behaviour than does the perception of the effectiveness of the risk-reducing mechanisms of the courts. Individuals’ perception of their ability to use institutions has a powerful impact on their use of institutions.

Finally, legal self-efficacy is proposed a concept for the study of laymen in business. But legal self-efficacy lends itself to studies of non-businessmen, ordinary people, and the study of legal consciousness. The legal self-efficacy test in a population of ordinary people is an excellent way of testing legal efficacy in of the population.
5.2 Discussion

This thesis did not promise to deliver an all-encompassing theory of legal self-efficacy and corporate governance, contractual behaviour, sanctioning behaviour, legal effectiveness and legal transplants. It did, however, deliver empirical evidence to support arguments concerning a new perspective on legal effectiveness – that legal effectiveness is best measured on the level of the individual using a combination of Luhmann’s theory of law as communication and Bandura’s theory of self-efficacy as tools to combine into the concept of legal self-efficacy.

The thesis does deliver a concept that is ready for business and legal scholars to use as a measure of the legal consciousness of laymen and its effect on transactional behaviour, contractual behaviour, sanctioning behaviour, legal efficacy and legal transplants in any and every business jurisdictional environment. It also presents a theoretical framework that supports the claim that it is a useful concept that fills a gap. As such it can provide risk reduction for laymen without addressing formal legal institutions.

The thesis empirically demonstrates that legal self-efficacy has a risk-reducing effect on the granting of trade credit. This finding can have further implications for transactional behaviour in the realm of business contracting in future research. It also demonstrates that legal proficiency is not correlated to legal self-efficacy. Legal self-efficacy is about attitude, whereas legal proficiency concerns absolute knowledge in current Russian business law. Legal self-efficacy might have been taken for granted by scholars of law and business before: Is it not a common-sense conclusion that businessmen with legal proficiency would take more risks when doing business than would those who are without it? The findings show that mere legal proficiency is not a risk-reducing factor, but that comfort with legal concepts is. The difference is not unimportant and has significant consequences. Mere knowledge of a certain topic does not imply self-efficacy, and self-efficacy does not imply knowledge on a certain topic.

The thesis also demonstrates that legal self-efficacy mediates customer sanctions both legal and social. Sanctions help mitigate business risk; in effect legal self-efficacy mediates business risk reduction.

Some interesting phenomena discovered in this thesis are the cognitive dissonance in individuals’ legal self-efficacy and their proficiency in current civil law. In Jörgensen and Svanberg (2008) seven questions were answered, with a result of four out of seven or 57 percent. The first six questions are identical to the questions asked in
1997 for the article Hendley et al. (2002) that were answered with the result of 2.3 out of 6 (38 percent). The consequence is that mere knowledge about current legislation is not enough to achieve risk reduction the individual needs self-efficacy to achieve effectuate reduction in risk. This is an important distinction that deserves mention. The difference between merely knowing how to achieve a goal and having self-efficacy to achieve that goal is addressed by Bandura (1977) in the four sources of: experience, modeling, social persuasion and physiological factors. Jörgensen (2010) lists legal sources (text, films, and friends) as an additional cradle of legal self-efficacy – these are effectively the same as experience, modeling, and social persuasion.

The substitution effect of norms is another curious finding in this thesis that deserves mention. When an economic agent performs a transaction this person uses a norm depending on the social setting of the transaction: business norms or social norms. Legal self-efficacy is related to the legal system, and business is most likely to use legal norms unless there is relational contract which drifts into a social relation type of norm without a written contract. A transaction can be done with reference to law or to social norms, with quite different results as the possibilities of sanction differ from the two systems. Every transaction has a specific contractual environment with specific risks.

The whole range of scale from social norms to officially sanctioned legal norms is one of De Soto’s (2000, 2002) major topics. De Soto’s (2000, 2002) main thesis is that the cause of poverty of the developing world is the lack of established private property rights to land and houses, businesses. This makes it impossible for owners with social private property rights instead of official legal entitlements to get credit. Capitalism requires capital, and when a person needs capital his/her closest source of capital is a mortgage on one’s house, land or other property. This is true everywhere, in Russia as well as in Peru (De Soto’s native country). De Soto (2002) reports that red tape in Peru (and most Third world countries) prevents businessmen from getting licenses to own a store, from land seekers to get a proper title to own land. Businessmen need years to cut through red tape to start a factory. This is root of evil and the foundation of the “informals” that trade, but not legally. From one perspective legal self-efficacy is a great asset to use when people need to handle red tape, it would increase effectiveness when dealing with legal regulation. From the other perspective legal self-efficacy can also translate into social rule self-efficacy – by rules is implied social rules, rules that the “informals” use to trade. Businessmen will use the most efficient norms available whether they be social rules or legal rules.
In order to do business, businessmen need to relate to laws and social norms as well as private property rights. It would be worthwhile testing whether there is a relationship between the success of businessmen and legal self-efficacy. One would hypothesize that legal self-efficacy is conducive to success in business, perhaps dependent on the density of legal rules involved in a particular business.

There is a remarkable gap in research about a common standard on how to measure the legal consciousness across legislations without losing relevance and accuracy due to jurisdictionally specific factors. Legal self-efficacy is the answer to this quest—it is totally neutral to any legislation, it measure but the individual’s comfort in using legal terminology and as such serves as a measure of “citizenship to the realm of legal concepts” in how well versed person feels with legal terminology, sometimes referred to as “legalese”.

The issue of whether the results from this thesis are valid in other jurisdictions and groups can be answered by replicating the same surveys elsewhere. One can but hope that legal self-efficacy and its clear relation to ownership rights and effect on business risks can be of significance for populations across the world; to enable the people to defend their private property rights, take business risks despite fault legal system, to adopt foreign legal concepts and to use law in their everyday lives and feel that they are not estranged to the legal order of their country but empowered to use the most powerful mechanism of risk reduction - their own mind in combination with the risk reduction mechanisms provided by both the public and the private order.

5.3 Concluding Remarks and Future Directions

The concept of legal self-efficacy has been demonstrated to fill a need for explaining contractual behaviour as well as the individual legal efficacy of a given population of end users of law. The concept of legal self-efficacy has a place in the theory of contracting. Previous research in law and economics or legal sociology has not connected research in cognitive psychology with contractual behaviour of businessmen. The endowment effect remains the best known challenge to the Coase theorem that originates from human psyche. The nature of the theorem makes it invalid as an empirically useful theory. The nature of risk perception is an amalgamation of the likeliness of incident plus the subjective handling of the event if it occurs. Legal self-efficacy helps explain why one part of a contract may be better at defending his or her private property rights in comparison to other people. It is readily testable in any class room experiment or real life tests. By better at defending
is implied two things, firstly that the person deems him or herself better at defending their private property rights if need be, and also that he or she estimates that there will be less threats to their private property rights than other people. As there is a risk in exactly every single contract that is made and every single transaction between people the concept of legal self-efficacy as risk reduction is relevant to all such instances.

Research questions can address the effects of this risk reduction in various contractual environments such as countries or legal families. The concept is readily testable on individuals who are dealing with contracts professionally such as businessmen and laypeople who less often involve themselves in contracts and transactions.

The issues of corporate governance, pervasive as they are can be explored by focusing on the relation of operators of firms to various institutions of control such as the legal system. The matter of the impact of creditor protection and “legal efficacy” on capital structure has been long standing on the research agenda. The findings in this thesis allow for an opposite approach to contracting. Instead of focusing on the impact of institutions on capital structure it is proposed that the legal self-efficacy of the individuals behind the decisions of risk be studied. Most likely a double approach – the human psyche and institutions - will have the best predictive power on contractual behaviour.

Another interesting research question is how legal self-efficacy affects contractual behaviour in comparison to other external risk reducing institutions such as courts, laws, law enforcement and lawyers. The tolerance of risk differs from country to country as Hofstede (1980) explains. An interesting research question would be to study the relation of legal self-efficacy to the general level of risk in a country. Do businessmen take more risks in risk-prone contractual environments? Other venues of research on legal self-efficacy include the study of causes of legal self-efficacy. In the thesis it was discovered that legal texts, movies, and consulting people was conducive to legal self-efficacy. We do not know in which combination. Why it is that legal proficiency is not conducive to legal self-efficacy? Does training in professional use of law lead to a higher legal self-efficacy? Another interesting prospect would be to test the causes and effects of legal self-efficacy in relation to various country and legal family contests. Is legal self-efficacy higher in the notably legalistic Anglo Saxon common law countries and lower in civil law countries?

Schumpeter (1950) stated that an increase in taking risks by businessmen leads to higher prosperity. Could it be demonstrated that a systematic decrease of business
risk and more risk prone businessmen has led to more economic prosperity? For policy makers the question of risk reduction is particularly relevant as risk reduction is a highly sought public and private good that can increase business opportunity and the standard of living across the world. Is it less costly to teach risk reducing attitudes and behaviour to the large layers of the population than to reform the entire legal system? Can these measures be performed in conjunction so as to provide risk reduction from both the psychological side as well as the institutional? In terms of future research on the impact of creditor rights and legal family, the findings justify further investigation of time-series data on changes over time.

It is only when we delve into the realm of the human mind that we can fully understand the issues of human interactions with norms. The next research frontier in behavioural accounting, finance and law could be opened up by legal self-efficacy. The concept lends itself to wider application in a host of various contexts involving norms and human action. The question asked for legal self efficacy was “How comfortable are you with using legal terminology?” but it could be ”How comfortable are you with investment terminology; tax terminology; or planning the next six months for your company?” Self-efficacy opens up for a positive study of how to enable businessmen with skills that they didn’t think they had. In this way the study of humans can become more than an a passive recording of what already is to a proactive move to what better businessmen should be. They should have all sorts of self-efficacies that allow them to expand their businesses and dare to act, dare to dream more to be more successful.

One of the issues of business risk and self-efficacy is – does legal self-efficacy lead to good risk or bad risk? The short answer is that it leads to more risk taking by businessmen. The long answer is that ability to communicate with legal ability is an integral part of doing business contracting. There should be a natural connection, since much business, if not all, involves contracting with parties internal inside the company or on the market. The least common denominator of business is economic transactions. Economic transactions involve contracting and the exchange of property rights in return for economic gain. Contracting and property rights are core to virtually all business activities. Legal self-efficacy could therefore be considered an indirect way of expressing business risk self-efficacy.

Another type of self-efficacy, in this case entrepreneurial self-efficacy interacts with other characteristics such as optimism, and environmental dynamism when it comes to predicting company performance. Hmielecki et al. (2008) found that the latter two moderate the effects of entrepreneurial self-efficacy. Consistent with estimates, in dynamic environments, the effects of high entrepreneurial self-efficacy on company
performance were positive when combined with moderate optimism, but negative when combined with high optimism. In contrast the effects of self-efficacy were relatively weak, and were not moderated by optimism. Overall, results suggest that high self-efficacy is not always advantageous for entrepreneurs and may, in fact, exert adverse effects under some conditions.

The implications for future studies of legal self-efficacy are that it is possible that external factors, such as e.g. environmental dynamism, can have an impact on the effect. In addition, psychological traits such as optimism can have an effect on risk. Also, as previously mentioned, the effect of corporations on legal self-efficacy could be taken into account. These measures as well as other relevant ones should be used to verify the effects on legal self-efficacy on business risk.

Finally, when conducting research on complex issues, such as corporate governance, and various sorts of accounting and auditing situations, it would be recommendable to test multiple types of personal traits and self-efficacies in order to eliminate other possible causes and establish a valid and robust set of significant factors that impact behaviour in that specific situation.
Legal Variation and Capital Structure: Comparing Listed and Non-Listed Companies

Thomas W. Hall and Fredrik Jörgensen

Abstract

We exploit the natural institutional variation in Western Europe to examine leverage (and debt maturity) for listed and non-listed companies (NLCs). We find that the legal efficiency measure (Djankov, et al, 2008) is more closely related to the amount of leverage and debt maturity than is the creditor rights score of La Porta, et al. (1996; 1997). One component of the standard measure of creditor rights was consistently and positively associated with leverage: whether secured creditors are paid first in the event of distress. Firms located in French and German legal family countries have less leverage than companies in common law setting, but Scandinavian firms have more. Asset specificity has a negative impact on leverage, but a positive impact on debt maturity. Finally, using a matched sample of otherwise similar privately held companies, we find that listed firms have less debt, consistent with a corporate governance interpretation that presumably more dispersed publicly traded firms are more likely to avoid the disciplining device of leverage. The findings are robust to use of industry-level fixed effects.

Keywords: legal origin, creditor rights, leverage, debt maturity

JEL Classifications: G32, G33, F30

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Legal Variation and Capital Structure: Comparing Listed and Non-Listed Companies

In this paper, we examine whether and how national-level institutions affect leverage (defined as long-term debt over total assets) and debt maturity (defined as long-term debt over total debt). Unlike many previous studies that focus exclusively on firms with equity listed on public markets (with presumably better relationships with capital markets), we include both listed and non-listed companies in our analysis. This is important when considering cross-country variation in firm-level financial behaviour, because unlisted companies are less likely to have access to international capital markets. It is likely that national-level institutions pose more binding constraints on the ability of such firms to raise external finance to fund growth above and beyond what is possible from retained earnings, or to adjust their capital structure to its ideal status.

Many previous studies have examined capital structure of firms in only one country, or have looked at listed firms in a variety of countries (Fan, et al. 2012; Song and Philippatos, 2004). An interesting global study provides detailed information provided by seasoned experts about how debt contracts are enforced in a procedural sense, but does not map this onto the actual behaviour of privately held companies (Djankov et al, 2008). Another recent study (de Jong, et al, 2008) finds that most of the country-level variation identified by previous work disappears when firm-, industry, and country-specific determinants are incorporated. That study does not examine privately-held companies, which are more likely than listed firms to be subject to segmented capital markets, and hence are more likely to be influenced by legal institutions in their country of operation. Giannetti, (2004) examines firm-level data from privately held companies, but only includes firms from two legal families (common law and French); therefore there is not sufficient variation to examine the impact of them on capital structure or other financial behaviour of firms.

We find that the legal efficiency variable from Djankov, et al. (2008) is more closely related to actual leverage and debt maturity than are the various creditor rights scores of La Porta, et al. (hereafter, LLSV; 1996, 1997). It is important to
consider this variable because it is so widely cited in the literature. One component of the CRED score was consistently and positively associated with leverage: whether secured creditors are paid first in the event of distress. Firms located in French and German legal family countries have less leverage than companies in common law setting, but Scandinavian firms have more; the results for debt maturity mirror these findings. Asset specificity has a negative impact on leverage, but a positive impact on debt maturity. Finally, using a matched sample of otherwise similar privately held companies, we find that listed firms have less debt, consistent with a corporate governance interpretation that presumably more dispersed publicly traded firms are more likely to avoid the disciplining device of leverage. The findings are robust to use of industry-level fixed effects.

The paper proceeds as follows. Section 1 provides a brief literature review to motivate our research questions. Section 2 describes the data and models we employ; statistical results are given in Section 3. The conclusion is presented in Section 4.

1. International Studies of Capital Structure and Debt Maturity

A very large literature using country-level macroeconomic data and firm-level data for publicly listed companies finds that creditor rights are associated with leverage and the maturity structure of debt. Examination of non-listed companies (NLCs), however, provides an out-of-sample test of these findings, and is relevant because smaller firms are more likely to face capital constraints relative to large, listed companies.

Previous studies have examined leverage in a comparative context, often employing country-level information (Aggarwal and Jamdee, 2003; Demirgüç-Kunt and Maksimovic, 1998, 1999, 2002; Booth, et al, 2001; Schmuckler and Vesperoni, 2000; La Porta, et al, 1998, often abbreviated as LLSV). Demirgüç-Kunt and Maksimovic (2002) mention one disadvantage of using a firm-level approach: data on relatively few companies can be used because of a typical reliance on publicly traded entities. To overcome this research obstacle, we employ tens of thousands of firm-year observation from a large number of unlisted companies, and compare them with listed firms. An advantage of using disaggregated data, however, is that we are able to control for firm-level variation (Fan, Titman, and Twite, 2003; Wald, 1999; Hall and Joergensen, 2008; Hall, 2011) in things like asset tangibility, return on assets,

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39 A recent search on the social science research network led to over 980 hits for the search word “investor rights” and over 300 hits for the search term “creditor rights”. The LLSV papers are widely cited as the seminal works in the so-called law-and-finance stream of literature.
effective tax rates, and firm size (here, natural log of total assets). An advantage of our approach is that we are able to include firms with as few as 100 employees, which allows us to examine capital structure choices in relatively small firms.

A groundbreaking global analysis of typical bankruptcy procedures (Djankov et al, 2008) considers national variation in the resolution of a hypothetical, distressed, privately-held firm (a medium-sized hotel). That analysis incorporated expert opinion in a large number of countries concerning a very simple hypothetical distressed firm situation. The hypothetical firm had only one creditor and a relatively straightforward capital structure. The case was designed to limit the complexity that could confront analysis of a hypothetical bankruptcy case. The study makes clear that large, publicly traded firms would face more complex legal procedures surrounding distress; this fact calls into question any unreflective application of their findings to the case of listed companies. Because their study uses a hypothetical case tailor-made to examine distress and bankruptcy (and, by extension, collateral and lending aspects of external finance, the central concerns of our paper), it makes sense to ascertain whether their findings shed light on (1) the leverage of observed listed vis-à-vis non-listed firms, and (2) the leverage of firms located in different countries, with different national institutions concerning the ability of a creditor to perfect a claim on pledged assets.

In fact, examination of privately held firms and their financial behaviour is an important yet very rarely studied aspect of the finance (and, by extension, law-and-finance) literature. Our study is in line with some recent examinations that contrast publicly traded and privately held firms to determine whether and how ownership (and the decision between public and private status) affects financial performance. Beck, et al. (2002 and 2004) shows that large, publicly-held firms are not fully representative of the legal constraints that face unlisted companies. Looking at US firms, Asker, et al. (2011) finds that publicly traded firms invest less and are less responsive to changes in investment opportunities vis-à-vis otherwise similar privately held companies. A contrasting result was found by Martal and Reisel (2009) who use the same data source that we do, and find that there is no substantial difference between privately held and publicly traded firms in terms of investment behaviour. Sheen (2009) contrasts the investment behaviour of privately held vis-à-vis publicly traded companies, again in the US context. Our study constitutes an extension of this unresolved issue in the literature on ownership and performance, but regarding leverage and debt maturity as opposed to investment behaviour. In addition, it extends the analysis to incorporate European firms, which allows us to exploit the natural variation in institutional environments (legal family, creditor rights, efficiency of bankruptcy procedures) there.
Finally, one important issue that has been under-studied in the literature on leverage relates to how institutional variation interacts with the “specificity” of fixed assets, which affects their liquidation value and use as collateral (Acharaya, et al. 2004). Firms in industries with highly “specific” assets possess property, plant, and equipment that is relatively illiquid vis-à-vis other industries. According to that study, asset specificity also may be indicative of credit-friendliness in the country’s legal systems—firms with high asset specificity in an equity-friendly environment use more leverage than in a debt-friendly environment. A follow-up study (Acharaya et al. 2008) examines the relationship between national institutions (bankruptcy codes) and leverage, but only considers the case of publicly traded firms in the US and UK. We examine this issue, but in the context of privately held firms that presumably face additional credit constraints relative to publicly traded firms.

In addition to examining leverage in this paper, we consider also the level of debt maturity (measured as long-term debt over total debt). Perhaps there are differences between the ability of privately held firms to access longer term debt, due to lack of good relationships with capital markets. Thus, the key questions we consider are:

- Is there any relationship between ownership (public/private status) and capital structure?
- Do institutions (such as legal origin and creditor rights) matter for leverage and debt maturity, and if so which are most important?
- How does the specificity of fixed assets affect the ability of firms to borrow, and to borrow at longer maturities?

2. Data and Models

A. Data and Descriptive Statistics

Globe-spanning studies face problematic research questions related to substantial variation in economic development and sophistication of national financial markets. We constrain our study to only include the relatively homogenous countries of Western Europe, where issues concerning dividend imputation, the role of institutional investors and informational intermediaries, and life insurance penetration are less likely to distort our data than for the global, cross-sectional approach of Fan, Titman, and Twite (2003). Differences in accounting treatments are less likely to confront our data compared to previous studies, due to the data cleansing and standardization methods performed by our data source (Bureau van Dijk’s Amadeus data set) and the fact that all firms report using the IFRS accounting standards. Finally, inflation and other variations in macroeconomic performance
were not major considerations during the period we consider, so problems related to firm-level data from, e.g., Turkey that encompass problematic accounting treatments of hyper-inflationary effects as in Demirgüç-Kunt and Maksimovic (2002) are not relevant for our analysis.\textsuperscript{40}

Therefore, to conduct our empirical tests, we employ the Amadeus database (data from the years 1995 – 2001 were available to us) that covers firms in most of Western Europe.\textsuperscript{41} Amadeus data on Western European countries are analyzed by Gianetti, 2004, but she only examines firms from two legal families (Common and French; Table 5 in that study), which we extend by considering firms from both German and Scandinavian legal origin settings.

We eliminate all firms with no reported SIC code and all firms with SIC codes beginning with a 6 (including financial services).\textsuperscript{42} To be consistent with previous leverage studies, we further narrow our data set following the SIC code selection of Fan, Titman, and Twite (2003), and include only firms with codes as follows: business services (SIC 73), chemicals (SIC 28), construction (SIC 15, 16, 17), food and beverage (SIC 20), communication (SIC 48), metal fabrication (SIC 33, 34), resources (SIC 10, 12), newspapers (SIC 27), paper and pulp (SIC 26), wholesale (SIC 50, 51), and retail (SIC 52-59). Finally, we truncated (see Frank and Goyal, 2005) the data set to eliminate 25,597 firm-year observations that had negative book value of equity. Finally, in order to eliminate some extreme values and ensure that our findings were not being driven by outliers, we windsorized several variables (long-term debt over total assets, long-term debt over total debt, effective tax rate, and return on assets\textsuperscript{43}). To ensure no loss of observations (Frank and Goyal, 2005), we replaced outlier values with more reasonable values at the 1% and 99% level for ROA and effective tax rate, and windsorized the dependent variables based on the balance sheet realities (e.g., such that total debt could not be greater than long-term debt, and for reasonable values of ROA and effective tax rate).

Following these procedures, we are left with a sample indicated in Panel A of Table 1. Panel B of Table 1 presents descriptive statistics for the two dependent

\textsuperscript{40} In addition, we checked national variations from IAS Plus accounting standards and found no major discrepancies that should be driving our results (Deloitte and Touche, 2000).
\textsuperscript{41} For analysis of the Eastern European firms in that data set, see Klapper, et al, 2002; Hall and Jörgenson, 2008; Hall, 2011.
\textsuperscript{42} The version of the Amadeus database we use includes firms with operating revenue in excess of €10 million, or total assets above €20 million, or 100 or more employees.
\textsuperscript{43} Long-term debt over total debt was windsorized at the value of 95%, long-term debt over total debt was windsorized at 100%, return on assets was windsorized at -0.266 and 0.261 (the 1% and 99% values, respectively), and effective tax rate was windsorized at -3.55 and 4.29, (again the 1% and 99% values).
variables in our study. We possess a large number of observations from each legal family, but it should be noted that we lack data from the income statement for Irish companies (one of only two common law countries along with the United Kingdom). Therefore, in many of the specifications, we alternate between estimations that include these variables and those that exclude them; by including ROA and Efftax, we have more control variables included in the statistical analysis, but by excluding them we obtain more observations. Because we only have data from two common law countries, inclusion of the Irish data allows us to provide something of a robustness check on whether our common law findings are in fact solely driven by observations from the UK. In this context, it should be noted that the UK is a much larger jurisdiction with many more firm-year observations.

We are aware of the findings of de Jong et al. (2008) that firm-level determinants of leverage vary by country, and for this reason conduct some country-level regressions for leverage (and debt maturity). Nevertheless, we are interested in the firm-level effect of country-level variation in legal origin and creditor rights. Given that we only had a limited number of countries in our analysis, it was necessary to pool firm-level observations from different countries. In the spirit of their argument, we also performed tests where firm-level data from the same legal family were pooled. We attempted to include country-level dummy variables, but this was not always possible in some specifications because there were high levels of correlation between creditor rights and legal origin.

Quite a lot of univariate variation exists in the sample, such that the average amount of leverage varies from a high of 27% (Iceland) to a low of six-tenths-of-one-percent (Italy). For debt maturity, the country with firms that have the highest average maturity (equally-weighted) is Iceland (43%), and the country with the shortest debt maturity is Italy, where only 1% of its total debt was long-term debt. There is no obvious univariate relationship between legal origin and levels of either debt or maturity, which motivates our multivariate examination, below.

**B. Empirical Tests and Models**

We perform a number of empirical estimations related to leverage, creditor rights, and legal origin. Our data are in unbalanced panel form (motivating our decision to use generalized least squares or GLS to control for correlation among observations of the same firm), such that not every firm-year observation will have data for all variables, in which case that observation will be dropped from the estimation. Because we are interested in how national characteristics (e.g., creditor
rights and legal origin) affect managerial decisions, but also with firm-level variation, we do not use firm-level fixed effects but rather use random effects. Otherwise, we could not include in the analysis variables such as asset specificity or even creditor rights and legal origin (or SIC codes or asset specificity) that do not vary over time at the firm level.

1. Leverage and Creditor Rights

We consider both the leverage (long-term debt over total assets) and maturity structure (long-term debt over total debt) of the firms in our sample. We begin by estimating the following leverage model:

\[ \frac{\text{LTD/TA}}{\text{j,i,t}} = \alpha_1 + \beta_1 \text{CRED}_{i,t} + \beta_2 \text{Control}_{j,i,t} + \varepsilon_1 \]

where the dependent variable of long-term debt over total assets is indexed on firm \( j \) in country \( i \) in year \( t \). CRED is a vector of variables based on the creditor rights score from LLSV (1996), enumerated in the Appendix. It is entered in various forms, either dummies for values (e.g., CRED-1 is a dummy variable that takes the value of “1” for all observations where the CRED score is equal to “1”, etc.), or dummies for the various components of the score (CRED-A, etc.). The vector of controls includes firm-level and country-level variables. Our firm-level controls include: EFFTAX (effective tax rate measured by taxes/net income), TANG (tangibility of assets measured by fixed assets/total assets), ROA (net income/total assets), and LNTA (the natural log of total assets).

We also employ two additional firm-level controls not used often in the previous literature. The variable LISTED takes the value of “1” for firms that were traded on a public stock exchange. There may be important distinctions between listed and unlisted firms in terms of their ability to obtain debt and to access longer-term debt. Finally, we include a variable ASSETSPEC (following Acharaya, et al, 2004), or asset specificity, which is a dummy variable taking the value of “1” for mining, manufacturing, and transportation firms (two-digit SIC codes 10-14; 20-39; and 40-49, respectively). Definitions and sources for all variables are contained in the appendix.

2. Debt Maturity

Our second set of empirical specifications uses debt maturity as the dependent variable; we estimate the following model:
\[
(LTD/TD)_{j,t} = \alpha_i + \beta_1 \text{CRED}_{i,t} + \beta_2 \text{Control}_{j,t} + \varepsilon_1
\]

(2)

where the dependent variable is long-term debt as a portion of total debt and the vector of independent variables is as defined above.

3. Legal Origin

We examine the robustness of the findings from estimations of equations (1) and (2), above, to inclusion of three dummy variables indicating French, German, and Scandinavian legal origin (Common law legal systems thus constitute the reference category). We base our legal family categorizations on LLSV, 1996 (which were consistent with those of 1997 for the countries in our sample).


The CRED variable has been used in a large number of studies. For this paper, we explored the variable in detail and attempt to examine its usefulness in terms of explaining the level of leverage of privately held and publicly traded firms in Western Europe. Our baseline models employ the creditor rights score and list of components contained in LLSV (1996), which was based on in-depth research into commercial codes and bankruptcy law in a large number of countries around the world that are cited in that paper. The variable takes the value of 0 to 4, and is meant to be a first take or approximation of the level of creditor protection in the country. See Panel C of the Appendix for a list of these values by country and legal origin.

Curiously, the values of the CRED score changed in a subsequent publication (LLSV, 1997) although the source for it in the more recent paper was in fact the original 1996 study. In Panel C of the Appendix, we specify how the variable changed between the two studies. Only one country (the UK) had its CRED score increase from 1996 to 1997, but a large number of countries (Finland, France, Ireland, Italy, Portugal, Sweden, and Switzerland) had lower scores in the 1997

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44 Unlike some non-European countries (e.g., Taiwan), we did not confront the situation where the commercial code was based on one legal family, whereas the bankruptcy code was based on another (Djankeov, et al, 2008).

45 The variable definition is presented on p. 49 of NBER working paper 5661 (LLSV, 1996), with values listed on p. 50. These scores constitute our baseline CRED variable, with components CREDA – CREDD. The “creditor rights” scores listed on p. 24 of NBER working paper 5879 on p. 24 are those we define as CRED97.
publication. We looked closely for an explanation of this in the 1997 publication, as well as a *Journal of Economic Literature* (La Porta, et al, 2008) article that served to consolidate the various arguments related to legal origin, but could not find a reason as to why the scores were reduced in the 1997 vis-à-vis the 1996 study. Therefore, we employ the creditor rights score from the original 1996 paper, but supplement that analysis by using robustness tests on the 1997 creditor rights variable. We name the latter CRED-97 to distinguish it from our baseline CRED variable (and its derivative vectors of dummy variables) from the 1996 study.

We examine creditor rights in two different ways. First, based on previous analysis (LLSV), we use the CRED score as a proxy for the overall level of creditor protection in the country. Because in a regression context it is unclear that a movement from, e.g., 1 to 2 is equivalent to a movement from 3 to 4, we break the variable down into a series of dummies. Thus, the dummy variable CRED-1 takes the value of “1” for all observations from countries with a CRED value of “1”. The dummy variable CRED-2 takes the value of “1” for all observations from countries with a creditor rights score of “2”.

Because there is likely also information contained in the various components of the score, in further tests we examine the disaggregated issues that were used to compile the score. The four categories are: (A) restrictions on reorganization, (B) no automatic stay that would prevent the right of creditors to take possession of property once petition for reorganization is recognized, (C) debtor does not retain possession of property pending resolution of reorganization, and (D) secured creditors are ranked first in the disposition of assets. For justifications as to why these legal characteristics support the interests of creditors (vis-à-vis debtors or other stakeholders), we refer the reader to the original paper (LLSV, 1996).

Based on the column headings in the Appendix (panel C), we construct a vector of four dummy variables taking the value of “1” for observations from countries in which that specific component of the creditor rights variable were extant in the law. Thus, observations from firms located in countries that had restrictions on reorganization (and hence would allow secured creditors to obtain their generally favored outcome of liquidation) would receive a value of “1” for CRED-A.

### 3. Results

Tables 2-6 present the basic results of our paper. In general, the models have very good fit, with Wald chi² of very high magnitude. The R² values, which range from 7.33% (model 5, Table 4) to 26.14% (model 6, Table 6), are fairly typical of previous work using similar data sets (e.g., Gianetti, 2003). The
independent variables with large magnitudes and high levels of significance include asset tangibility as well as return on assets. Not surprisingly, firms with higher levels of tangible assets are in general and on average able to obtain a higher level of debt relative to total assets—we might expect this to be the case especially where better collateral laws and regulations make it easier for creditors to perfect claims on assets (Hall, 2012). It is also expected that firms with higher profitability will use less debt, a consistent finding throughout all of the specifications that included the return on assets variable. (ROA, along with the effective tax rate, was sometimes excluded so that observations from Ireland, the only other common law country besides the UK in the data set, could be included in some specifications.)

In terms of the major research questions posed at the beginning of the paper, we found relatively little evidence that the LLSV variable CRED (either from the 1996 or 1997 papers) has the expected relationship with leverage (or debt maturity). There was better evidence to suggest that legal origin (family) has a significant impact on leverage (and debt maturity), and this finding was confirmed, especially for French legal origin countries. We did find, however, that the legal efficiency measure (Djankov, et al, 2008) had better explanatory power than any of the versions of CRED we considered, or of legal family. Of the components of the CRED variable, we found that CRED-C, which measures whether creditors are to be paid first in the event of distress, was positively and significantly associated with leverage, as well as debt maturity. The other component parts of the CRED variable generally had either a negative or not significant relationship with leverage.

Some interesting findings regarding asset specificity emerged from the research. We found that, in general, firms with more specific assets (as defined above) employed less leverage on average, but had debt of longer maturity. This pattern was robust to consideration of the legal efficacy measure (although the relationship was not universal, as in Tables 5 and 6). The evidence is consistent with an interpretation that more specific assets discourage the use of debt, but that they were associated with a firm’s ability to attract longer-term borrowing. We now turn to discussion of the results table by table.

A. Baseline Models for Legal Origin

In Table 2, we present regression coefficients for the baseline models for legal origin. We see from columns 1 and 2 that, in line with the LLSV literature, firms located in German and especially French jurisdictions had less leverage and debt of lesser maturity, controlling for our independent variables. Scandinavian firms, ceteris paribus, had more leverage and longer-term debt.
For these estimations, the reference category is common law, and the UK was the only such country in our dataset that had information on the income statement variables (return on assets and effective tax rate). To ensure that these basic results were not being driven by the fact that the common law category was exclusively occupied by UK firms, we omitted the income statement variables and re-estimated the baseline models in columns 3 and 4. We found very similar results, with very similar magnitudes and z-statistics for the legal family dummies.

B. Creditor Rights

Table 3 presents results relating to creditor rights. Each of four specific creditor rights were detailed by LLSV (1996), and we use the sum of such rights indicated as the CRED variable (see the Appendix, Panel C). Although previous papers have simply entered the CRED variable into regression analysis, we do not feel this is the best way to proceed, because a one-unit change may not correspond to an equal impact on lending and collateral realities faced by banks and industrial firms. Thus, a movement on the CRED variable from 0 to 1 may not be equivalent to a movement from 3 to 4. This suspicion is confirmed in later analysis, where we reveal that some of the components of the CRED score were more strongly associated with leverage vis-à-vis other components.

We get around this problem by generating a set of dummy variables taking the value of “1” for corresponding levels of the CRED score. Thus, for observations from a country with a CRED score of “3”, the variable CRED-3 will take a value of “1”, and “0” otherwise. Because there were no countries with a CRED score of zero (at least not until we encounter the CRED97 variable, see below), the reference category is CRED-1, or observations from countries with a CRED score of “1”. If the CRED score is effectively measuring the ability of creditors to perfect claims in the event of distress (which encourages them to lend to industrial firms), then the magnitude of the CRED dummy variables should in general and on average monotonically increase as we go from CRED-2 to CRED-3 to CRED-4.

Table 3 provides evidence on this. We do see that, in general, the coefficient for CRED-3 is higher than that for CRED-2, which is in line with expectations. The coefficient for CRED-4, however, has the opposite sign from expectations, and is highly significant across specifications, whether we include or omit legal family; whether we include or omit the income statement variables. This is
not strong evidence in favor of the LLSV thesis that stronger creditor rights are associated with more robust corporate lending markets.

C. Legal Family Results

We continue our analysis by considering the argument of de Jong et al. (2011) that the firm-level determinants of leverage may in fact vary in different institutional settings. We find that, consistent with that perspective, the magnitude and significance level of several of our key independent covariates does depend on legal family. Thus, firms in common law and Scandinavian countries tended to have a very high coefficient for tangibility (around 20% for specifications with LTD/TA as the dependent variable) whereas French and German family countries had a substantially lower value (of around 12%). Many of the coefficients for the independent variables differ substantially by family, bolstering the perspective that legal origin matters.

D. Components of the CRED Score

It is important to realize that the CRED score is merely a sum of four different factors along which legal systems differ. Even if the battery of dummies created from the CRED variable do not have an important impact on leverage, it is possible that some of the component scores may affect the portion of debt in a firm’s capital structure. Thus, consideration of the disaggregated elements of the score, and their impact on leverage and debt maturity, may be worthwhile.

Table 5 presents results from just such an exercise, with Panel A devoted to the four components (CRED-A through CRED-D) entered singly whereas in Panel B they are entered jointly. The first part of the table indicates, perhaps surprisingly, that many of the components of the CRED score are not in and of themselves associated with positive and significant impact on leverage. (Note that in Table 5, all regressions use LTD/TA as the dependent variable; we do not report results for LTD/TD for ease of presentation.) Whether omitting (columns 1-4) or including (columns 5-8) legal family dummy variables, we find that the only component of the CRED variable to have a consistently positive and significant coefficient is CRED-C, which relates to whether secured creditors are paid first (in the U.S., this is known as the absolute priority rule). We could imagine that this is one of the key aspects of credit markets, because if a lender is not first in line for any proceeds related to the liquidation of a distressed firm’s assets, it may retard the
development of lending facilities, leading to lower levels of debt relative to equity on balance sheets. Although an intuitive argument could be made for the other three components of the CRED score, they seem not to matter, or indeed to be associated with negative impact on leverage. This finding is robust to either entering the components singly (Panel A) or jointly (Panel B).

E. Matched Sample Results

A growing new area of research compares and contrasts financial performance of listed vis-à-vis unlisted companies. One of the advantages of using a large dataset including both types of firms is that we can examine the importance for leverage of having equity that is traded on a public exchange. Tables 2, 3, and 5 indicate consistently negative (and significant) coefficients for the listed dummy in terms of leverage, but positive (and significant) coefficients for debt maturity. The coefficients for this variable, however, vary based on legal family as shown in Table 4. Perhaps the results for the pooled data only reflect different composition of the underlying distribution of listed vis-à-vis unlisted firms in the different legal families.\footnote{Indeed, it is been argued by LLSV, as well as a vast literature contrasting bank-based vis-à-vis market-based financial systems, that the prevalence of robust equity markets (as opposed to banking sectors) is related to the ability of firms to raise external finance for innovative (e.g., risky) projects.}

We investigate this issue further by constructing a set of matched unlisted companies for each listed firm in the data set. For each firm-year observation of a listed company, we found unlisted firms with identical year, country, and SIC code. We then selected an unlisted firm with slightly larger total assets, and another unlisted firm with slightly less total assets. For 2,725 firm-year observations of listed companies, we found a matched set of 5,414 unlisted firms. Such matched unlisted companies were much larger than the typical unlisted firm in the dataset. (The mean value of log total assets for the non-matched unlisted firms was 9.583; the value of log total assets for matched unlisted firms was 10.955; the \( p \)-value for difference in means is 0.000 and the nonparametric test for difference of medians also had a \( p \)-value of 0.000.)

Table 6 provides evidence concerning whether the basic findings from previous results are robust to the matching procedure. The table indicates that the tangibility coefficient is still highly significant and positive, and the previous results for return on assets and size are robust to the matching procedure. Listed firms, relative to their unlisted matches, generally had less leverage. This is consistent with
the argument made at the outset of the paper that corporate governance mechanisms may be at play in that unlisted firms (with presumably less dispersed ownership) were more likely to finance assets with debt, which can serve as a disciplining device. The finding is robust to whether we control for the CRED variable’s level (in columns 3-4) or whether we control for the various components of the CRED score (in columns 5-6). The matched results did not show a significant impact of listed status concerning debt maturity. Consistent with earlier results, we found a positive and significant relationship between CRED-C and both leverage and debt maturity.

4. Robustness and Interpretation of Results

We employ three additional tests to determine the robustness of our results. First, we examine the efficiency of distress procedures in countries from various legal traditions with different types of creditor protections (Djankov, et al, 2008). The score developed by that paper is meant to measure the level of social utility that accompanies the “typical” scenario for resolving a distressed firm which is otherwise healthy as a going concern. Legal systems that allow for either a quick reorganization or liquidation receive higher scores, whereas countries where the bankruptcy process drags on for a long period, is very costly, or where social value is destroyed, received a lower score. Do the various findings we have developed so far stand up to inclusion of this variable? Second, we consider the alternative specification of the CRED variable that was released in the LLSV (1997) paper. Third, we examine whether the results so far are robust to inclusion of SIC fixed effects; the industry composition of firms in our sample varies somewhat by country and by legal family. We examine each set of robustness tests in turn.

A. Social Efficiency of Bankruptcy Procedures

Following Djankov, et al. (2008), we included a country-level estimate of the efficiency of “typical” bankruptcy procedures. This efficiency rating was based on survey responses by legal experts to likely resolution of a hypothetical, distressed, privately held firm. The measure incorporates the amount of value that would be recovered in the case, which was purposefully designed to test whether the legal system in question would either (1) retain the value of the firm, or (2) allow an otherwise profitable going concern to be liquidated. The study considered not only the cost of resolution, but the likely outcome in the form of foreclosure, liquidation, or reorganization. Because the measure of efficiency provides more information than
dummy variables such as legal family, creditor rights, or CRED components, we consider it in our analysis of leverage (and debt maturity). Our supposition is that if creditors have confidence that the legal system will deliver value to them in the event of distress, they may be more likely to make a loan in the first place. This should affect the ability of firms to attract external finance in the form of debt, and hence affect capital structure.

Table 7 provides results of various estimations from previous results, but this time including the legal efficiency score. In every specification, the score has a positive and highly significant coefficient, with very stable magnitude for both leverage and debt maturity estimations. This indicates it is capturing something important about credit markets in the countries in our dataset.

Are the previous findings using various measures of creditor rights and legal family robust to inclusion of the efficiency variable? The legal family results are very different: all three legal family dummies now exhibit generally positive and significant coefficients (for both leverage and debt maturity). The legal family dummies include a lot of information about many different aspects of how commercial and bankruptcy codes operate, distilled into a single dummy variable. Conversely, the efficiency score is a composite based on the likelihood of various resolution scenarios specific to a privately-held firm. In this light, it is not surprising that the efficiency score captures better information about the functioning of credit markets in a cross-national perspective. The high z-scores (especially for columns 1-4) and consistent coefficient reinforce this interpretation.

Another interesting finding coming out of Table 7 is that, as shown previously, the CRED-C variable is positive and highly significant, both for leverage and debt maturity. Indeed, when the CRED components are considered in columns 5 and 6, the level of significance of the efficiency variable declines substantially, with z-scores now in the range of 11-14 as opposed to 50-64 as before.

B. Difference in CRED scores between LLSV (1996) and LLSV (1997)

As we noted above, the CRED scores released in LLSV (1997) were different from those of the original publication that detailed the components of CRED and then summed them to form the original scores. Because we were unsure as to why certain scores were changed from the 1996 to the 1997 papers, and because we were focused on examining the individual four components of the original score, we decided to use the CRED scores from 1996 for the bulk of the results for our paper.
Nevertheless, the CRED scores were changed by LLSV for a reason, perhaps because of some errors in coding the 1996 data, or due to differences in interpretation of which scores reflected actual legal realities in the countries listed. In this section, we examine whether the basic findings are robust to consideration of the 1997 CRED scores. As before, rather than enter the CRED variable into a regression context, we use it to generate a number of dummy variables, with the reference category being CRED-4, the score for the United Kingdom.

The results using CRED-97 scores are indicated in Table 8. If the CRED-97 variable accurately reflected the importance of creditor rights for external debt financing of unlisted (and some listed) firms, we would expect a negative coefficient of the highest magnitude for CRED-0, and somewhat lower magnitudes decreasing to the lowest for CRED-3, indicating that relative to CRED-4, CRED-3 was closest in terms of providing protection to creditors in the event of firm distress.

We find that, as with the 1996 CRED scores, the expectation of monotonically progressive magnitude of coefficients as we move along values of the CRED score is not fulfilled. Indeed, we see that, for many specifications, the magnitude of the CRED97-3 is similar to that of CRED97-0. There is no consistent monotonic relationship, even between CRED97-1 and CRED97-2. We therefore conclude that the re-stated values of the CRED score in 1997 do not provide a superior measure of creditor protection than the 1996 paper.

C. Industry Fixed Effects

The analysis of listed firms in many nations by Fan, Titman, and Twite (2012) employs industry-level fixed effects. Are our results robust to such treatment? Table 9 indicates that, by country (Panel A) and by legal family (Panel B), there is some variation in the prevalence of different industry groups, such that, for example, almost twenty per cent of Portuguese firms are in SIC category 1, whereas only four per cent of Swiss firms are in that category. Similarly, about thirteen per cent of Common law family observations come from firms in the first SIC category, yet only nine per cent of Scandinavian firms do. For this reason, it makes sense to examine whether the major findings of this paper are robust to industry level fixed effects.

Table 9 (Panel C) presents summary findings, based on re-estimation of the models in Tables 2-8 but employing industry level (three-digit SIC codes) fixed effects specifications. Because asset specification is merely an artifact of industry
code, that variable drops out of the analysis. We found that the majority of the key findings hold, even considering industry-level fixed effects.

D. Note on Interpretation of “Good” Institutions

This paper has focused on the ability of firms to obtain external finance, specifically debt finance. Although we have occasionally referred to the amount of leverage, we have throughout considered only the level of long-term debt relative to either the level of assets, or to the level of total debt. There has been a large literature related to whether access to external finance is facilitated by a well-functioning banking sector (e.g., Beck, et al, 2004) or by robust equity markets. It should be noted, however, that our study does not examine access to all forms of external finance, but specifically to debt finance. Therefore, one should not necessarily draw the conclusion from our work that, e.g., Scandinavia has a “good” system (vis-à-vis common law countries) because its dummy variable has generally positive coefficients. For example, it might be the case that Scandinavian firms face incentives to obtain high levels of debt finance because equity markets (related to low levels of legal protection for small shareholders) do not function as well as they do in common law countries. Similarly, a generally negative sign is not an inherent critique of French and German legal systems, because it might be the case that their equity markets are superior in some ways to common law (or Scandinavian countries); there is little evidence to support this supposition, however. Further research is warranted into the causal effects of institutional arrangements, and whether capital constrained firms (including small, privately held ones) are able to access external finance of various sorts to allow for expansion of successful projects in different institutional settings.

4. Conclusion

Fan, Titman, and Twite (2012) argue that, “Specifically, the fact that institutions influence how firms are financed may provide an indirect channel through which a country’s institutions affect economic growth. For example, there is reason to believe that if firms can raise more of their capital with equity and long-term debt, they will be better able to make longer-term investments, which may better promote economic growth. This suggests that an analysis of the relation between investment horizons and institutional structure offers an interesting avenue for future research.”
In this paper, we exploited the natural institutional variation of Western Europe to examine leverage and debt maturity. Unlike in most previous studies on leverage, however, we considered not only companies that are listed on public equity exchanges, but a large number of non-listed companies (NLCs) as well. We focused on firms in Western Europe, where the historical legacy of legal origin has not been diluted or adapted due to transplantation to another continent or to a wholly different social and historical tradition.

One of our key findings is that the widely-cited LLSV (1996, 1997) creditor rights measure CRED is not ideal for aspects of investor protection that affect leverage. We did not find that higher CRED scores, using either the version released in 1996 or the one from 1997, had the expected relationship (monotonic increase as creditor rights improve) with either leverage or debt maturity. One component of the CRED score was consistently and positively associated with leverage: whether secured creditors are paid first in the event of distress.

By supplementing the typical analysis of publicly traded companies with a very large sample of privately held firms, we were also able to consider whether status as a listed company affects leverage decisions. Using a matched sample of otherwise similar privately held companies, we find that listed firms have less debt, consistent with a corporate governance interpretation that presumably more dispersed publicly traded firms are more likely to avoid the disciplining device of leverage. The findings are robust to use of industry-level fixed effects.
REFERENCES


La Porta, R., Lopez-de-Silanes, F.; Shleifer, A.; and Vishny, R. (1996), Law and Finance, NBER working paper 5661.


Appendix: Variables Employed

Panel A: Dependent Variables

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<thead>
<tr>
<th>Variable</th>
<th>Description</th>
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</thead>
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<tr>
<td>LTD/TA*</td>
<td>Long-Term Debt/Total Assets</td>
<td>Amadeus data base</td>
</tr>
<tr>
<td>LTD/TD*</td>
<td>Long-Term Debt/Total Debt</td>
<td>Amadeus data base</td>
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Panel B: Independent Variables

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<th>Variable</th>
<th>Description</th>
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</tr>
</thead>
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<tr>
<td>EFFTAX*</td>
<td>Effective Tax Rate: Taxes/(EBIT-Interest)</td>
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<td>TANG</td>
<td>Tangible Assets: Net Fixed Assets/Total Assets</td>
<td>Amadeus data base</td>
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<tr>
<td>ROA*</td>
<td>Return on Assets (EBIT-interest-taxes)/Total Assets</td>
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<td>LNTA</td>
<td>Natural Log of Total Assets</td>
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<td>CRED97</td>
<td>Creditor Rights</td>
<td>La Porta, et al, 1997</td>
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<tr>
<td>CRED96</td>
<td>Creditor Rights (for components A-D, see Panel C below)</td>
<td>La Porta, et al, 1996</td>
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<td>LISTED</td>
<td>Dummy taking value of “1” for publicly-traded firms</td>
<td>Amadeus data base</td>
</tr>
<tr>
<td>ASSETSPEC</td>
<td>Dummy variable taking value of “1” for firms with highly-specific assets (SIC categories 10-14, 20-39, and 40-49 including mining, manufacturing, and transportation)</td>
<td>Author calculations based on Amadeus data base SIC categorization</td>
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<tr>
<td>Common</td>
<td>Dummy variable taking value of “1” for Ireland and UK</td>
<td>La Porta, et al, 1997</td>
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Panel C: Specifics on Creditor Rights and Legal Family Variables
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<td>4</td>
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*Windsorized as described in text (Frank and Goyal, 2005).*
Table 1: Data Description

(Following SIC-code narrowing, truncation of firm-years with negative book equity, and windsorization of outliers)

Panel A: Firm-Year Observations by Year and Legal Family

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<th>Year</th>
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<th>German</th>
<th>Scandinavian</th>
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<td>729</td>
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<td>2001</td>
<td>7,448</td>
<td>23,549</td>
<td>262</td>
<td>3,676</td>
<td>34,935</td>
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<tr>
<td>Total</td>
<td>58,326</td>
<td>139,549</td>
<td>6,488</td>
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Panel B: Observations and Average Values of Dependent Variables
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Panel C: Observations by Legal Family and Creditor Rights Score

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<tr>
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<th></th>
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<td>87,614</td>
<td>6,166</td>
<td>56,191</td>
<td>220,723</td>
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</table>
The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CREID variables reflect dummies based on LLSV (1996) as indicated in the appendix.

Table 2: Baseline Models

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<td>-0.000</td>
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<tr>
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<td>0.225***</td>
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<td>German</td>
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<td>(11.97)</td>
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<td>20.55%</td>
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</table>

†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively
### Table 3: Creditor Rights and Legal Origin

The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CREID variables reflect dummies based on LLSV (1996) as indicated in the appendix.

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<th>Dependent Variable</th>
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<th>(2) LTD / TD</th>
<th>(3) LTD / TA</th>
<th>(4) LTD / TD</th>
<th>(5) LTD / TA</th>
<th>(6) LTD / TD</th>
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</thead>
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<td>--</td>
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<td>0.217***</td>
<td>0.143***</td>
<td>0.221***</td>
<td>0.146***</td>
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<td>-0.081***</td>
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<td>-0.005***</td>
<td>0.003*</td>
<td>-0.007***</td>
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<td>(1.81)</td>
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<td>0.006**</td>
<td>0.008**</td>
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<td>0.021***</td>
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<td>-0.008**</td>
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<tr>
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<td>(22.91)</td>
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<tr>
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<td>21.89%</td>
<td>16.50%</td>
<td>21.19%</td>
<td>11.49%</td>
<td>15.49%</td>
</tr>
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<td>186,477</td>
<td>191,278</td>
<td>191,246</td>
<td>186,498</td>
<td>186,477</td>
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<td>47,339</td>
<td>47,334</td>
<td>46,453</td>
<td>46,450</td>
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<td>Firms</td>
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<td>14,872***</td>
<td>19,631***</td>
<td>11,137***</td>
<td>14,358***</td>
</tr>
</tbody>
</table>

†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively
Table 4: Legal Family

The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CRED variables reflect dummies based on LLSV (1996) as indicated in the appendix.

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<th>Dependent Variable:</th>
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<th>(4)</th>
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<td>(0.00)</td>
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<td>-0.0005*</td>
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<tr>
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<td>Tang</td>
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<td>LnTA</td>
<td>AssetSpec</td>
<td>Listed</td>
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<td>Obs.</td>
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<td>-0.186***</td>
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<td>(-7.34)</td>
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<td>(-12.70)</td>
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<tr>
<td></td>
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<td>0.022***</td>
<td>0.013***</td>
<td>0.019***</td>
<td>0.001***</td>
<td>0.001***</td>
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<td>(15.38)</td>
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<td>(5.37)</td>
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<td>21.38%</td>
<td>17.30%</td>
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<td>7.33%</td>
<td>9.91%</td>
<td>12.68%</td>
<td>16.83%</td>
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†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively
Table 5: Pooled Estimations of CRED Components and Legal Origin

**PANEL A: Components Entered Singly**

The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variable is leverage (long-term debt over total assets). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CRED variables reflect dummies based on LLSV (1996) as indicated in the appendix.

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| Obs. | 186,498 |
| Firms | 46,453 |
| Overall R² | 10.64% | 14.52% | 13.49% | 11.83% | 17.59% | 20.39% | 16.88% | 15.97% |
| Wald chi² | 10,545*** | 13,092*** | 12,639*** | 11,566*** | 15,885*** | 17,880*** | 15,268*** | 14,507*** |

†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively.
The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variable is leverage (long-term debt over total assets). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CRED variables reflect dummies based on ILSV (1996) as indicated in the appendix.

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<td>(-4.75)</td>
<td>(3.48)</td>
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<td>-0.084***</td>
<td>-0.056***</td>
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<td>0.017*** (8.15)</td>
<td>-0.018*** (-7.17)</td>
<td>-0.015*** (-4.40)</td>
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<tr>
<td>CRED-C (Secured creditors paid first)</td>
<td>0.080*** (42.25)</td>
<td>0.119*** (47.02)</td>
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<td>--</td>
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<td>Overall $R^2$</td>
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<td>20.91%</td>
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†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively.
Table 6: Matched Sample Results

The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility: defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CREd variables reflect dummies based on LLSV (1996) as indicated in the appendix. Observations are restricted only to listed firms with matched non-listed firms; matched observations have identical year, country, and SIC code with either slightly larger or slightly smaller size (measured as log total assets).

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<th>(4) LTD / TD</th>
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Table 7: Robustness to Legal Efficiency

The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CRED variables are dummies based on LLSV (1996) as indicated in the appendix.

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The table reports coefficients (with z-statistics in parentheses) for estimations using general least squares. The dependent variables are either leverage (long-term debt over total assets) or maturity (long-term debt over total debt). EffTax is the effective tax rate, defined as tax payments over net income; Tang is asset tangibility defined as fixed assets over total assets; return on assets (ROA) is defined as net income over total assets. The variable LnTA is the natural log of total assets; AssetSpec refers to the specificity of assets and is a dummy variable taking the value of “1” for the mining, transportation, and manufacturing firms. Listed is a dummy variable taking the value of “1” for all firms that are listed on stock markets. The various CRED97 variables reflect dummies based on LLSV (1997) as indicated in the appendix; note that in the rest of the paper, we use values from the 1996 LLSV paper. Columns 7 and 8 use only matched observations of listed firms based on year, country, SIC, and size (log of total assets).

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†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively.

**Table 8: Robustness to CRED97**
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<td>0.088***</td>
<td>0.102***</td>
<td>0.170***</td>
<td>0.116**</td>
<td>0.165**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(3.29)</td>
<td>(4.97)</td>
<td>(7.82)</td>
<td>(9.84)</td>
<td>(2.36)</td>
<td>(2.48)</td>
</tr>
<tr>
<td>Scand.</td>
<td>--</td>
<td>--</td>
<td>0.024***</td>
<td>0.043***</td>
<td>0.028***</td>
<td>0.049***</td>
<td>-0.036</td>
<td>-0.064*</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(3.57)</td>
<td>(4.88)</td>
<td>(4.28)</td>
<td>(5.70)</td>
<td>(-1.34)</td>
<td>(-1.75)</td>
</tr>
<tr>
<td>Overall R²</td>
<td>14.69%</td>
<td>18.66%</td>
<td>16.30%</td>
<td>20.96%</td>
<td>20.17%</td>
<td>24.99%</td>
<td>18.54%</td>
<td>25.49%</td>
</tr>
</tbody>
</table>
Table 9: Robustness to SIC inclusion

PANEL A: Prevalence of SIC Codes By Country

<table>
<thead>
<tr>
<th>Country</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>13.06%</td>
<td>19.91%</td>
<td>13.38%</td>
<td>1.02%</td>
<td>49.68%</td>
<td>2.94%</td>
</tr>
<tr>
<td>Finland</td>
<td>11.30%</td>
<td>20.96%</td>
<td>8.18%</td>
<td>2.83%</td>
<td>50.45%</td>
<td>6.28%</td>
</tr>
<tr>
<td>France</td>
<td>6.98%</td>
<td>18.74%</td>
<td>6.38%</td>
<td>0.79%</td>
<td>56.90%</td>
<td>10.21%</td>
</tr>
<tr>
<td>Germany</td>
<td>9.99%</td>
<td>23.65%</td>
<td>11.95%</td>
<td>0.93%</td>
<td>44.46%</td>
<td>9.01%</td>
</tr>
<tr>
<td>Greece</td>
<td>8.05%</td>
<td>31.50%</td>
<td>7.33%</td>
<td>1.08%</td>
<td>48.42%</td>
<td>3.62%</td>
</tr>
<tr>
<td>Ireland</td>
<td>11.38%</td>
<td>27.17%</td>
<td>12.88%</td>
<td>6.23%</td>
<td>38.27%</td>
<td>4.07%</td>
</tr>
<tr>
<td>Italy</td>
<td>8.23%</td>
<td>19.68%</td>
<td>12.62%</td>
<td>0.44%</td>
<td>52.43%</td>
<td>6.60%</td>
</tr>
<tr>
<td>Portugal</td>
<td>19.93%</td>
<td>21.49%</td>
<td>7.13%</td>
<td>1.04%</td>
<td>47.66%</td>
<td>2.76%</td>
</tr>
<tr>
<td>Spain</td>
<td>13.61%</td>
<td>19.03%</td>
<td>6.54%</td>
<td>1.19%</td>
<td>51.83%</td>
<td>7.80%</td>
</tr>
<tr>
<td>Sweden</td>
<td>8.35%</td>
<td>15.90%</td>
<td>8.38%</td>
<td>1.34%</td>
<td>56.84%</td>
<td>9.19%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3.73%</td>
<td>25.16%</td>
<td>5.28%</td>
<td>3.42%</td>
<td>46.58%</td>
<td>15.84%</td>
</tr>
<tr>
<td>UK</td>
<td>13.02%</td>
<td>20.10%</td>
<td>6.94%</td>
<td>4.17%</td>
<td>42.13%</td>
<td>13.64%</td>
</tr>
</tbody>
</table>

†, *, **, and *** indicate significance at the 15%, 10%, 5%, and 1% levels, respectively.
PANEL B: Prevalence of SIC Codes By Legal Family

<table>
<thead>
<tr>
<th>Legal Family</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common</td>
<td>12.96%</td>
<td>20.36%</td>
<td>7.16%</td>
<td>4.24%</td>
<td>41.99%</td>
<td>13.29%</td>
</tr>
<tr>
<td>French</td>
<td>9.45%</td>
<td>19.65%</td>
<td>8.05%</td>
<td>0.83%</td>
<td>53.81%</td>
<td>8.21%</td>
</tr>
<tr>
<td>German</td>
<td>10.42%</td>
<td>22.83%</td>
<td>11.96%</td>
<td>1.08%</td>
<td>45.82%</td>
<td>7.89%</td>
</tr>
<tr>
<td>Scandinavian</td>
<td>9.08%</td>
<td>17.68%</td>
<td>8.35%</td>
<td>1.80%</td>
<td>55.25%</td>
<td>7.84%</td>
</tr>
</tbody>
</table>

PANEL C: Impact on Findings from SIC Fixed-Effects Models

<table>
<thead>
<tr>
<th>Key Variable</th>
<th>Comparison with reported results (Tables 2 – 8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRED (1996)</td>
<td>Basic findings from Tables 2 and 3 hold—dummies derived from CRED inconsistent</td>
</tr>
<tr>
<td>CRED components</td>
<td>CRED-C still consistently positive and significant (others negative or unstable)</td>
</tr>
<tr>
<td>Tangibility</td>
<td>Maintains strongly positive coefficient (high significance)</td>
</tr>
<tr>
<td>ROA</td>
<td>Maintains strongly negative coefficient (high significance)</td>
</tr>
<tr>
<td>Asset Specificity</td>
<td>Not able to test this (specificity is an artifact of industry code)</td>
</tr>
<tr>
<td>Listed</td>
<td>Negative relationship to leverage for common law, but positive for others; inconsistent sign when including CRED-A-D; negative and (generally) significant for matched sample (Table 6); negative and significant when holding for efficiency</td>
</tr>
<tr>
<td>Legal Origin</td>
<td>Findings related to legal family variation for firm-level determinants of leverage hold (Table 4)</td>
</tr>
<tr>
<td>Efficiency</td>
<td>Findings hold—efficiency coefficient positive, stable, and highly significant</td>
</tr>
</tbody>
</table>
Legal effectiveness: Theoretical Developments Concerning Legal Transplants

Jan Torpman and Fredrik Jörgensen, Stockholm

Published in Archiv Für Rechts und Sozialphilosophie (4) 2005.

ABSTRACT

The dominating view of legal efficacy is based on the idea of a gap between what the law states, or commands, and how the population acts. When behaviour is not in accordance with law, the legal system or a norm is not considered effective. This idea is challenged in this article. Previous research on legal transplantation is used as reference for an analysis of legal application and legal effectiveness from a sociological and systems theoretical perspective. It is well known that imported laws function less well than internally developed laws, but explanations differ. According to the currently known effectiveness concept the poorly functioning imported law is a paradox. In this article a new effectiveness concept is developed. It is shown how the poor functioning legal transplants can be explained using our new approach to legal application and legal effectiveness.

1. Introduction

Some evidence seems to support that countries developing effective laws on the books have stronger economic development than other countries. Therefore many countries changing from socialism to market economies have attempted to enact new corporate codes or revive legislation from the period before socialism. The idea to rapidly develop transition economies or developing countries more effectively has been applied also by American legal assistance to for example African countries, where American legislation has been transplanted with the purpose of improving economical parameters as well as moral justice. In the American assistance case it has been discovered during the 1970’s that the legal aid did not lead to expected outcomes. Instead of economic development, even distribution of wealth and power, the countries receiving legal

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assistance often suffered serious adversaries. Investments in legal education, designed to change the orientation and role of the lawyer, have yielded little change in economic performance or social relations. Transplantation in developing countries often means that more formalized, or complex, procedure and thinking is mounted in a legal system not accustomed to it. The legalization of areas of social life and increased formalization of the legal process increases the costs of protest. The social structure and economic interests of the legal profession may cause natural alliances between lawyers and powerful groups, possibly to prevent fundamental changes in developing countries or transition economies. From the auditing profession this type of problem is a well known, but debated, theme – auditors issuing of new auditing standards has been understood as more of symbolic that substantial action.4 Thus issuing new rules may be a way to complicate a subject, to cause a layman’s understanding of it to decrease and to increase the gap between public knowledge and professional knowledge.5 Countries transplanting modern law have experienced a rising gap between public and professionals, law in the books and law in action, in terms of lower degrees of involvement among the population in political processes creating legal change in turn causing domestic legal development to halt. Norms are not internalised and the responsibility of the state to provide official enforcement action to compensate becomes an impossible task.

Despite negative experiences from legal transplantation, theory and practice has not managed to change perspective on the role of law in social processes. A search for new ideas that can explain anomalies seen in the failures of legal transplantation should be useful not only for the future designs of transplantation projects, but also for the understanding of western, domestic legal systems. When we, time and time again, note that legal rules of whatever level of abstraction or formalization, when promulgated in processes that have little contact between the end users of these rules result in low degrees of utilization of rules, we should take care to re-appraise our understanding of what legal effectiveness should mean and how it can be attained. Traditional ideas about the relationship between strong law enforcement and norm compliance is questionable. The strong focus among scholars of legal transplants on professional aspects and legal institutions is due for a review as well. The reasons are that these approaches target only a fraction of the legal system, and regrettably the parts that are not frequently involved in the social processes where law is applied in everyday life.

A current problem for our understanding of the processes affecting success and failure of legal transplantations, mostly concerning transition economies and developing countries but not necessarily restricted to them, is that the conventional concept of legal effectiveness builds on assumptions about the relationships between law and its environment that lay too strong emphasis on the professional and institutional aspects of law. Thus when we discuss problems concerning legal effectiveness we are already applying the ideas that underlie this type of thinking: (1) The idea of society is based on Hobbes – society is made of its individuals and consequently the legal system of a nation state is also defined as a person-based concept. We tend to assume that law is the result of the activities of a profession. (2) Law is a teleological tool, used by the state with the purpose to control the persons who live in the territory of the state. The form of control is primarily coercive, which means that the state coerces those who violate law and refuses aid to those who fail to comply with requested conditions. (3) The positivistic idea that law is the will of the people. We tend to assume that law is a set of norms, and that norms can be designed through a pluralistic political process where intermediate groups aggregate individual interests. Thus, rules are seen as the realisation of individual interests of the population of the state. (4) The division of power. Promulgation and

5 In auditing this gap, the auditing expectations gap, is of primary importance. It is interpreted as a sign of a serious problem since it may cause erosion of the public’s trust in auditing. Frequently auditors have to take the blame for economic scandals in which they actually play minor roles.
change is typically performed by legislatures, but courts and other executive authorities perform application and interpretation.

In this paper the assumptions of the person-based idea of law are critically analysed in order to determine what it may sensibly mean to say that a legal order and a legal norm in it is effective. Conventional conceptions of effectiveness are shown to rely too heavily on a too narrow definition of law in order to contribute to an extended understanding of the relationship between law and its environment. A new definition of legal effectiveness is suggested which is not restricted to the assumptions mentioned above, but can include a wide array of norm types and functions of law. Legal transplantation, the import of foreign law to a legal system as a means to speed up legal change, is discussed as an example on which the new effectiveness concept is applied with beneficial results.

Theoretical assumptions

The argumentation of this paper is based on three closely related assumptions regarding how legal application occurs in non-professional contexts. The first assumption considers the role of trust as facilitator and regulator of legal application. Here it is argued that trust functions as gatekeeper for a layman’s choice to adopt law as his/her means to communicate a matter and therefore as a facilitator of or hinder for law’s contact with the socio-economic reality.\(^6\) Trust is most frequently defined as reliance on something one cannot control and on which one is dependent.\(^7\) In this paper we adopt the conventional view in order to understand what makes law effective and how effectiveness should be defined. Legal effectiveness from a sociological perspective should not be restricted to the effects of the professionally supplied services of lawyers and officials. Instead it should be concerned with a broad concept of law and the actual use of law by laymen in the streets including the married couple discussing family relationships, directors in a boardroom debating possible strategies, as well as the purchase of a car. The supply of professional services in this view becomes only a special form of legal application. I have chosen to make a distinction between primary (by laymen) and secondary (by professionals) legal application for the purpose of emphasising the focus on a broad perspective on legal effectiveness. Phenomena concerning trust are most relevant for primary legal application. For reasons explained later in this paper primary legal application takes place with insufficient knowledge of law and therefore the consequences of applying it in real situations are often relatively diffuse for those who apply law.\(^8\) The end user of law is only occasionally a professional lawyer, why we should assume that the user must live with significant levels of ambiguity when choosing to debate a matter in legal terms. The user of law will tend to choose law as system’s reference only if he/she feels confidence in his/her ability to do so successfully. Trust in subjects’ ability to deal with ambiguous situations should therefore be a concern for the analysis of primary legal application.

\(^{6}\) Such concepts as socio-economic reality are admittedly diffuse, and highly questionable but are employed here for the purpose of simplifying an otherwise burdening discussion which is beyond the scope of this paper.


\(^{8}\) The legislator often has insufficient knowledge too of the consequences of legal application according to Means, R. C. (1980) Underdevelopment and the development of law. Chapel Hill: University of North Carolina Press. Means found that Spain and Colombia have promulgated laws that did not fit the economic conditions of the countries and therefore were not used. Legal development in these countries therefore took place without much contact between law and economy.
A focus on the activities of laymen has merits. The question of how law is actually applied by ordinary people in ordinary experiences can be reformulated as the question regarding how law is in contact with society. Causal models where law is assumed to cause occurrences in the environment are oversimplifications and misappropriations of the relationship between law and society. Law seldom by itself causes action, but interplays with other motivational factors and contributes to shifted distributions of probabilities for diverse forms of action. Furthermore, there are forms of law that can persuade and define rather than command, why a model of law’s contact with society cannot be a causal chain. If we chose to understand law as a structure or backbone of society, as most legal philosophers and legal sociologists do in normative perspectives on law, we are inspired to ask instead how law can function as an institution or as a system of meaning and thus in more indirect ways affect the behavioural premises of man. A perspective and theory of law that offers many degrees of freedom at this point is Luhmann’s theory of law as a systems reference – a difference between law and its environment that can, but does not have to, be referred to in communication between people in everyday life. Thus law may be assumed to be a system of meanings that can be referred to, voluntarily or coercively. It is important to note that law does not have to be used. It may be used, but there are other means to communicate and law may bring about consequences, which are too burdening or too costly in some instances. One could say then that a person with the option to use legal meanings for communication does not feel content with the expected consequences of referring to legal figures for defining a situation. The discontent may be related to undesired effects of using law. A person may expect to lose a trial, why the person should refrain from litigation. A person may be negative to the prospect of looking at a relationship as a contract, why the person chooses to be silent rather than to speak and refer to a presumed contract. But this type of calculative advantages or disadvantages should even themselves out between parties. What some see as advantages are disadvantages to the opposing side. Therefore motivation for interpreting and defining relationships in legal terminology will typically emerge, and we recognize from our own experience that references to law, direct or more indirect, are very common. Many aspects of life cannot even be communicated without referring to the legal system. Marriage and partnerships as well as owning property are meaningless without the legal system.

If the motivation for referring to legal terminology and even legal provisions vary between parties and from time to time depending on some estimation of cost and benefit another aspect that is not evened out between parties must also be taken into account. A person who calculates costs and benefit from referring to law must include in the calculation his ability to interact not only with a counterpart but also with the communication system referred to – law. Therefore we use the combined idea that trust in the system and trust in the ability of oneself to use the system are preconditions for legal application. For the professional jurist only the first condition is normally relevant. The jurist will apply law if he/she believes it fruitful to do so. But for the layman it is different. The layman should find it attractive to refer to law only if both conditions are fulfilled. Only if law could be expected by the person to be advantageous should law be referred to, but even in a favourable calculation the person could be deterred. If the layman feels uneasy about his ability to discuss his relationship in legal terminology the calculation of the effects of defining the relationship in legal terms may not even happen. The choice to abstain from legal wording is intuitive and possibly unconscious. The person who feels low degree of confidence in his ability to define and argue a relationship with reference to law will tend to choose not to do so.

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The choice whether to apply or not apply law a means for communication should be governed by some expectation (rational or emotional) of the consequences of doing so. Here it is argued that the estimation however accomplished should even out between parties, so the positive prospects of one side should compensate for negative expectations on the other. A systematic reluctance to adopt law for defining situations and relations should be independent of this type of economic causes. Instead it is argued here that, if there is a choice at all, law tends to be used by persons who trust their ability to use legal communication for relating to their environment. Therefore the argumentation for an extended effectiveness concept will focus on aspects of trust concerning application of law in ordinary, frequently occurring situations where legal experts are not available.

The second assumption concerns how the main part of legal application happens. A national legal system can be described at many levels of complexity and from many perspectives. Legal application must be one of these descriptions, since applying law is a form of knowing law, being aware of its boundaries, and filtering unacceptable from acceptable legal argumentation. The conventional view of legal application defines it as application of the knowledge normally in the possession of professional jurists. Even if professional jurists are not referred to in definitions of legal application the kind of argumentation brought forth implies that a precondition for legal application in the sense of the conventional view must be professional knowledge of the legal system. However, the idea of legal application, or legal argumentation, seems to be a theoretical construct with little basis in reality. Legal application in concrete legal conflicts is less methodical and less determined by general principles than literature has suggested. It varies from situation to situation and between persons. Typical legal argumentation runs from part to part rather than from system to part. Conclusions are derived from examples rather than from systematic deduction. Parties to legal conflicts are morally free to disregard the possible systematic consequences of their reasoning, while judges must bear in mind not only the case at hand but also future cases and general principles relating cases to each other. Litigants and defendants may twist and bend the binding method of interpretation and creatively read legal texts in favour of their interests, but judges must be more neutral. Thus, the style of legal application or legal argumentation varies between roles in a legal system.

The most marked difference, however, runs between laymen and professional jurists, regardless of role or position. Legal application is to a large extent an information problem, and knowledge of the juristic method of interpretation is a precondition for a legal application in the conventional lawyers’ law sense. How the information problem is handled divides legal application in two layers, between primary and secondary legal application. Only in a secondary sense does legal application correspond to lawyers’ conception of law.

If the assumption is accepted that people in general do not possess the specialized professional knowledge of law that jurists have and therefore that people cannot base their expectations and actions on this knowledge a revised idea of legal application should be developed. Let us propose that legal application in the streets is something quite different from legal application in the courts although related. Paradoxically the conceptual apparatus available to laymen is similar to the tools developed and used by legal scientists. Analytical jurisprudence operates with definitions: What is law? What is a state? What is a right? What is real estate? What is possession? Laymen operate with definitions as well, but they do not possess the expertise necessary for

12 Institutionalists would argue that the extent of the choice is minor, but no rational calculation is supposed here why the choice suggested can be imagined to take place regardless of school of thought concerning choice in terms of decision-making.
understanding the sharper distinctions between concepts. Instead laymen use concepts incompletely understood. The situation is similar to how rules of thumb replace the search for optimum in organizational decision-making.\textsuperscript{16} Organizational decision makers follow heuristics according to a logic of appropriateness rather than optimisation when they decide matters concerning the organization. But even for analytical jurisprudence conceptual definitions have great ambiguity.\textsuperscript{17} Regardless of philosophical perspective, basic legal concepts are at least useful tools for understanding the system of norms that we call law. Our questions, both as laymen and as philosophers of law, regarding the exact meaning of the concepts have therefore a function beyond clarity for its own sake. When we think that we owe tax to the state it is useful for us to know what the state is, and consequently what the word ‘state’ stands for. When we follow the rules for calculating our annual income in order to determine how much tax we ought to pay this year we almost never refer directly to legal provisions, unless we are legal professionals. Instead it is common to use brochures from the tax authorities and oral instructions. The state as particular corporate body is taken for granted as an overarching societal body that represents the common sector on which we all are dependent. The basis for our conception is far from clear for us when we use them and difficult philosophical problems may be hidden in them, but they do not concern the function of basic legal concepts for the kind of primitive legal application that laymen indulge into in everyday life. Ambiguous meanings are not a problem for legal application, but a solution to the information problem that laymen experience when attempting to relate to law without expert assistance. They do it by referring to diffuse ideas of rights and obligations in a search for certain but not perfectly specified meaning. What they want cannot be got out of a dictionary but is part of a particular language game.\textsuperscript{18} When a layman says that I have a right it does not mean that we can look up in a dictionary and understand the meaning of the phrase. However when the addressee of his communication is trying to decipher his intended meaning and determine what and if to answer it will be shown that there is no object in the world corresponding to the word ‘right’. Any attempt at a definition once and for all in the form ‘a right is a set of expectations’ is either too general for any clarification of meaning or moves the target again when referring back to law which is an equally elusive concepts as a right. The layman refers to his right but is not able to generally define what he means. He simply refers intuitively to a pattern of interpretations called law that he presumes will back his demand for ‘a right’.

The use of basic legal concepts that takes place in the layman when he tries to communicate referring to law has been dealt with for a long time in legal philosophy. Their conceptual use is very different from that of the layman but philosophers are struck too by the complexity of entangling the meaning of basic legal concepts. Efforts to define have divided philosophers in schools of thought or paradigms. American realists have claimed that the term right simply signifies that one should expect that a court would rule in a certain direction. The probable behaviour of courts or officials gives meaning to a concept. Scandinavian realism has taken a further step to think that a right corresponds to nothing real at all, but is an ideal, fictitious, or imaginary power. The theory summarized by the name natural law and criticized by all realist or positivist theories assumed that rights and obligations were some sort of things. But the less reflected idea that rights are things in themselves and the fierce criticism of it shares a problematic relationship to how such words as rights and obligations are to be understood in legal terminology. When asking for the facts to which a right corresponds one could indulge into diverse reductions of legal interpretation so as to define law in terms external to law. Thus it is an attempt to describe what law says without using the terms of law. It appears from attempts at defining legal concepts in non-legal language has failed precisely because the meaning of the words such as right or corporation is to be understood contextually, as references to legal

\textsuperscript{18} Wittgenstein, L. Von (\?) Filosofiska undersökningsar.
interpretations rather than imports of images or meanings from the world of facts. Any attempt to define a right or a corporation in other than legal language is impossible. A translation of legal phrases to factual meanings is impossible.  

When legal concepts are analysed it is assumed that definitions can be made stating the exact meaning of words. Legal dogmatic does not search for definitions of legal terms in extra legal language, but is a quite legal affair. Legal terms are defined with the aid of other legal terms, but when the legal scientist goes about interpreting and defining it is a different task from that of the layman. It is not only a difference in degree of complexity of the tasks but also a difference in scope. While the professional legal scientist defines legal problems so as to be able to spot paradoxes in the system of concepts the layman sets an interpretation in motion. When the layman utters 'I have this right' it means that the layman claims a legal position as he/she understands it according to legal consciousness (Rechtsbewusstsein). When the legal scientists see legal persons as analogies with physical persons and suggest that legal persons should be able to acquire rights and obligations according to the same principles as do physical persons laymen imagine their corporation as a separate, independent body in order to understand a set of legal rules already in operation. For laymen basic legal concepts serve the purpose of enabling legal claims without detailed knowledge of specific rules. Basic legal concepts reduce complexity sufficiently to enable a primary application of legal rules. By primary application of legal rules we understand the relatively unspecific legal claims made by laymen when attempting to advocate law as means for defining the relationships with other entities, whether physical or other persons.

We immediately recognize the importance of this observation. The large majority of legal application should be of this simple kind. They do not involve any advanced knowledge of law. This form of legal application is the simplest of legal argumentations. It involves the claim ‘I have a right’ and a justification ‘because the situation is this’. It does only distantly relate to the textual self-description of law as a system of interrelated texts. Instead it states relatively without context that the right is a fact in the case. Contrary to most discourse of legal application the primary legal application takes place on the level of basic legal concepts. In conventional ideas of legal application it is frequently assumed that legal application is, if not informed on the level of a legal scientist, at least uses a concept of law as a number of relevant texts, which is essentially what is taught to students of law in common introductions to law.

The third assumption of this paper concerns the concept of law. Critics have noted that the concept of law as it appears in law and society studies is based on, but often moderated, on the idea of commands backed by threat. For our purposes, which are to find a definition of legal effectiveness that allows for more precision in the description and empirical investigation of how legal systems develop and cooperate with society, another aspect of the common approach to legal effectiveness is even more important. We must depart from a view of law that overemphasizes the individual, group or professional aspects of law. It does not suffice for our purposes to suppose that laymen, who according to the person-based or professional approach to law and society are external to law, do not apply law when they claim for example ‘I have a right’. We need a concept of law that is truly societal, relevant and present in all circumstances where law in some sense is in contact with other parts of society as well as with persons. We need a concept of law that can reduce the apparent technical character of law without loosing the peculiar features of this system. For these reasons law may be defined as a system of

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communications in Luhmann’s sense.\(^{21}\) As a system of communications law we can understand how law is applied as much in the layman’s words as in the courts of law and other official institutions. The conventional understanding of law is that it consists of norms. What norms consist of is often bypassed in sociological approaches to law and society and the question of how norms are upheld is directly approached instead. The consequence of this type of reasoning is that norms are held to be some sort of thing – often a text, a provision, or more abstractly a command or directive. But norms are not necessarily the exclusive property of law. Norms can be observed in moral, ethical, and religious conditions where law is totally irrelevant. As sociologist one should, and this lies behind the peculiar definition of law as a system of communications, be able to ask how norms can exist in such different conditions and yet share some features that make us call them norms. This study of law as a system of norms describes law as a normative system among other normative systems.\(^{22}\) Norms are described as statements that imply some cause for behaviour according to them. An \textit{ought to} statement which implies that if it is not followed something pleasant or unpleasant could happen. It can be learnt from von Wright that norms cannot be reduced to imperatives alone as a type of language phenomenon.\(^{23}\) There are norms that do not take the form of imperatives why the special character of legal norms are sought elsewhere. At this point different theories depart and it is not possible to discuss here the advantages and disadvantages with the multitude of different approaches, or schools of thought, attempted at explaining the special nature of legal norms. Here we must contend with a description of a concept of law that allows treatment also of the non-professional legal activities that should, in an intuitive sense, be part of what we call the legal system when describing its contacts with other parts or society. This treatment can be accomplished if we look at norms as an example of a more general phenomenon – expectations or communications. As expectations, structure, the possibility to repeat and predict communications, legal norms form a basis for institutionalisation. Many things can be taken for granted thanks to law. The ordering of social and economic relationships can proceed without securing and negotiating everything. Parties can rely on that some expectations remain the same, regardless of the dispositions chosen in a particular case. Other expectations must be formed by experience (learning) and they constantly change as new observations are made. There is a difference, then, between cognitive (learning) and normative (non-learning) expectations and we can use it to explain how the expanded concept of law will provide a stronger basis for a new view on legal effectiveness.

Cognitive and normative expectations, first conceptually developed by Galtung, helps relate the behavioural aspects of law and a theory of legal validity.\(^{24}\) While a dentist changes his opinion of his sick patient if he observes other patients recover from the same disease by proper treatment, we remain firm in our judgement of the criminal regardless how many times we see the same criminal act.\(^{25}\) Normative and cognitive expectations are two different orientations towards experience – you either learn or remain the same. Law is typically normative expectations, or ‘contrafactually’ stabilised expectations, which means that when expectations are disappointed it is the experience and not the expectation, which is dealt with.\(^{26}\) From the perspective of the layman the legal system consists of presumed static norms. Law is applied when the layman uses legal communication to provide legal meaning to a situation. The


application is limited to what the layman understands and feels comfortable with. This sense of legal application is related to a theory of legal validity, which is the core of legal theory and the hart of law, through the expectations platform. We can understand the peculiarity of legal norms by the ways legal norms are made valid. They are expectations, which cannot be controlled by the single individual referring to them. Legal application involves recognising that law is normative expectation. In turn this means recognising that law is established through procedures, which is outside the individual’s control. No individual, but a set of institutions – the legislator, the courts of law, legal doctrine, and possibly custom determine what law says and which law applies. The circumstances, under which law can or should change, are determined by the same institutions. In this sense law is a set of expectations, or a factual repetition of a code legal/illegal that separates legal communications from other communications so that one can see law in a sense as a hermetically closed system of autopoietic (self-produced) operations. The closed aspect of law concerns only the production of validity of legal communications, and does not exclude extensive contact with non-legal systems or persons.

Thus it is assumed here that law is a system of legal communications that includes not only the traditional sources of law, but also the method of interpretation and method of deduction of a legally valid answer to a problem. Compared with Kelsen’s pure concept of law it contains the notion of basic norm in the systems theoretical autopoiesis-concept. Law is necessarily a self-positing system and the idea of the final element on which it is built is therefore logically impossible, why Kelsen had to propose the basic norm as an endless regression where Luhmann and others could instead use systems theory for handling the circularity of systems formation. Without diving any deeper into these discussions, we may note that law is not a system of norms in the traditional sense, not a typology of norms, but a continuously processed difference between law and environment. We do not assume as did Hart in his The Concept of Law, that there is a given hierarchy of norms according to which we may classify law as consisting of them. Instead law is processed as operations, however they look and function, that must address again and again, by carrying with them a sense of legal validity, the difference between law and environment. It is at this point where the theory of legal validity coincides with the layman’s application of norms. The processing of the difference that constitutes law cannot be the exclusive property of any person, group, or profession, but must be distributed among any persons who are able to communicate. Legal application must be understood as the reproduction of validity by recognition of the difference between law and environment, which in practice means some knowledge of the legal sources and basic legal concepts. Law is valid because it is produced through certain symbolic procedures (Legalität durch Verfahren), not because it is enforced or complied with, and the recognition of the procedures can be distributed among the population.

As background to an extended idea of legal effectiveness this frame of reference has the following to offer: Legal application is, if interpreted very broadly, the single occasion


28 The self-positing or self-referential systems concept was first developed by Maturana and Varela in a classical essay about life and cognition, see Maturana, H., och Varela, F., 1980, “Autopoiesis and Cognition: The Realization of the Living”, Boston: D. Reidel.


when law may have any effects on society, however defined, why legal application is the key concept for a definition of legal effectiveness. The restricted, compliance-oriented, effectiveness concept builds on the professional services view of law. But it can easily be shown that law is applied even before professional services are provided. Even before a person goes to court with a dispute the person has used the legal system for understanding his/her situation from legal perspective. The person has recognized that the courts have peculiar meaning for solving legal conflicts and the person has therefore conducted a legal analysis. This could not have been done without legal application, for it is for example a matter of legal application to decide which forum is the proper for a certain case. When deciding to see a relationship as a legal conflict, which must have taken place before seeking legal aid, the parties have also indulged in legal analysis. Without applying legal norms the description of a relationship as a legal conflict is meaningless.

Legal application as it occurs in the streets and the basic reasons for the existence of valid legal norms are therefore intimately intertwined. The accomplishment of a legal system that is in contact with the surrounding society and co-develops with it must be a question for the distributed legal application, taking place among laymen, not solely the more intricate legal problem solving you may find among professional jurists.

**Behavioural aspects on effectiveness**

In legal sociology the effectiveness of law is defined with an explicit purpose of explaining how law can be used as a regulatory device for governmental control. A law and society tradition has emerged, which attempts to explain not only the development and meaning of formal legal doctrine or the behavioural aspects of judicial decision-making, but the broader question of the effects of law on society at large. There are differences among approaches but most of them treat law as independent variable and its consequences as dependent variables. These approaches have attempted to measure the effectiveness of laws and measurements are typically intended to register the gap between the law as a normative ideal and actual behaviour in society as deviations from the law. Measurements of legal effectiveness tries to establish what features laws must possess and the social conditions that must be present if a law should affect behaviour according to intentions. Typical questions for this type of research are: What determines law’s effects on behavioural changes or attitude changes? Which factors determine the deterrent function of law?

When addressing these questions and others this branch of legal sociology has often defined law according to the Austinian concept of commands supported by sanctions. According to this view, law is a command to do or refrain from doing some specified acts, and is distinguished from other norms by the threat of physical coercion attached to the order. The idea has been that the legislator intends to control peoples’ behaviour by issuing certain norms, why the intention of a norm should be the measuring stick for us to judge when the essence of a norm has been accomplished. Compliance with norms becomes the sought effect and legal effectiveness is equated with the compliance to governmental commands under diverse forms of treaties.

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Other effectiveness concepts may rely on other ideas of law, but share the focus on norm compliance. Navarro and Moreso for example related legal effectiveness with the applicability of legal norms, and “we shall therefore say that a legal norm is effective when it is observed by its addressees.” Applicability and compliance are common assumptions, which relate to a definition of the legal system as a set of norms defined by the professional activities of jurists – courts, legislators, advocates, prosecutors etc. The legal system is perceived as a system with input and output whose function it is to mediate conflicting interest or solve conflicts.

But compliance is a problematic concept as the basis for the effectiveness concept. It may be intuitively appealing to define the effects of law in terms of behaviour that complies with law and most definitions presuppose compliance as prerequisite for legal effectiveness. According to the conventional approach law is effective when it is complied with. It is ineffective when it is breached. The law and society school has often defined compliance as a question of coercion. Law is complied with if there is effective law enforcement. Thus effective law and law enforcement has been identified as practically the same thing. Even when voluntary compliance is suggested as an expanded view of effectiveness the idea of compliance is the core concept. However, as noted by Feeley, the idea of compliance as basis for the legal effectiveness concept is limited and far from satisfactory as the basis for sociological analysis of the effects of law on society. Let us analyse the possibility to define legal effectiveness in terms of compliance by referring partly to but partly departing from Feeley’s criticism.

(1) The idea of prescribed behaviours: According to the standard legal effectiveness approach, law is posited as the goal or ideal to which behaviour is supposed to comply. Thus a prohibition of loans to shareholders in limited liabilities companies implies a purpose to prevent such loans. If loans occur in a case, the law has not been effective in that particular case. Sometimes goals can be extracted immediately from the letter of the law, or implicitly as the spirit of the law. But the interpretation of goals or ideals expressed by legal norms is not without degrees of freedom. The language of the law is frequently so vague that determination of the exact behaviour prescribed or forbidden must be extracted by using a certain method of interpretation. Often laws must be interpreted authoritatively by an appellate court in order to determine what the law says about a certain behaviour. However, all actions can be judged as legal or illegal per definition, and even if legal texts can be general and vague it does not give us a cause for Feeley’s claim that legal norms as commands are not uniquely determined. Norms state that in certain conditions certain legal effects ought to happen. It does not mean that if certain conditions are met, certain effects will follow. Therefore norms are a form of expectations that calculate the possibility of disappointment. Expectations are disappointed when behaviour is illegal. The environment reacts with irritation and frustration, but the deviation from legality is not understood as a paradox. It is a consequence of the normative form of expectations.

We assume that norms are expectations, which earn their particular meaning, their normativity, in the processes that establishes them as legally binding (legalität durch Verfahren). This means that

the validity of norms is caused by the symbolic conditions through which they are formed, not by an inherent relationship to a class of actions existing independently of law. Our conceptual distinction is significant when compared with the idea of compliance normally put forth. According to the compliance-definition of effectiveness law is not effective when illegal behaviour occurs. As determinant of behaviour law is nullified when deviations from legal behaviour occur. Illegal behaviour is equated with failure of the legal system.

The idea of a law as commands, and the analysis of legal effectiveness as the difference between law in theory and law in practice does not account for the particular meaning of legal norms. When effectiveness is defined as compliance, and consequently ineffectiveness as deviation or gap between law and action, law is treated as though it consisted of factual statements about reality – statements of how something is, not normative expectations – statements about how something ought to be. When law is not effective if deviations from it occurs and ineffectiveness is considered as a form of non-functionality, law is supposed to have no effect if people deviate from it. The command and compliance idea of legal effectiveness thus presupposes that law has only one significant side – law exists as long as it is complied with.

(2) Determinants of action. If law as command backed by threat is effective it means that behaviour is caused by law, and when it is ineffective that behaviour is independent of law. Behaviour is the dependent variable and law is the independent variable. This idea as well stems from the command perspective on law. As long as law is understood as a set of directives it is reasonable to assume that law can cause behaviour, and as we have seen under (1) its ability to cause behaviour is used by the state and government to control citizen’s behaviour. The assumption gives an incomplete picture of the relationship between the legal system and individuals’ behaviour. Only a small fragment, if any, of an individual’s behaviour is exclusively determined by legal commands. Instead an act can often be interpreted as the effect of many social systems at once. Pacta sunt servandadoes not necessarily evoke an automatic compliance in all human souls, but may in many persons be mediated through a calculation of the economic costs of breaching the contract. The utility of the legal concept real estate or property is determined not only by the means of legal enforcement available but also on the economic value of using the rules summarized by the concept. Any application of law presupposes motivation and only part of that motivation can be supplied relatively directly from law and law enforcement. Compliance is not necessarily a measurable of effectiveness of the legal system as an isolated phenomenon. It should be combined with the economy, morals, politics, religion etc. in order to give the full picture of what causes compliance in a given situation. The effectiveness concept is consequently not even defined for the legal system alone, but for a combination of societal subsystems or for society at large.41

(3) Diverse forms of law. As noted under (2) law is only one of several types of expectations (structures) motivating or post factum rationalizing action. Thus, we cannot except for a few assumptions assume that law deters from undesired actions simply with the aid of threats. Penal law is the most obvious area where threats of punishment is relatively effective, but even there law interferes with peoples’ choices of actions in innumerable other ways. According to Swedish law real estate must be bought with written contracts. Unless the purchase has the correct legal form no purchase has taken place. The only sanction supplied for non-compliance is nullity – and nothing is hardly a punishment. But if a person wants to give legal meaning to his action, then he must in a sense comply with the definitions of legal concepts. It is possible that the person uses the legal definition of a concept and even adapts to the image of an object projected by the concept, but still chooses to behave illegally. In a sense partial compliance and partial deviation

41 For a definition of society detached from both political images as the concept of the state as well as from Hobbes’ heritage referring to a conclusive contract between citizens see Luhmann, N., (1998), Die Gesellschaft der Gesellschaft, Frankfurt am Main: Suhrkamp.
appears in this case. The traditional idea of legal effectiveness would conclude, however, that law in this case has been ineffective.

The legal definition is not the single instance when phenomena appear that could be considered for an improved definition of legal effectiveness. Laws may confer abilities and status to a subject, without demanding any particular behaviour of anyone and without any threats of law enforcement. Such norms extend or withhold officially recognized status to designated classes of persons. The most striking example is public officials. Status-conferring laws define what communal or state organs should be allowed to allocate public benefits and deprivations. Specifically juridical tasks are exclusively conferred to courts, and provisions carefully distribute cases among courts dedicated only to special legal areas. But norms also confer legal capacity to fictive persons – for example legal personality. Limited liabilities companies are the most economically significant among them.

Finally, when modern government can only catch a small fraction of all citizens in the act, and thus commanding them to do or refrain from doing something, government must use indirect modes of control. The recent debate of deregulation has pointed at this regulative crisis and posited diverse solutions and concepts such as post-interventionist law\(^{42}\), proceduralized law\(^{43}\), neo-corporatist law\(^{44}\), ecological law\(^{45}\), medial law\(^{46}\), and reflexive law\(^{47}\). The point here is not to discuss these conceptual developments, but to point at the significance of the social problems they address. The reduced perspectives on direct control of citizens by government activity indicates that our idea of legal effectiveness as compliance with legal norms in terms of obedience is a radical overkill of an idea that is not strong enough for the regulation of modern society. However, norms that distribute incentives rather than directives can modify the picture. The use of incentives is an important aspect of modern policymaking. It marginally influences activities most frequently in the private sector, without determining exactly how action should be accomplished. The most conspicuous examples of incentive creating norms are taxes and subsidies. Taxes can have other ends than fiscal. Subsidies and grants have explicit ends in terms of equalized income distribution or migration between social classes. Such norms determine to some extent how individuals and corporations invest and consume without having to deal with the complexities of the processes of investment and consumption. For incentive creating norms


\(^{45}\) K. Ladeur, Abwägung - Ein neues Paradigma des Verwaltungsrechts, Frankfurt am Main, 1984.


the compliance definition of legal effectiveness is practically useless. It does not account for the
behavioural implications of this type of norm at all.

These considerations show that the effectiveness concept of most legal sociology and legal
philosophy could benefit from a revision. The shortcomings encountered here give hints about
how a reformulation could be made that covers several effects of law on society. Demands of
such a concept are high. It must allow observations of how several types of legal norms give rise
to or cooperate with other societal subsystems in causing social phenomena of diverse nature. It
must be compatible with and derived from legal theory of enough complexity and enough
compatibility with theories of society.

The effectiveness of law should be related to a theory of action and consequently to a theory of
social phenomena. We need to combine perspectives from legal philosophy with sociological
theories of action in order to find a combination of ideas that can carry the complexity of the
problem of relating law to its environment. The point of departure must be a definition of law.
What we mean with legal effectiveness is directly dependent on what law is and thus what society
is which law is suppose to affect more or less effectively. For a jurist, the question about a legal
definition can be answered simply by a practical enumeration of legal sources. For the jurist it
suffices often to say that law consists of legal provisions, authoritative court decisions, doctrine,
and custom. But from the perspective of the legal philosopher or the legal sociologist the juridical
perspective is insufficient. They cannot take the concept of legal sources for granted, but must
enquire of the nature of legal sources. Paradoxically the enquiry about the validity of legal norms
halts either at a description of the procedures for creating or interpreting legal norms or with the
concept we are looking for – legal effectiveness. For example, Hart postulated a hierarchy of
norms in order to describe the legal order as law made from law in positivistic sense. Kelsen
proposed the basic norm as logical necessity (infinite regress) if valid norms should be derived
from valid norms. The basic norm defined as the infinite continuation of the search for a higher
norm. This type of internal calculation of validity is the alternative of the legal scientist or legal
philosopher. The sociologist normally asks why legal norms, however they derive their formal
validity, actually as an empirical object become binding for people. Sociologists enquire how law
affects society – or how it can be effective. The questions concerning legal validity, then, can be
approached in two ways. Either we presuppose that norms are complied with – legal
effectiveness, or we explain how it can happen – legal effectiveness. Conventional approaches for
the definition of a legal system end up with the concept of legal effectiveness even before they
have the chance to define it. Legal systems are effective because they are effective.

The compliance approach can however be abandoned in favour of a communications based
concept of effectiveness, where compliance is not a precondition of effective law. The idea of
compliance is related to the professional or conflict-resolution definition of law. According to it
law consists of services delivered as conflict resolution to laymen. Government, courts, jurists
help society provide better conditions for peaceful coexistence by helping individuals to resolve
inherent conflicts of interest. But law is applied also before the courts have been approached and
before jurists are consulted for advice. When two or more persons identify their relationship in
legal terms they have already applied law to their situation. They have defined their cooperation
for example as a legal person and they have understood the concept according to the national
provisions regulating legal personality. If a conflict arises it is legally defined in terms of legally
protected rights and obligations. If there is an extra-legal conflict independently of law, it is
transformed to fit the possibilities of legal language. Furthermore, when a conflict is so advanced
or infected that it must be resolved by a court of law, again legal norms are applied spontaneously
by the conflicting parties. The correct forum is determined according to national rules or
international conventions, costs of litigation are estimated according to norms regarding the
distribution of costs between conflicting parties, often depending on who won and who lost.
Therefore legal interpretations, decisions, and communications are applied even before
negotiations in court. The professional services then are only the termination of a legal process of application of legal norms that takes place outside the legal institutions.

**The revised legal effectiveness concept**

We have seen so far that the conventional approach to legal effectiveness builds almost entirely on legal compliance. But legal compliance presupposes something that the communication systems approach makes possible to reveal but which is hidden for the conventional approach. It presupposes that law is actually applied, that legal meaning is referred to and accepted as such, even though its content may be rejected and not complied with. Legal effectiveness as legal compliance is related only to the level of legal application that takes place when law is already referred to and possibly understood. It misses to see the basic processes at the social and communicative level of legal application that should be the sociological contribution to the understanding of legal effectiveness. Legal compliance fails to see the element of choice in legal application.

Some parts of law force themselves on legal subjects. It is compulsory to not only comply with penal law, but also to have knowledge of it and reference to penal law is implicit in all actions. One does not have to be sued by a private citizen in order to be punished or blamed according to penal law, for it is mostly the task of a public prosecutor and the police to investigate and pursue crimes. But even penal law has an element of voluntariness over it in the sense that a person may choose, illegally of course, to disregard penal law not as non-compliance but as point of reference for action at all. Non-compliance may be combined, and probably most frequently is combined, with some knowledge and some level of acceptance of the validity of the penal law which is breached. The non-compliance is not frequently an element of wholesale rejection of legal validity, but a choice to depart from the expectations of penal law. However, the voluntary aspect and the aspect of choice are more apparent in other legal areas. Most obvious it appears perhaps in private law, which to a large extent concerns economic and other less than necessary matters. There a person is free to establish a contract, to form a legal person as basis for a community, to purchase real estate etc. But the person is also free to abstain from these acts. He may choose other means of furthering the same needs. The person may deliver onerous services and hope for payback from a friend based on thankfulness rather than a contract. The person may form a community without any intention of ever forming a legal entity as its basis. The person may instead of purchasing real estate benefit from the property due to friendly ties. The voluntary aspect, obvious in private law, less obvious in penal law and other public law (for example taxes), makes it possible to tell two levels of legal rejection apart. At the second level a legal communication, explicit or implicit, is accepted as legally valid meaning, but what the law contends is dismissed. If a person knows that a contract exists and recognizes its meaning but breaches it anyway a case of pure non-compliance is at hand. However, a more primitive rejection of legal communication can be observed. When a person rejects, not only the terms of a contract or the fact that there is a contract, but also the legal communication in total - referring to a contract, one observes a the more fundamental form of rejection that sometimes may be improperly called non-compliance but is based on another social phenomenon. Non-compliance – the rejection of the content of a legal meaning such as the terms of a contract or the neglect of a, possibly consciously observed, command by the state in terms of penal law, means that legal glasses are used for the observation of the actions performed and for the judgement of their morality. The breaching part may feel guilty of the breach. The counterpart is disappointed and angry. The reactions are caused by the fact that the breach is observed from a point of view inside the legal system. The communicative operations are parts of the legal system.
Luhmann once developed a distinction in his theory of social systems where he similarly separated levels of rejection of communications. A communication is often or always given physical form, for example either as a text or as a bodily motion. But the physical form may be faulty interpreted by an observer as a bodily motion or as a piece of paper with some colour on the pages. Perhaps the observer is not familiar with the custom of gestures and reading. Perhaps the observer is obstinate and decides to reject the communicative effort wholesale for other reasons. Anyway the communication will not continue along the lines suggested by the first attempt. The communication will not cause coupling of operations to operations. It will not grow to become for example the theme of a conversation or the focus of analytical reading. Thus communications involve the hopes or demands of continuation, but this cannot be guaranteed. No one can totally control a counterpart. Not even law can be sure of attention in this respect. The essential point to note here is that if the legal voice is not heard it cannot lead to compliance either.

From this basic sociological perspective the question of legal effectiveness has taken new contours. Law has effects on society if and only if legal communication (implicit or explicit) is accepted as such. Here it is claimed that the voluntary aspects of legal application is as important as the effects observed by the legal compliance paradigm. Effectiveness should be connected primarily to the extent law is used in communication as much as to the extent law is complied with. The extent that law is actually referred to should depend, not only on the availability of courts and other law enforcement or the internalisation of norms, but also on familiarity with law among the people who conduct the primary legal application defined above. It is the layman’s application of law we are looking for. Prior to any calculation of cost and benefit of using law as means for defining and regulating situations there is the choice whether or not to accept or reject the idea of communicating through legal terms at all. Thus, before it is possible to judge who is going to win or loose from discussing a matter in terms of rights and obligations the parties have the options to proceed legally or to abstain from that route totally. Their choice at this primary level is guided not by a calculation of costs and benefits but by a judgement of the sensibleness and usefulness of law as means for communication about a matter.

Our assumptions of the role of trust in choices to apply or not apply law leads to the following conclusion: Legal application by a layman will tend to occur if and only if the layman feels confidence in his ability to apply law in relation to a counterpart and in that his communication will be accepted as a valid legal communication by the counterpart. The confidence will typically be concerned with basic legal concepts, since a layman has no knowledge about details in single laws, or provisions. In this sense the type of legal application here encountered is a diffuse, ambiguous calculus of trust. If legal effectiveness is connected with this primary legal application and with the choice to accept or reject a communication as a legal valid statement legal effectiveness is defined as: A legal norm is effective in a population of users to the extent that users feel confident in their ability to use legal terminology and in the acceptance of the communication as law. Compared with Hirschman’s classic definition of customer loyalty as a function of individuals’ judgement of their ability to communicate with a certain supplier, be understood and accepted, legal effectiveness is surprisingly similar. Hirschman’s framework made possible a separation of the loyalty concept from actual customer duration or recurrent purchase and the social process where the probability is moulded. Hirschman had managed to show that companies who fostered customers with a high degree of confidence in their ability to communicate with their supplier could benefit from frequent repeated purchases while suppliers which where more difficult to communicate with tended to loose their customers quicker.

Now it can be explained why seemingly effective legal design is not necessarily the way to truly effective law. That design of law is not as intimately related to legal effectiveness, however defined, as we might have thought has been shown by Berkowitz et al. (2003) in a

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comparison of effects on effectiveness between the design of law transplanted and the manner in which the transplantation took place. Thus a poorly designed law may be more effective than a, on paper, good design. The reason is supposed to be that law must be made meaningful in the context in which it is applied so citizens feel motivated to use the law. Institutions (courts and authorities) must be able to increase the quality of law in response to local demand. Other pieces of evidence support these statements. According to Rodrik (2000) a well-designed strategy for institution building should take into account local knowledge rather than emphasize best practice from international comparison. The claim from this stream of research is that law is effective when it is in contact with society. We see through our effectiveness concept how these pieces of evidence fit the picture. When law functions not as a gathering of texts, but as a system of concepts, familiarity with concepts among the population is a necessary requisite to avoid a vacuum between law and the rest of society. Law, which is in contact with society, is typically preferable to law, which on paper is a good design. The contact points between law and society are the basic legal concepts applied by non-professionals. If these points are not given appropriate consideration when designing new laws individuals risk loosing faith in their ability to apply law and they will consequently be less prone to do so.

These new discoveries actualise new interpretations of legal effectiveness. It seems as though it is not enough to assume that legal norms are effective if they are applicable or valid. Jurists’ descriptions of law may assume that the norms that make up the system are applicable and effective.\textsuperscript{49} To assume that law is effective when it is observed (Navarro and Moreño, 1997) simply translates to behavioural compliance and the gap model between law and society assuming perfect knowledge about legal norms regardless of abstraction level and accessibility. But in practice only a few persons in a society have any direct access to legal text, and even fewer actually read them. Law is communicated among the population in a form of oral tradition where metaphoric images serve as carriers of messages. When we conclude as do the students of law and society that law has been complied with or observed or otherwise law has affected behaviour of people, we consequently have to define the difference between the ideal of the law in the books and the actual behaviour in practice taking into account a behavioural definition of law. When gauging the effectiveness of law the jurists’ view of it is a minority conception, however important, and the effects of law on large parts of the population is caused by a metaphorical and ambiguous understanding of law rather than the exact phrasing of provisions, the guides in travaux préparatoire, the fine tuning distinctions in stare decisis. If the layman has distinct knowledge of any of the sources of law it may be the parts that are regulated by custom. Otherwise a reasonable prediction should be that the application of law by the layman differs widely from the application by the professional jurist. Only limited knowledge of the legal method can be assumed, and even if the layman would know how to derive legal norms from legal sources they would not be available to him/her without considerable effort, an effort seldom expanded without particular cause.

If law is applied according to what could be called a logic of appropriateness\textsuperscript{50} rather than a calculative, juristic legal rationality a shift of focus when investigating the gap between what the law says and what people do is necessary. One should suspect that what the law says in a particular sociological sense has hitherto not been appropriately defined and therefore possibly led the theory of law and society to false conclusions regarding the effectiveness of law. With a more realistic understanding of how law is applied in laymen situations legal effectiveness should also be defined appropriately. We preliminarily conclude that a concrete expression of a legal norm is effective when there is a connection between it and basic legal concepts. The basic legal concepts are used in ordinary language by laymen to communicate about legal expectations. The possibility of their


\textsuperscript{50} The concept was developed for the explanation of organizational decision making by March, J. G. (1999) The Pursuit of Organizational Intelligence, Malden, Mass.:Blackwell.
efficient use in common experiences determines the extent to which concrete and complex sets of norms are appealed to. If a gap emerges not between the behaviour of people and the norms of a legal system but between the technical and professionally defined meaning of basic legal concepts and the understanding of them by laymen, a deterioration of laymen’s trust in their ability to employ law as meaning reference.

The effectiveness of legal transplants

An example of how the revised effectiveness concept can provide a potentially improved understanding of the processes that inflict upon how law is connected to its surrounding society is the legal transplant. Legal transplantation, as explained above, takes place when one country imports law from another country. Sometimes the import occurs within the same legal family, where legal systems are conceptually related, sometimes without close relationship between donor and receptor. Many empirical studies have observed that countries receiving law from abroad tends to function less effectively than countries that have developed the corresponding set of norms internally. It has also been observed that while there is a gap between formal law on the books and law in action in all countries, as maintained by the dominating approach to law and society, larger gaps are found in legal transplants, i.e. countries receiving considerable amounts of law from abroad. Thus in legal transplants many norms find no application at all or are applied in a sense that was not intended by the legislator.

A series of large quantitative empirical investigations has been conducted in order to shed light on this phenomenon. The findings can be summarized as follows: The way in which the law was initially transplanted determines effectiveness more than the choice of legal family from which to transplant. Assumptions have been that for law to be effective it must be meaningful in the context in which it is applied so citizens have an incentive to employ it, and that judges and lawyers as well as other intermediaries must be able to develop law in a way that is responsive to demand for effectiveness. Thus it has been assumed from the beginning that local adaptation in some sense is important for effective law. Law, which is not suited for local conditions, could be expected to be less effective than the locally produced or adapted law would be. The assumptions have been confirmed by data. There is a strong relationship between what has been defined in these studies as legal effectiveness and the way transplants are carried out. There is no corresponding relationship between the legal effectiveness and the legal family from which law has been transplanted. Thus it seems as though the manner of import is more important than the quality of the goods.

This result is paradoxical for the conventional idea of legal application and interpretation. According to it one may assume that the user has knowledge of law sufficiently to make the necessary legal interpretations. Thus knowledge of the valid legal method and professional insight into legal rationality and the redundancies on which legal argumentation builds is assumed. The observations on the problematic of legal transplants however point in another direction. When law in the books differs from law in action, and transplantations from closely related legal systems does not result in higher effectiveness, however defined, than legal transplants from distant legal systems the connection between law and its surrounding society

must be put in question. The conventional law and society framework would define the kind of 
deviations from law in the books found in many transition economies borrowing law from 
western countries as illegal deviations. Behaviour would be described as deviating from the 
norms defined by the official legal order. Even if this characterization is formally correct it 
ignores the social processes that form the interplay between law and its environment. The 
traditional description overemphasizes the importance of institutions and the professional 
services of a legal system. A conventional approach to measurement of legal effectiveness 
concerning economic regulation would consist of an amalgamation of legal properties such as 
efficiency of the judiciary, rule of law, absence of corruption, risk for expropriation, and risk of 
contract repudiation.52 This combination of risk measures and institutional variables reveals that, 
though the explanation offered in the speculative parts of these studies have more dimensions 
the data is related to a more strictly institutional perspective on legal application emphasising the 
formalized aspects of the subject. The social process where law is supposed to transform into 
action, via norm compliance, appears to be treated as a black box. Mention is given of the 
knowledge aspects of legal application: “The fact that formal legal orders have put the key elements of the 
legal order in writing tends to disguise the fact that the effectiveness of these rules also rests on knowledge and understanding of these rules and their underlying values by social actors.”53 However, this quote and other 
evidence support the effectiveness concepts developed here. The gap between law in the books 
and law in action will be greatest where basic legal concepts are not adapted to the specifics of 
individual rules in provisions due to the fact that laymen tend to apply law as it appears in the 
basic legal concepts to which he is accustomed while professional jurists apply law as it appears in 
relatively technically written provisions seldom practically accessible to laymen. When basic legal 
concepts according to generally dispersed knowledge, or myth, are reminiscent of a legal system 
which has been replaced with a transplanted set of rules, a reinterpretation of the basic legal 
concepts may be necessary in order to avoid that new, often modern and western, rules are 
understood or interpreted in a vulgar way. There is ample evidence that misinterpretations 
often occur, if not among professional lawyers then the more frequently among laymen. In a 
large empirical study which well summarizes typical findings in this area Hendley et al. showed 
how Russian enterprises systematically managed to avoid the possibilities of the new civil code 
implemented after the fall of the Soviet regime.54 According to their results Russian enterprises 
made little use of law and legal institutions in structuring their economic relationships. A sign of 
this state is that lawyers are often peripheral actors in enterprises. When formal contracts are used 
they are constructed as they were in during the Soviet era, which means that contracts do not 
make use of the degrees of freedom in the nowadays modern, and transplanted, Russian civil 
code. Thus it appears that the legal system has little significance for business strategy. It is not 
understood among practitioners as an effective tool for organising relationships with for example 
suppliers, customers, and personnel. It was also found that the knowledge of the new civil code 
was extremely poor, even among professional jurists employed at the law departments of the 
companies investigated. Company officials often had good knowledge about such laws that were 
in accordance with previous Soviet laws but were not properly informed about changes that 
meant updating Russian law to modern western standards.

The inertia observed in Russia and the observation that the manner in which 
transplants are done is more important than the transplanted rule both support the proposed 
definition of legal effectiveness in this paper. When legal change is initiated that is not connected 
with the basic legal concepts of the country, there is a gap between the basic legal concepts and

the transplanted laws. When law is applied by laymen, and by insufficiently educated professionals, basic legal concepts are kept, why a conservative idea of law as an instrument for organizing situations and relations results. Furthermore, if people are aware of that legal change has occurred but are unaware of the exact meaning of the change, a widening gap between law in the books and law in action can be expected because people feel low degree of trust in their ability to employ the legal system as meaningful communication instrument. The discussion of matters in legal terms on the level of basic concepts will be staggering and bothering for both parties if they know that the law expressed by the concepts has been changed in unknown directions. The change itself introduces decreased levels of trust in communicating through legal conceptual channels, why law tends to be seen as less valuable.

When people judge that their ability to communicate with legal terminology, be understood and accepted by a counterpart is low legal effectiveness is low by definition. Law will not affect the organization of relationships between people whether of economic, family, or national character. The problem of insufficient trust in one’s own and one’s counterpart’s ability to use law for purposes of fruitful communication and forming valid expectations of future actions cannot necessarily be solved by a combination of better law enforcement, more efficient legal institutions or modernized legal provisions which has been commonly assumed by the law and development school. It has been proposed that legal transplantation not adapted to the local social and economic conditions decreases the need for the transplanted law and thus weakens the interest to apply law. For example, while many firms in China used the label limited liability company they remained unincorporated family owned business. Where the corporate form was used the external capital was marginal and kinship was the most important financial resource. Demand, or desire, cannot be seen in isolation from trust as defined here. If there is no trust in the legal system and in one’s own capability to communicate through law with desired effects there is typically no demand for law. Furthermore, if trust somehow can be accomplished, and legal rules are not designed so that they serve economic or social functions, for example provide means for incorporation of large industrial enterprises in new industrialised economies, the transplanted laws are less effective than internally developed laws according to solid empirical evidence. However, it has not been clear why this effect occurs. Frustrated policy makers refuse to give up the idea to accelerate legal evolution in developing countries and transition economies by using laws from economic ideals such as Germany or the United States in large legal reformations. The results are frequently that a gap opens between the technically advanced laws and the activities of the people. Surprisingly, the imported law tends to be used less frequently than internally developed law and the internal development begins to stagger. A conclusion would be that legal effectiveness decreases with the import of laws. The question, however, is how legal effectiveness should be defined in order to further our understanding of the so-called transplant effect.

Conclusions and implications

Transplanted laws are less effective than internally developed laws according to solid empirical evidence. However, it has not been clear why this effect occurs. Frustrated policy makers refuse to give up the idea to accelerate legal evolution in developing countries and transition economies by using laws from economic ideals such as Germany or the United States in large legal reformations. The results are frequently that a gap opens between the technically advanced laws and the activities of the people. Surprisingly, the imported law tends to be used less frequently than internally developed law and the internal development begins to stagger. A conclusion would be that legal effectiveness decreases with the import of laws. The question, however, is how legal effectiveness should be defined in order to further our understanding of the so-called transplant effect.

The purpose of this article has been an investigation of the legal effectiveness concept. It was noted that the presently used concept did not contribute to our explanation of the transplant effect and we reviewed our others’ criticism that supported our attempts to develop a different effectiveness concept. A previous analysis of legal effectiveness, by Ingram, in this journal emphasized the importance of obedience and conformity in common understanding of legal effectiveness. Ingram suggested that effectiveness should be defined as the ration of application to non-application of law in order to avoid measurement problems. Our analysis leads to a more radical approach to effectiveness. By using the system theory of Luhmann we suggest that effectiveness should not be understood as a matter of obedience, conformity, or application in the sense put forth by most thinking in this area. Conventional ideas assume that laws are tools for regulating society, and therefore that the gap between what laws express and people do is a problem. Here, this idea is not rejected, but another level of analysis is introduced when it is recognised that people can reject not only the content of the legal message, but also the type of message (legal). Understood as a form of legal communication, legal references are voluntary. People may refer to them, or choose some other form of expressing the functionally equivalent effect. When other than legal communications are used, the legal system does not affect, or affects only through its ineffectiveness, the choice of behaviour.

When the layman applies law, it is without the detailed knowledge of the professional. The exact phrasing of provisions is not available to him. Instead, the layman uses his legal consciousness, or a basic conceptual understanding of what law says on an issue. For example, the layman may claim that a corporation cannot lend money to its shareholders because it would be counterintuitive to the idea of a corporation as a separate entity and violate creditor rights. The exact formulation of this rule and the boundaries for its application, however, is unknown to the layman. Therefore, the application of law by the layman differs remarkably from the professional activities of jurists. We suggest in this article that a difference between primary and secondary application should mark the difference between these levels of legal application. Our analysis reveals many of the most decisive social processes for determining legal effectiveness lies in the primary application of law that takes place among laymen. Due to narrow definitions of law and legal effectiveness, this level of analysis has not previously been addresses in terms of legal effectiveness.

Laymen are, according to our analysis, the appropriate level of research on the effectiveness of legal systems. Professionals are involved only after a conflict ahhs been identified and interpreted in legal terms. The preliminary interpretation, the primary application of law, should determine what areas of law are used and what areas lie fallow. Effective norms should be such that can be applied by laymen, applied in its broadest sense. When a house is bought and paid for, property rights and obligations are referred to implicitly or explicitly. When a house is protected only by muscle strength of the occupying persons, no reference, implicit or explicit, is made and law is not applied. There are innumerable circumstances that impact on the decision to apply or not to apply law in particular situations, but our analysis has concluded that many of them will rule each other out, leaving self confidence or trust in ones own capability to deal with legal concepts as a key determining factor. The extent that law is actually referred to should depend not only on the availability of courts and other law enforcement agencies or the internalisation of norms, but also on the familiarity with law among the people who conduct who conduct primary application. Before any calculation of costs and benefits of appealing to law there is a choice whether not to accept or reject the idea of communicating through legal concepts at all. This decision is the focus for our definition of legal effectiveness. A legal norm is effective in a population of users if users feel confident in their ability to use legal terminology with relevance for the norm, and feel confident that their communication will be accepted as law. This definition relates effective laws to the their functionality as communication tools rather than as commands and obedience or conformity. Thus effective laws become a matter of designing laws that relate to a tradition of conceptual use as much as, or more than improving efficiency of courts, expanding the police,
and otherwise improving institutions. If the conceptual tradition, or legal consciousness, is not in
tune with legal reform, research on legal transplants has shown that the gap, between the
technical construction of laws and the understanding of basic legal thinking by the population is
increased, ineffective laws end up, at worst, in a societal vacuum.

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The Law Businessman and the Trade Credit Decision

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Abstract

This study analyzes the impact of private and public order institutions on the provision of trade credit in Russia. It shows, ceteris paribus, that managers’ perception of their own ability to use legal terminology and their perception of lawyers’ effectiveness in the solution of commercial conflicts have a significant impact on the provision of trade credit to clients. The perception of the effectiveness of commercial courts and law enforcement has little or no impact at all on the provision of trade credit. 246 managers in three towns in northwest Russia participated in the survey. The results propose that internal legal determinants in the form of legal consciousness better explain provision of trade credit than do external legal determinants in contrast to current theory. This observation suggest that human legal capital has unexploited potential for explaining financial transactional behaviour.

Keywords: Legal self-efficacy, self-efficacy, self-concept, lawyers, legal consciousness, trade associations, courts, law enforcement agencies, trade credit, Russia, contract enforcement mechanisms.

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This study compares private and public order contract enforcement mechanisms and their effect on the managers’ trade credit decision in Russian enterprises. It shows that human legal capital both in the form of managers’ legal self-efficacy and their appreciation of lawyers’ ability to solve commercial conflicts have an impact on the trade credit decision that is equal to or greater than the public order mechanisms of courts and law enforcement. The paper also adds to the theory
of law and finance in that it surveys the issue of external funding of enterprises from a legal consciousness perspective and compares it to external legal institutions. It is also a reaction and comment to McMillan and Woodruff’s (2000) study that surveys various mechanisms of private order in Eastern Europe.¹

Previous research by Jörgensen & Svanberg (forthcoming) has demonstrated a strong positive and significant correlation between legal self-efficacy and the use of sanctions against other firms. The purpose of the study is to test the impact of human legal capital on contracting; legal self-efficacy and the perception of lawyers in comparison to other common mechanisms of contract enforcement. This paper tests five mechanisms that support contractual assurance on trade credit of Russian managers. The mechanisms are divided into two groups, the first one is private order mechanisms; legal human capital in the form of legal self-efficacy, and the perception in lawyers’ ability to solve commercial conflicts. The third factor in this category is social network capital in the form of trade associations. The second group is that of public order mechanisms; the perception of effectiveness of courts and that of law enforcement agencies on the trade credit decision of Russian enterprises.

Law as a means of communication – coined legal self-efficacy in doing business is at least as important for reducing transaction costs for enterprises as the institutions of private and public order, such as trade associations, law enforcement, and courts. Legal self-efficacy is used as a measure of legal capital of the individual. It’s an application of Torpman and Jörgensen’s (2005) and Jörgensen & Svanberg (forthcoming) new theory of legal efficacy.² According to this definition of legal efficacy individuals tend to accept legal communication if they believe they comprehend it and feel at ease with legal terminology. Laymens’ use of law diverges from that of professionals. Professionals are familiar with the exact phrasing of laws. Laymen on the other hand structure their relationships with their private and often confused understanding of abstract concepts, i.e. rights, debts, contract, and property. Knowledge of legal concepts makes communication with them more likely and consequently law will be more frequently referred to. According to the definition of legal efficacy of Torpman and Jörgensen (2005), which can be referred to as the “application perspective” on legal efficacy, law is effective when users feel confident in their ability to use legal terminology and in the acceptance of the communication as law. Businessmen who have a high level of legal self-efficacy are labelled law businessmen. Almost all businesses in Russia receive trade credit.

Trade credit is the single most important source of external financing of Russian firms. 51 percent of total debt by Russian firms (23 percent of firms’ total assets) is in the form of trade credit. 97 percent of all Russian enterprises receive trade credit from their suppliers. Yet only 41 percent of firms report having bank credit. Even among the enterprises that have bank loans, it is

¹McMillan, J., Woodruff, C., (2000) “Private Order under Dysfunctional Public Order” Michigan Law Review 98(8) p. 2421-2458. This study surveys various mechanisms of private order contractual assurance mechanism with the aim of finding out if and how private order mechanism can act in the place of a faulty public order in five former Soviet republics and Eastern Europe. They find that social networks, such as a trade association, and informal gossip substitute for the formal legal system, while business networks and trade associations work in conjunction with the formal legal system.
only the second most important source of credit after trade credit. The trade credit decision is affected by many firm specific factors, the most cited being information asymmetry — suppliers know more about their client enterprises than other lenders, such as banks. Other cited factors are price reduction as a measure to stifle competition, and the maintenance of a beneficial corporate image. Only a handful of studies have looked at the determinants of supply of trade credit in developing countries. The factors that affect managers' trade credit decisions in Russia have not received a lot of research attention. One study concludes that the quality of courts has


4 Cheng, N.S., Pike R. (2003) “The Trade Credit Decision: Evidence of UK Firms”, Managerial and Decision Economics 24 (6-7) p. 419-438. Schwartz R.A., Whitcomb, D.K. (1979). The trade credit decision. In Handbook of Financial Economics. Bickers J.L. (ed) North-Holland: Amsterdam, 257-273. Other factors include the financing motive; trade credit can be considered an interest free loan, for which the monitoring costs are lower than for banks. Especially if the seller is wealthy and buyer has poor financing this motive becomes especially strong. Very wealthy entrepreneurs don’t need trade credit, and the conditions for granting of trade credit to very poor entrepreneurs are similar to that of the granting of bank credit. Melzer, A. H., (1960), “Mercantile Credit, Monetary Policy, and Size of Firms”, The Review of Economics and Statistics, 42(4) p. 429-37: Suppliers may lend more liberally than banks, since it is less lucrative for an opportunistic borrower to reroute direct inputs than to divert cash. This is true especially in countries with an imperfect legal protection of creditors, since trade credit loses its advantage since it becomes as difficult to divert cash as to redirect trade inputs. Perhaps this is why trade credit is relatively more prevalent in countries with worse legal institutions. Burkart, M., Ellingsen, T., Giannetti, M. (2004) “What You Sell is What you Lend? Explaining Trade Credit Contracts” Stockholm School of Economics Working Paper. This study shows that ceteris paribus, service suppliers offer as much trade credit as suppliers of differentiated goods and significantly more than suppliers of standardized products. It also shows that the most important product characteristic for explaining trade credit contracts is the ease with which the input can be diverted. Demirgüç-Kunt, A., V. Maksimovic, et al. (2002). Firms as Financial Intermediaries: Evidence from Trade Credit Data. World Bank Working Paper. The investment motive: receivables, such as trade credit, should be treated as an investment rather than a passive consequence for sales. Copeland and Khoury (1980) “A Theory of Credit Extensions with Default Risk and Systematic Risk”, The Engineering Economist, 26(1), p. 35 – 52. It signals an intention from the seller to keep an on-going relationship with the customer. It also allows the seller to invest in the buyers business to this end. It signals an intention from the seller to keep an on-going relationship with the customer. It also allows the seller to invest in the buyers business to this end. Finally there are marketing and competitiveness motives behind the granting of trade credit. Trade credit forms a part of a package deal, which stimulates demand. The lengthening of trade credit can also be considered a price reduction, and when competition is strong, the granting of trade credit can be considered a tool for competition with other similar sellers. Finally, trade credit can be seen as a part of keeping a beneficial corporate image (Cheng and Pike 2003).

3Johnson, S., J. McMillan, and C. Woodruff (1999) “Contract Enforcement in Transition,” CEPR Discussion Paper No. 2081. This paper shows that firms that have more confidence in courts are more willing to extend trade credit to customers. Fisman, R., Rutari, M. (2003) Does Competition Encourage Trade Credit Provision? Evidence from African Trade Credit Relationships. NBER Working paper 9659. This study examines the relationship between monopoly power and credit provision, using data on the supply relationships of firms in five African countries. It finds that monopoly power is negatively associated with credit provision. Fafchamps, M. (1996). “The enforcement of commercial contracts in Ghana.” World Development 24: 427-48. The paper documents how commercial contracts are enforced in Ghana. Results show that compliance with contractual obligations is mostly motivated by the desire to preserve personalized relationships based on mutual trust. Harassment is the main form of debt collection. Other enforcement mechanisms — court action, reputation effects, use of illegitimate force — are less important. McMillan, J. and Woodruff, C. (1999) “Dispute Prevention without Courts in Vietnam”, Journal of Law, Economics, and Organization, 15(3) p. 637-58. This study surveys private order mechanisms when firms cannot fall back on courts to provide contractual assurance. Firms use repeated-game incentives. Contracting is supported by the threat of loss of future business. Most businesses do not have access to external finance markets, only 21 percent of surveyed firms had bank loans. The absence of laws governing property rights adds to the hazards of investing. McMillan, J. and Woodruff, C. (1999) “Interfirm relationship and informal credit in Vietnam” The Quarterly Journal of Economics, 114(4) p. 1265-1320. This study shows that firms belonging to business networks receive more trade credit. Networks are used to sanction customers that default on the payment of trade credit. If a customer finds it hard to locate alternate suppliers, it is easier to get trade credit. The length of the trade relationship is positively correlated to the granting of trade credit. The more information a supplier has about a customer, the more trade credit is granted.
an impact on the trade credit; however the effect is more significant on bank finance. The research field of law and finance, which studies the relationship between legal systems and the external financing of enterprises, has received increasing attention. Individual human perception of legal institutions and its impact on external financing of enterprises has not been extensively studied. Instead the macro level variables of contract enforcement and legal systems have been employed. The advantage of studying legal consciousness on the level of the individual is that we can study the perceptions of businessmen and they affect transactional behaviour regardless of the characteristics of external legal institutions. As this paper argues, the perceptions of institutions predict behaviour better than the innate character of institutions themselves.

The context of this study is in the cross-section between legal sociology, law and economics and law and finance. It also related to the research fields of law and society and law and development. Research in the field of law and economics and law and finance has focused mainly on law as a phenomenon external to the individual and has not studied the legal consciousness on the individual level. The law and development school has assumed that better law enforcement, more efficient legal institutions, and modernized legal provisions are the key instruments to legal efficacy. The legal consciousness in relation to economic transactions has not been entirely avoided in previous research: sociolegal scholars have looked into the legal consciousness of individuals and studied it as factor that has an impact on economic behaviour of managers and brokers etc.

The “New Law Merchant” is a reaction to the focus only on formal legal institutions as mechanisms of change in the process of improving contractual assurance in society. The “New Law Merchant” is the collection of trade associations, business networks, and social norms that regulate economic exchange. The argument is that it should be more extensively utilized in


transition economies, at the expense of investing in formal public legal infrastructure. The World Bank proposes that the New Law Merchant be used because private associations are often thought to facilitate relational contracting, provide third-party contract enforcement mechanisms, or provide dispute resolution to firms, the new law merchant has proven a favorite prescription for facilitating market exchanges when the courts are weak. Underlying this prescription is an implicit assumption that private order is a viable substitute for public order. Research and evidence on the interactions of public and private order is in short supply.

La Porta (1998) pointed out that we really do not know which features of the contractual environments that matter and in which combinations. There is a significant gap in the literature on how the factors that provide contractual support differs both inside and between legal systems. The central question in the framework of transaction cost economics is Williamson’s “Which governance mechanism best coordinates the disparate plans and interests of the various individuals making up society?” This study is a partial answer to this question in the Russian context.

The key message of Ronald Coase is that individuals who are free to bargain about the price and distribution of external effects will come up with more socially efficient solutions than courts, since it is far more costly to use courts and the court’s distribution of private property rights and external effects may not become socially optimal. The cost of negotiation about private property rights between two parties decreases if the parties have confidence in the use of legal terminology, i.e. they are law businessmen and therefore possess legal self-efficacy. In the case of managers’ trade credit decision legal self-efficacy has double effect. First, they will have a fuller


13La Porta 1998 see note 3. La Porta’s study only included law on the books and not law in action i.e. how law is actually perceived and understood by its users.

14See Katz (2000) note 12

15Coase, R. (1960) "The Problem of Social Cost" Journal of Law and Economics, 3(1) p. 1-44. In this paper Coase addressed a problem that had previously been unsolved – the problem of the allocation of external effects in the socially most efficient way. He gave two examples to illustrate the problem; the first was that of a rancher whose cattle drift onto the cropland of his neighbour. If the rancher is made to contain his cattle, he is harmed just as the farmer is if the cattle remain unrestrained. Coase argued that with no transaction costs it is economically unrelated who is assigned original property rights; the rancher and farmer will work out an agreement about whether to restrict the cattle or not based on the economic efficiency of doing so. By letting the related parties work out the distribution of external effects among themselves and not going to court, the most optimal social solution to the problem of external costs can be found. In this paper Coase also uses another example of a train that lets out sparks onto adjacent farmland. The costs of burnt farmland have to be weighed against the social interest of keeping the train running. How can running of trains on a railway track and the costs for farmers be optimized? Coase’s answer was that the farmers and the train company should solve the problems by negotiating the costs themselves, without third party or government intervention. The train company will adjust its train schedules to the optimal time table, and farmers will be reimbursed for damage caused by the trains.
understanding of private property rights and the legal terminology needed to protect it. The costs for filing a claim and pursuing it in the legal system are therefore lower. Secondly, they will have lower costs for communicating with legal terminology with the client creditor. The effect being that the client understands that the costs of default will rise. The sum of the effect of legal self-efficacy on the trade credit decision is that transaction costs for borrowing to clients are lowered. Legal self-efficacy is relevant to transactions costs, for example in the protection of private property rights, both in the case of trade credit and in the case of Ronald Coase's trains and herds of cattle. The difference is that Ronald Coase assumed that all people have perfect understanding and knowledge of law and know how to find the law and, which they don't. This study shows that legal consciousness matters for transaction costs. Legal self-efficacy improves the chances of businessmen protect their private property rights.

The dilemma of contract enforcement and indirectly transaction costs is extensively acknowledged as a key issue in transition of formerly planned economies. The common view is that under communist times these countries have relied on state to enforce dealings among state-owned enterprises. Once the economies became decentralized and privatized, the mechanisms of contract enforcement were lacking. The post-Soviet legal systems were universally viewed as insufficient for the more demanding requirements of market economies. Many scholars thought that a more hurried upgrading of the institutions of law enforcement was the most crucial ingredient to achieve success in transition. The absence of contract enforcement may lead to selection into less efficient contracts, and put a ceiling on aggregate productivity. This problem has been particularly prevalent in Russia and Ukraine. Survey evidence shows that the insecure contractual environment and lacking private property rights in Russia and Ukraine impede investment. Mechanisms of contract enforcement have always existed in the days of the Soviet Union, legal as well as non-legal. However as Russia embraced market economy and a new civil code was launched in 1995 the need for legal competence has increased, as a result legal proficiency has increased.

Legal proficiency is low among managers; the average score on the legal test performed in another part of the survey was 4 out of 7 (57 percent) questions on credit law, the best proxy for knowing civil law. Yet this is somewhat higher than in a previous study with similar questions. The questions are found in appendix 1. The average score at that time was 2.3 out of 6 (38 percent), and in 2005 (now 10 years after promulgation), the average knowledge of law was a mean of 4 out of 7 (57%). This increase in legal proficiency suggests that it takes time for the population to get acquainted with law, and also that present commercial law is in demand in Russia. The first six questions are identical to the questions asked in 1997 for the article Hendley, K. Murrell P. & Ryterman, R. Law Works in Russia: The Role of Law in Inter-Enterprise Transactions in Peter Murrell, ed. Assessing the Value of the Rule of Law in Transition Economies, Ann Arbor: University of Michigan Press, 2002. The seventh question is ours. My gratitude to Professor Peter Murrell for allowing me to use these questions.
We might attribute this increase in legal proficiency to a greater demand of law, and more contact with law over time. Legal self-efficacy and legal proficiency are not correlated. Legal proficiency has little to do with legal self-efficacy. Legal self-efficacy has more to do in an individual’s belief in his/her ability to use legal terminology and less to do with actual knowledge of current law.

We mean that law is efficient when managers’ feel that they can use the law. Only then there will be a true demand for law, and demand for law is also a prerequisite for legal efficacy. Previous theory on legal efficacy has used obedience to law as the sole measure. Legal efficacy has been measured by the characteristics of legal institutions, such as speed of trial, days to register a firm. The results from this study on the effect of legal self-efficacy challenge theories that resort to solely analyze external legal institutions as the mechanisms of contract enforcement.

**Mechanisms of Contract Enforcement**

The selection of private order mechanisms such as legal self-efficacy is motivated by previous studies which have shown that it has a more significant impact on the use of law than do perception of courts and the effectiveness of the legal system. The public order mechanisms of courts and law enforcement are selected as they are the most observable public order mechanisms to which all managers have a relationship. The most popular method of conflict resolution with a client or supplier is without outside intervention. Lawyers are the most popular choice among third parties, and the legal system the second choice. Trade associations and informal organizations linger far behind, see figure 1 below and table 2 in the appendix.

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22. An unreported correlation was not significant.

23. See Hendley, K. (2001) “Beyond the Tip of the Iceberg,” in Assessing the Value of the Rule of Law in Transition Economies Ann Arbor: University of Michigan Press. P. 20-55. She states— ”Most of the scholarly attention has been devoted to analyzing the content of these reforms, rather than to investigating their impact on the day-to-day lives of ordinary Russians.” She goes on “…‘demand’ has taken on a more expansive meaning, standing for the bundle of attitudes and behaviour toward law as affected by historical experience, both personal and societal. It goes beyond seeking victory in specific categories of cases to encompass a broad acceptance of law as a means of both protecting and advancing one’s interests”. Hendley thus has captured the use of law that this paper wishes to convey, law as a tool for advancing the interest of the individual in society.

24. See Hendley, K. (2001) P. 20-55 note 21. She states—” Most of the scholarly attention has been devoted to analyzing the content of these reforms, rather than to investigating their impact on the day-to-day lives of ordinary Russians.” She goes on “…‘demand’ has taken on a more expansive meaning, standing for the bundle of attitudes and behaviour toward law as affected by historical experience, both personal and societal. It goes beyond seeking victory in specific categories of cases to encompass a broad acceptance of law as a means of both protecting and advancing one’s interests”. Hendley thus has captured the use of law that this paper wishes to convey, law as a tool for advancing the interest of the individual in society.


Figure 1. In order to solve a commercial conflict, my firm;

<table>
<thead>
<tr>
<th>Prefers to use the legal system</th>
<th>Prefers to use a third party, such as a lawyer</th>
<th>Prefers to use a third party, such as a trade association</th>
<th>Prefers to solve the conflict without external intervention</th>
<th>Prefers to use informal organizations</th>
<th>I don’t know</th>
</tr>
</thead>
<tbody>
<tr>
<td>20.9%</td>
<td>30.9%</td>
<td>1.3%</td>
<td>33.9%</td>
<td>1.7%</td>
<td>11.3%</td>
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Private Order Mechanisms: Legal Self-efficacy, lawyers, and trade associations.

Private order in Russia has evolved in response to deficient public order. Private order fosters economic efficiency by making gains from trade realizable. It is a supplement to law, yet it cannot entirely replace it. In order for private order to be able to realize gains from trade, there need be a democratic public order that can help curb the potential for private order inefficiencies. Private order norms can produce benefits that the public realm cannot produce effectively. When the public order mechanisms such as courts and law enforcement failed, private order mechanisms in the form of trade associations, private networks and reputation were take their place. Yet there are ample reasons not to rely entirely on private order despite dysfunctional public order. Private order, such as trade associations can discriminate traders on various grounds. Price collusion among closed groups of traders is another problematic feature of the public order. Private-order organizations’ enforcement techniques can overflow into criminal violence. Legal self-efficacy cannot replace a faulty legal system, lawyers cannot replace judges, and trade associations cannot replace courts to achieve contractual assurance.

28 Katz (2000), note 12 p. 2488
30 See note 1
Legal Self-efficacy

This study may be conceived of as a study of legal self-efficacy, and is, as such, an application of a tried and tested theory of cognitive psychology on individuals’ use of law. Legal self-efficacy has not been discussed previously in relation to transactional behaviour. Jörgensen & Svanberg (forthcoming) demonstrates that legal self-efficacy is a stronger determinant of managers’ use of law than perception of formal legal institutions. This study is the first study on the impact of legal self-efficacy on managers’ transactional behaviour.

Legal self-efficacy may be a very useful concept for understanding laymen’s use of law. Legal professionals are familiar with the exact phrasing, connotations and implications of laws. Laymen however, structure their thinking along more symbolic paths of reasoning. Their understanding of abstract legal concepts such as obligation, rights, debt, and contract may not always be clear. However familiarity with these concepts makes their use more likely and as a result they will be uses in communication more easily. According to the Torpman & Jörgensen definition of legal efficacy, the effectiveness of law is a direct result of their ability to use legal terminology and in their acceptance of law as a means of communication.

It is reasonable to assume that self-efficacy is relevant for the choice to apply a legal perspective to a situation. Although there is presently no prior research on self-efficacy regarding the use of law, self-efficacy assessments mediate the influence on other predictors of behaviour on particular performance. Earlier experience and performance help create self-efficacy perceptions, which are strong predictors of subsequent performance. Self-efficacy is a mediating mechanism of personal agency that mediates between the sources of its creation and subsequent outcomes. The foretelling and mediational role of self-efficacy has received support from a growing body of findings from diverse fields and applications. Self-efficacy has been proven to be effective in; lessening alcohol and drugs abstinence, exercise, avoidance of tobacco smoke, personal and social development of youth, weight loss, parental skills, knowledge-sharing, computer use.

32 Ibid.
36 Chen, C.M., Ching-Min, L., PH, et al. (2007) “Avoidance of environmental tobacco smoke among pregnant Taiwanese women: Knowledge, self-efficacy, and Behaviour” Journal of Women’s Health 16 (6) p.669-676. A multiple regression revealed that overall avoidance of environmental tobacco smoke was positively associated with self-efficacy, with a no-smoking policy at home, and with both a woman and her partner's educational levels.
at work. The role of intellectual abilities for self-efficacy is found to have a significant correlation.

Students’ self-efficacy was found to be a useful predictor of perceived competence in science. Self-efficacy has been proven to be a strong predictor of behaviour in numerous fields.

Self-efficacy reflects beliefs about one’s ability to organize and execute courses of action necessary for attainment of a goal. Self-efficacy relates to an individual’s beliefs about personal control and agency. Efficacy beliefs heighten the likelihood that people will strive to attain certain goals and be persistent in their goal-directed behaviour, and be successful in their pursuit of these goals. Self-efficacy is only the faith in one’s ability to do something, yet there is significant support for a positive correspondence between self-efficacy and performance. Persons with high level of self-efficacy view circumstances as presenting achievable scenarios. They envisage success scenarios that provide guides for winning performance. Those who judge themselves of low self-efficacy conversely view situations as perilous and cannot seem to visualize affirmative prospects.

References:


2. Leerkes, E.M., Barney, R.V., et al. (2007) “The development of parenting efficacy among new mothers and fathers” Infant, 12 (1) p. 45-67. Prenatal self-efficacy for mothers was significantly related to postnatal self-efficacy. For fathers this was not the case, whose postnatal self-efficacy was primarily a function of their amount of involvement in parenting tasks and social support.


Law shapes the individual’s expectations, calculations of action and understandings. 48 Lindenberg (1990) stresses the role of “framing effects” the preferences and action space available to a manager depends on the way a situation is framed. 49 In many disputes people may choose between several different types of norms. 50 Claims, during both formation and processing, may be framed or transformed in ways that reject law, or include it. 51 Legal self-efficacy is facilitative and enables the individual with the means to construct meaning and negotiate relations with other enterprises; it also helps the individual frame a conflict about private property rights in a legal perspective.

It is important to understand the perceptive quality of legal self-efficacy and that the individual discernment of institutions, rules and sanctions plays a larger role for behaviour than do the inherent qualities of institutions themselves. 52 Legal self-efficacy is also a measure of how much an individual has internalized legal norms. Internalised legal norms are closely related to emotions – non-legal sanctions of the individual upon himself in terms of shame, guilt, and remorse. 53 Emotions of the individual are the sanctions that internal norms impose on the individual. This is helpful or enforcing second and third party sanctions as well. Norms enjoy a scale economy, i.e. a person who has internalised norms, will be willing to pay a price in order to ensure that other people if not internalise these norms, and then at least adheres to them. 54 It is therefore less costly to transact with a person, or firm, who uses similar norms, as there will be no need to teach them or enforce them. An individual can communicate legal norms in various forms; a typical one is that of the use of contract, or oral communication with a client. Legal norms can also be communicated in oral communication with customers and clients. Typically, a manager who has internalised legal norms is comfortable with using them in the line of business. The implications are that legal self-efficacy has an emotional side, of self-punishment when legal norms are breached. It also helps in written and oral communication with clients. A businessman who has a high level of legal self-efficacy finds it less costly to communicate with other...

likeminded businessmen. Legal self-efficacy can therefore help make law a focal point when doing business.

Businessmen’s use of law is a self-reinforcing mechanism. The more law is used and the more successful the use, the more loyal businessmen will be to law. Hirschman (1970) findings that customer loyalty is based on the ability to communicate shares many common qualities of the concept of legal self-efficacy as a measure on the belief in law as a means of structuring social expectations as well as a means to structure business. Loyalty to the legal system is created by the ability of managers to communicate in legal terms as a way of doing business. It is possible to make a comparison of the impact of legal self-efficacy and the impact of public legal institutions. From this reasoning follows the proposition:

P1: Legal self-efficacy has a larger impact on the provision of trade credit than do the perceptions of public order institutions such as courts and law enforcement.

1.2 The Role of the Lawyer in Russian Enterprises

Lawyers are a very flexible and versatile part of the private order; their aid in provision of contract security is unequalled. Commercial lawyers create value by creating transactional arrangement that reduce insecurity. Lawyers reduce transaction costs by bridging the cognitive cap of businessmen when structuring transactions. Lawyers are transaction cost engineers. They also function as contractual support for businessmen in legal recourse. Commercial lawyers do more than just law; they are at least as often involved in matters of financial, accounting and business nature. Lawyers are engaged in developing approaches to private ordering that minimize transaction costs. Their function is also symbolic, in the notion that if laymen have confidence in commercial lawyers, they are more likely to take more risks, as they know that they can rely on their commercial lawyer for contractual support, both by structuring the deal, and as a legal aid in court. In this paper we measure just to what extent they reduce transaction costs, in comparison with judges, trade associations, and law enforcement.

Not much is known about the role of Russian lawyers in the provision of contractual support to firms. Hendley et al. (2001) find that lawyers are marginalized within the enterprise. Lawyers

13Ibid p. 255
14Ibid p. 295
15It is possible to empirically measure the impact of commercial lawyers, as we do in this paper, in contrast to what Gilson (1984) stated "A truly empirical approach to measuring the impact of a commercial lawyer's participation seems impossible for a number of reasons. It is unlikely that we could find data covering both a sample of transactions in which a commercial lawyer did participate and a control group of transactions which were accomplished without a lawyer."
focus on established, routine tasks, such as labour relations or drafting form contracts, rather than on shaping enterprise strategies in the newer areas created by the transition, such as corporate governance or securities law. She further stipulates that the failure of in-house lawyers to emerge as agents of change in Russia reflects a continuation of their low status during the Soviet era and the lack of professional identity among these company lawyers. In Soviet times, lawyers played a diminutive role for doing business. The mechanisms of trade were placed mainly outside of the firms, in the central planning committees and inside the Communist party. After the breakup of the Soviet Union, however, the need for lawyers has increased, as they now serve to coordinate among other things firm transactions. In Russia, lawyers are an advantage, yet they are not quite as pivotal as lawyers in the United States. No more than about half of the cases in courts are unrepresented by legal counsel. This is evidence that lawyers play a greater part when structuring business outside of court than inside in Russian business. Hadfield stresses that lawyers are carriers of legal human capital. In her context legal human capital implies the shared knowledge accumulated within the legal profession – judges, lawyers, legislators, and law professor. Lawyers do have the potential to act as agents of transformation in economies that undergo reform.

When there is a commercial conflict, the choice of norms to solve the conflict depends on a variety of factors; such as the efficiency and effectiveness of the norm. The lawyer’s role can be interpreted as a mediator between social and legal norms, between private norms and public order norms. As such the lawyer becomes very valuable in a changing legal climate. Managers in our survey appreciate lawyers more than judges as agents of conflict resolution. A client who knows how to use legal terminology will be more likely to be able to communicate with a lawyer and will not be screened out. The lawyer can serve as a gatekeeper as to which cases end up in court. Legal aid attorneys in Chicago screen out clients with which they had difficulties communicating and clients perceived as shifty, of questionable moral character and credibility. Lawyers are repeat players in both drafting contracts as well as representing their clients in court. In comparison to judges, it may very well be so that lawyers are the most trusted legal players surpassing judges, and to some extent substitute for the lack of this essential

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Trubek and Galanter (1974) see note 8
part of the public order. Porat (2000) argues that if judges, being the most important part of the court system, deviate from their function, all sorts of compensation need to be performed by private order. I argue that lawyers are one very palpable substitute, which this analysis demonstrates. It is possible to make comparison the impact of legal self-efficacy and the impact of public legal institutions. We therefore make the proposition:

P2: Belief in lawyers’ efficiency in solving commercial conflicts has a larger impact on the provision of trade credit than do the perceptions of public order institutions such as courts and law enforcement.

1.3 Trade Associations

Trade associations pool resources among members and can be seen as an uncertainty-reducing device. An example of private order is the trade association, which facilitates contracts under uncertainty. Trade associations do four things: a) they coordinate information about their members, b) they can apply sanctions against members when necessary c) they can often act as forum for conflict resolution d) they can promote the interests of the members in society, such as lobbying etc. The vast changes in trading patterns that have occurred in transition countries have led to firms to find new clients and networks. These networks differ in degree of openness and competition. Guilds, throughout history, created rules for transactions, with multilateral enforcement.

The main raison-d’être of trade associations is the provision contractual assurance and trade partners for its members. Trade associations coordinate information and serve as norm standardisers. Firms that have a special interest can form trade groups; there are prevalent business norms in the trade association. Trade associations proved information about their industry to others; it can act as a representative for its industry to the government in lobbying. It can serve as an expert when the government creates new legislation. In addition to this, trade association coordinate sanctions to members in breach of association norms. They also coordinate information between members. In short, they provide several versatile functions to their members. Membership in a formal organization can, among other things, formulate the law in ways advantageous to its membership. Some people belong to organizations that are regularly counselled by lawyers and others about their legal problems.

Trade associations help raise the confidence in trade between firms, especially if that organisation offers contractual support, to solve a conflict. Another function of trade organisations is to disseminate information

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There are various forms of trade associations, some which are very strong in all of these areas, and the other extreme, which performs virtually none of the functions above except granting membership to its members.


While trade associations provide many different functions to their members, courts can provide far less services. This is an example of the richness of private order in comparison to public order.


about contractual breaches and coordinates the community’s reaction to breaches. Trade associations and networks lower the costs of information gathering, resulting in better-informed manufacturers. Both business and social networks are significantly associated with trading locally, which suggests that geographic immediacy makes repute easier to communicate. Fafchamps and Minten (2000) conceptualize membership networks as social network capital. They find that it has a strong positive effect on trade. They divide social networks into three categories – relationships with other traders, which help economize on transaction costs, relations with individuals who can help in times of financial difficulties and insure traders against liquidity risks, and family relationships, which reduce efficiency, as opposed to the former two groups. They also find that the density of interpersonal relationships is significantly related to trust and information flows. One study finds no evidence that courts or trade associations support long-distance trade. Firms that believe that courts are effective are more likely to trade locally, and that those who are members of trade associations are more likely to sell to distant buyers, but these results are not significant.

A previous study found that the marginal value of business associations increases when the parties are in different cities. The role of business association in promoting flow of information is sensitive to the degree of local competition in the members’ markets. On the other hand, another study found that business associations only play a marginal role in helping enforce contracts and spread information on prospective customers’ ability to pay. Trade associations have many roles that reduce uncertainty for enterprises; they coordinate information about suppliers and clients. They inform about contractual breaches and some even provide contractual support in case of conflict with a client. All of these roles can be useful for an enterprise that decides to provide trade credit to a client. In light of the benefits of membership in a trade association the following proposition is formulated:

P3: Membership in trade associations has a larger impact on the provision of trade credit than do the perceptions of public order institutions such as courts and law enforcement.

1.4 Public order mechanisms

Some researchers seem to think that private enforcement is inferior to state enforcement of contracts, since private enforcement is more costly, creates competition of violence and is more difficult to monitor and often inhibits changes in economic institutions that may increase efficiency. Others seem to think that private substitutes to law can take the place of legal

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77 see note 1.


arrangements and create the environment that enables economic growth. Katz (2000) stresses that nevertheless, public order institutions are needed to provide public legitimacy of well-functioning private order norms. Efficient public order norms give legitimacy to private order norms and efficient private order norms can serve as examples for norms that the public order can adopt. Private and public order can complement and substitute, but they cannot entirely replace one another.

1.5 Courts

Courts serve as beacons of legal norms. The strongest impact of courts on the general population of enterprises is that of norm communication which informs about which expectations to have on breaches of contract. The vast majority of firms are never sued, and likewise do not adjudicate other firms to court. The results from this survey show that Russian managers consider courts to function rather well. Many scholars agree with these findings. They also show that private firms find that suing another private firm to have reasonable prospects. They refrain however from suing state enterprises due to court bias. When Russian managers compare judges and lawyers in the role agents of resolution of commercial conflicts lawyers come out ahead, see figure 2, below.

The innate characteristics of courts matter for enterprises, in both positive ways and negative. Previous research has shown that the most important features of courts are fairness and honesty as opposed to their efficiency or ability to enforce decisions. Powerful economic interest groups avert weak firms from the justice system. The inequality of influence over government

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81 See note 54
82 See note 12.
85 Raiser, M., Roussos, A., Steves, F. (2003) “Trust in transition: cross-country and firm evidence” EBRD working paper 82. This paper shows that trust among businesses is higher where confidence in third party enforcement through the legal system is higher. It also found that a variable capturing the fairness and honesty of the courts was more closely correlated with trust than the courts’ efficiency or ability to enforce decisions.
86 Glaeser, E., Scheinkman, J.A., and Shleifer, A. (2002) “The Injustice of Inequality” NBER Working paper 9150. The authors point out that when justice is subverted by powerful economic interest groups, other businesses tend to turn away from the justice system, with negative consequences for the whole economy. In many countries, the operation of legal, political and regulatory institutions is subverted by the wealthy and the politically powerful for their own benefit. This subversion takes the form of corruption, intimidation, and other forms of influence.
institutions has a strong negative impact on weak firms’ use of the legal system. This can imply that weak private firms are less likely to sue a large state company for unpaid trade credit.

Measuring perception of courts’ effectiveness, controlling for court use, is the most effective way to assess court impact on trade credit. Perception of courts’ effectiveness has previously been shown to have a positive significant effect on the granting of trade credit to clients. Courts have also shown to have a direct impact on banks’ lending to enterprises; the effect on trade credit is less significant. Other effects of the perception of courts have been shown, such as significant positive effect on the level of trust shown in new relationships between firms and their customers. One study found that court effectiveness has a significant impact on local, not distant trade. Perceptions of Russian courts seem to not diverge very far from actual performance.

Russian courts require 37 steps before recovery of disputed debt, it takes 281 days to get the debt, and the price is on average 13.4 percent of the debt. In comparison to Sweden, where there are 30 steps before recovery of disputed debt, and the average time period of 508 days, at a cost of 31.3 percent of the debt. The comparison divulges that the Russian court system is not far behind Western countries when it comes to the formalities of debt recovery through courts. In sum, Russian courts function, however there are serious flaws that deter private and weak firms from using them. It could be the case that it is the mistrust of businessmen of courts that deters them from using them.

Figure 2. Lawyers vs. Judges: Efficiency in Solving Commercial Conflicts.

Scale from (0 to 10)

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87 Hellman, J. and Kaufmann, D. (2004) “Political Inequality and the Subversion of Institutions in Transition Economies” in Trust in Post-Socialist TransitionKornai, J. and Rose-Ackerman, S. (eds) provide a preliminary investigation of the determinants of enterprise perceptions of the quality of the courts in the BEEPS, taking into account the role of interest groups and capture. The paper shows a consistent pattern in which the inequality of influence over government institutions has a strongly negative impact on assessments of public institutions that ultimately affects the behaviour of firms towards those institutions. The data suggest that the inequality of influence of weak firms not only damages their trust in these institutions, it also affects the likelihood that they will use and provide tax resources to support such institutions.


90 See also Shvets note 6. In this study Shvets shows that the immediate effect of improvement of quality courts is that more firms get access to bank finance, not that more credit is granted to those firms that already have credit. Trade credit also responds to changes in quality of courts. However bank credit is much more sensitive to quality of courts than is trade credit. Chemin, M. (2004) “Does the Quality of the Judiciary Shape Economic Activity? Evidence from India,” mimeo, LSE. This paper demonstrates that the speed of court execution of cases has a significant impact on the rate of lending of banks in India on the financing of firms.

91 Johnson, McMillan and Woodruff (2002) see note 5


1.6 Law enforcement in Russia

Law enforcement agencies in post-Soviet Russia suffers from severe shortages. They have been reported to be underpaid and outnumbered. Their place is taken by private armies and protection rackets. There are five recognized powers in Russia today, the executive, legislative, judicial, the mass media and the bandits. The police are reported to have problems confronting a krysha, which literally means “roof.” As a slang word, krysha refers to a criminal protection racket, such as a gang that extorts money from a store owner. Many businessmen report that the use of krysha as the only way to enforce a contract. Shopkeepers view private protection organizations primarily as a substitute for state-provided police protection and state-provided courts. The research on law enforcement in Russia has been focused on the general picture, researchers often painting a sad picture of the law enforcement agencies. Corruption is usually mentioned as one of the reasons to this. In a situation of debt recovery, law enforcement acts upon a court order only, and not preventively. Survey studies that measure the impact of law enforcement is in short supply. Law enforcement agencies in Russia leave much to be desired.

Data Collection and the Survey

The survey was completed by the author and his Russian students among 246 enterprises between March and May 2005 in St. Petersburg, Pskov and Kaliningrad in northwest Russia. St. Petersburg embodies three fifths of the enterprises and Pskov and Kaliningrad one fifth apiece. Enterprises were represented from ten diverse industrial categories. Enterprises were of sizes 5, up to 7,000 employees, with average firm size of 44 employees. The average time span of firm activity at the point of the survey was 9.5 years. 72 percent of the respondents were male, 28 percent female. 7 percent of firms were registered on a stock exchange. 8.3 percent were at least state-owned to some degree. 18.1 percent of the enterprises were open stock companies (OAO), and 30.3 percent were closed companies (ZAO), the remaining 51.9 percent were of other legal affiliation or unrevealed. The blend between industry and services in this survey, is 60 - 40, reflecting the Russian economy as a whole. The survey instrument contained 200 queries on topics ranging from firm legal strategy to methods of financing the firm to client structure and

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96 My gratitude to Vyacheslav Eropkin in Pskov, and Olga Belova and Elena Osipova in Kaliningrad for assistance with collecting and the surveys. I would also like to thank the Inga-Lill Norlin at the Visby Programme with the Swedish Institute and for two generous grants supporting the data collection in Russia.
trade credit. We approached CEOs and top managers in each firm at trade fairs and directly in offices. The total response rate was 50 percent or above. The internal response rate within the questionnaires themselves was 80 percent or above.

Results and Discussion

In this section the hypotheses are tested controlling for enterprise size and court use. The results are examined in light of previous research. In the ensuing discussion the implications for theory

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<tr>
<th>Private order institutions</th>
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<td>Legal self-efficacy</td>
<td>Perception on lawyers' ability to solve commercial conflicts</td>
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<th>Trade credit to</th>
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<tr>
<td>Friends and relatives</td>
<td>-0.001 (0.993)</td>
<td>0.182** (0.013)</td>
<td>-0.076 (0.308)</td>
<td>0.045 (0.548)</td>
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<td>(Df 182)</td>
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<td>Business clients</td>
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<td>0.231*** (0.002)</td>
<td>0.053 (0.478)</td>
<td>-0.065 (0.384)</td>
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<td>Clients in the same town</td>
<td>0.151** (0.040)</td>
<td>0.193** * (0.008)</td>
<td>0.096 (0.193)</td>
<td>-0.021 (0.784)</td>
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<td>(Df 180)</td>
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<tr>
<td>Clients in other towns and abroad</td>
<td>0.165** (0.025)</td>
<td>0.175** (0.017)</td>
<td>0.012 (0.867)</td>
<td>0.010 (0.896)</td>
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* Significance at the 10 percent level  
** Significance at the 5 percent level  
*** Significance at the 1 percent level

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Private order institutions; Legal self-efficacy, lawyers and trade associations

Proposition one: Legal self-efficacy correlates more strongly with the granting of trade credit than do the perceptions of public order institutions such as courts and law enforcement is affirmed, legal self-efficacy has an equal impact on the granting of trade credit as courts and superior to that of law enforcement. Legal self-efficacy can be interpreted as a way of trust in one’s own capacity to use law. This capacity enables managers to grant trade credit to three out of four groups, all except friends and clients. The most distinctive characteristic of this measure is that it is based in managers’ beliefs in their legal capacity, as “citizens in the world of law”. The mere knowledge that one can apply law to certain situations is significant, only that one may not know which law to apply. Legal self-efficacy as a measure of distributed legal efficacy in the population is affirmed as having as significant impact as courts. In business, the lawyer plays an essential part in communicating legal norms between parties. It is no coincidence that internalization of legal norms and the use of legal terminology when doing business and belief in lawyers’ ability to solve commercial conflicts concur. An individual’s belief in law as a means of communication is significantly correlated to the confidence in lawyers to solve commercial conflicts. Legal self-efficacy has a medium impact on the granting of trade credit to Russian enterprises.

Proposition two: Belief in lawyers’ efficiency in solving commercial conflicts correlates more strongly with the granting of trade credit than do the perceptions of public institutions such as courts and law enforcement is affirmed; lawyers have a stronger impact on the granting of trade credit than do courts and law enforcement. The significance of impact is impressively high, in particular among business clients. This result supports the view of lawyers as transaction cost engineers. The need for lawyers has increased since the fall of the Soviet Union. The findings about the role of lawyers as a significant factor for the contractual assurance for Russian firms is partial response Hendley et al. (1999), who questions of what the role of lawyers in post-Soviet Russia play. Lawyers help structure deals between firms, and to recuperate unpaid trade credit. The perception of lawyers’ ability to solve commercial conflicts has a medium impact on almost all Russian firms granting trade credit.

Proposition three: Membership in trade associations correlates more strongly with the granting of trade credit than do the perceptions of public institutions such a courts and law enforcement is…

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1 This theory is validated in a 0.161 correlation with 1.4% significance.
2 More than in 998 out of 1000 trade credit decisions, the perceived efficiency of lawyers’ ability to solve commercial conflicts has a 23 percent impact.
3 See note 61. p. 860
not affirmed; trade associations play an inferior role to that of public order institutions when firms grant trade credit in Russia. The findings of Fafchamps and Minten (2000), that trade associations have a strong positive effect on trade are not supported. McMillan and Woodruff (2000) find no evidence that trade associations do not support long distance trade. This study supports that observation. Pyle’s (2005) observation that the marginal value of trade associations increases when the parties are in different cities is not supported. The study supports Hendley, Murrell and Ryterman’s (2001) observation that trade associations only play a marginal role in helping enforce contracts is supported. Trade associations have a weak effect only on local trade and no effect on other groups of clients.

Legal self-efficacy and perception of lawyers’ ability to solve commercial conflicts have a strong impact on the trade credit decision in Russian enterprises in comparison to the impact of courts and law enforcement. The human legal capital of businessmen and lawyers are a strong and significant factor in the provision trade credit for Russian enterprises.

Public order institutions: courts and law enforcement

Courts have no impact on the granting of trade credit for any group. Courts are local, just like law enforcement and would be expected to have a stronger impact on local clients than on distant ones. This may depend on the fact that the firm that puts up trade credit usually writes a condition of use of local courts in case of default of payment. Law enforcement is local, which the results reflect; the only significant impact is on local clients. Courts must first order law enforcement agencies to collect an overdue debt, and are not allowed to act on their own. The view of law enforcement agencies as having difficulties supporting contract enforcement gets support in this study.

Discussion and theoretical implications

Legal human capital has a significant impact on transactional behaviour. La Porta et al. (1997 and 1998) explain the external legal determinants of finance in terms of legal origin and legal rules covering protection of corporate shareholders and creditors. This paper takes the opposite approach and uses managers’ perception of their ability to use legal terminology as a determinant of granting trade credit to client enterprises. The results of this paper are that external legal determinants of finance have no impact on external financing of firms, but that legal self-efficacy as an internal legal determinant of finance does. These results add to the theories of external legal determinants of finance and contradicts them in that they say that human perception of law is a stronger determinant of behaviour than the innate characteristics of legal institutions. Financing of firms do not hinge entirely on the characteristics of the legal system, but also on the degree that entrepreneurs are law businessmen.

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100 The logic behind this reasoning is that the provider of trade credit runs the higher risk, and is therefore compensated by use of a local court in case of dispute.  
101 An exception to this may be the Russian tax police, but they are usually not involved in collecting trade credit debt.  
102 See note 7
This paper demonstrates the importance of the individual and the degree of internalization of legal norms and reliance on legal means of communication. It has demonstrated that the more confident a person is with using legal terminology for defining and communicating about matters the more prone a person will be to take the risk of granting trade credit to a customer. The assumption derives from Hirschman’s classical work on loyalty, which has formed the basis for significant amount of theory on customer loyalty and service quality. According to Hirschman’s original idea customers are loyal not by repetitive trading with a supplier, but by feeling confident in their ability to correspond with a supplier. Thus, what people believe about their abilities to correspond through a channel or a set of concepts, constitutes loyalty towards the supplier, but notably in this respect, loyalty also to the communication channel and the set of concepts they use. In the same fashion, the legal efficacy concept developed by Torpman & Jörgensen assumed that law is effective when it is the basis for social expectations. One implication of the finding that manager’s legal self-efficacy has a larger impact on the granting of trade credit than the perception of courts and law enforcement is that policy makers can find more efficient ways of improving contractual assurance.

In light of current theory on trade credit, which explains the trade credit decision in terms of enterprise dependent factors the findings of this paper add a new dimension – legal human capital legal self efficacy and the belief in lawyers’ ability to solve commercial conflicts. All other things equal, human capital has a significant impact on the granting of trade credit. The implications for trade are that human legal capital boosts growth. In Russia for example, trade credit is by far the largest source of external capital and improves the chances of growth of the enterprise. Legal human capital helps enterprises guard their private property rights and cut transaction costs. In transition economies, where bank financing is even harder to find, trade credit plays a larger role for firm growth than in developed economies. Typically, private property rights are more challenged and less well established in transition economies. Improvement of human legal capital can be a key for advancing growth in transition economies.

Legal self-efficacy can be considered a means of risk reduction. Risk reduction occurs before the management decision with involving risk, as well as after. The way in which a problem is framed affacts the perception of and attitudes towards risk. As Karl Llewellyn (1941) put it “Law purports to channel behaviour in such a manner as to prevent or avoid conflict; and law does in important degree so channel behaviour. Without the purposive attitude, law is unthinkable: without the effect attribute, law cannot be said to “prevail” in a culture, to have “being” in it.” As a result managers who appreciate that their ability to communicate with legal terminology will be accepted by their counterpart experience a high degree of legal efficacy. In the case when both parts of a business agreement accept law as communication law can be said to be a focal point. Law has an expressive effect in that it coordinates expectation of behaviour of business partners and can serve as a point of equilibrium. Law is thus expected to be a norm in the coordination of an economic exchange.

103See note Hirschman 55
104See Torpman & Jorgensen (note 2)
107See Torpman & Jorgensen 2005 note 2
legal rule may guide behaviour merely by influencing the expectations on how others will behave. The internalization of law and the acceptance of law as a means of communication, both captured in the concept of individual legal efficacy, provide economic actors the means to rely on law as a way of coordinating expected behaviour. Individuals who display a high degree of internalization of law are more likely to be able to frame a problem in legal terms and communicate it in legal terminology, as in the case of i.e. default in the payment of trade credit. The communication with the client will be more permeated by legal language. It is only through the application of law in a population that law can be said to be effective. It is also the single occasion when law can have an effect on society. The confidence in lawyers’ ability to solve commercial conflicts correlates significantly with legal self-efficacy. Managers’ belief in their ability to use legal terminology facilitates communication with lawyers. The coincidence of these two observations is not unexpected as lawyers are visible representatives of the legal system that communicate with legal terminology. Lawyers function as the link between laymen and the legal system in their role as representatives of the legal system. Laymen who feel like law businessmen can communicate with a lawyer without strenuous effort. This study demonstrated that the impact of the perception of lawyers’ ability to solve commercial conflicts on transactional behaviour is not insignificant. The affirmation of lawyers as necessary, useful and trusted supporters of enterprise transactions is a sign of the Russian market that moves towards an economy of private property rights.

Membership in trade associations means being part of a group of enterprises. This group has a certain identity, or social network capital. The identity of this group forms a part of the individual’s self concept. The self-concept is a merged view of oneself that is presumed to be formed through direct experience and assessments adopted from significant others. It is a knowledge organization that helps people organize and give meaningful to memory and actions. As such it mostly includes direct self-descriptions and such elements as institutional legal structure can be self-descriptive for an individual only as a result of collective classification at the societal or national level. It is typically not an important aspect of an individual’s self. Thus, a person may describe him/herself as a good painter, a poor tennis player, and a good brother, but only to a much lesser extent as a citizen of a state with inefficient law enforcement. These descriptions serve both as guides for (automatic) behaviour choice and as motivators. Other information which is not self-descriptive of the individual is also motivating, but only if it has importance for the self either through perceivable consequences for the individual or through values that the individual hold. Thus, the individual is motivated to use law if “being lawful, or legal “ gives rise to positive effects for the self-concept, for example by making positive interpretations of the self possible through self-verification. The individual is motivated to avoid law if it has connotations that are unfavourable or unsuitable for the self in a situation. There is solid confirmation in psychology that support the primacy of the self-concept as motivator, for instance information may be stored better in memory when it is self-relevant and self-relevant information may be more systematically linked to other information. This study demonstrates that the self-concept

109 Torpman and Jörgensen 2005 see note 2 p. 29, 14
110 See Bandura note 44.
of the individual does not have a momentous impact on trade credit behaviour of Russian enterprises. This suggests that the characteristics of the individual, such as legal self-efficacy are a more suitable for analysis of trade credit behaviour of Russian enterprises than group identity or social network capital.

This study demonstrates the strength of the human legal capital of the individual manager in terms of legal self-efficacy and also of the human legal capital of lawyers in the transactions of Russian enterprises. The results underscore the importance of individual characteristics of legal self-efficacy and the importance of lawyers for granting of trade credit. Individuals are more important for contractual assuredness in the Russian economy than collective organizations, such as trade associations. When comparing the private and public order institutions, the public order comes out weaker than the private order in this study. The policy implications are that programmes for improving individuals trust in their own ability to use law can be at least as purposeful as efforts to improve formal legal institutions. The role of lawyers as mediators of transactions and interpreters between legal language and laymen’s communication is evident. It is therefore easy to agree with Jeffrey Sachs in that Russia needs more lawyers. It also needs more law businessmen who have a high level of legal self-efficacy. The findings in this paper warrant future research on the impact on legal self-efficacy and lawyers on other economic transactions, such as money lending and borrowing between firms and banks in various comparative country contexts.
Appendix

Table 1

Participants responded to the following seven items:113

According to the law, must the following types of agreement be in writing?

Agreement to sell goods:

A. Written form is always required by law.
B. Written form is sometimes required by law.
C. Written form is never required.
D. I don’t know.

2. According to the law, must the following types of agreement be done in writing?

Agreement on collateral:

A. Written form is always required by law.
B. Written form is sometimes required by law.
C. Written form is never required.
D. I don’t know.

113 These questions are identical to those in Jørgensen & Svanberg (forthcoming)
According to the law, which of the following types of pledges must be notarised?

Pledges of buildings:

Yes
No
Don’t know

According to the law, which of the following types of pledges must be notarised?

Pledges of vehicles:

Yes
No
Don’t know

5. According to the law, which of the following types of pledges must be notarised?

Pledges of inventory:

A. Yes
B. No
C. Don’t know

6. Suppose an enterprise is in the process of liquidation because the enterprise was seriously overdue in its payments of taxes to the government and on a loan to a bank. The loan was legally secured with collateral. According to the law, which of the creditors – the government or the bank – should be paid first from the proceeds of the liquidation?
The government should be paid in full first.
The bank should be paid in full first.
Both must be paid, if not in full, then in proportion to the size of the two debts.
The court must decide which should be paid first.
I don’t know.

7. When litigation occurs in court, is it necessary for the plaintiff and defendant involved to pay salaries of the judges and clerks as compensation for their time?

Yes
No

TABLE 2
Answers to questions regarding use of law enforcement methods

| S1. Telling other enterprises about the behaviour of an enterprise that did not honour its agreement | 54 | 5.3 |
| S2. Forcing the enterprise to pay a financial penalty | 47.1 | 5.5 |
| S3. Stopping trade with the enterprise | 76.0 | 6.9 |
| S4. Filing a complaint against the enterprise with an antimonopoly committee | 8.4 | 3.4 |
| S5. Sending pretenzia or other notices suggesting a possible court action | 57.4 | 5.8 |

114 Ibid.
<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>S6. Filing a claim in court</td>
<td>42.5</td>
<td>6.0</td>
</tr>
<tr>
<td>S7. Reporting the enterprise to a local government organ</td>
<td>13.5</td>
<td>3.5</td>
</tr>
<tr>
<td>S8. Reporting the enterprise to a federal government organ</td>
<td>11.0</td>
<td>3.0</td>
</tr>
<tr>
<td>S9. Reporting the enterprise to a business association or a financial-industrial group</td>
<td>7.6</td>
<td>3.3</td>
</tr>
<tr>
<td>S10. Reporting the enterprise to social, religious, or civic organizations</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>S11. Reporting to a private security organization or other physical persons or group of persons in order to extract unpaid debt</td>
<td>26.1</td>
<td>5.8</td>
</tr>
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Legal Self-efficacy and Managers’ Use of Law

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Abstract

This study demonstrates that legal efficacy may depend on how an individual perceives him/herself as a competent user of law. The hypotheses tested in this study are that the self-perceptions of people may be more important for legal efficacy than are the objective factors such as law enforcement agencies and the effectiveness of commercial legislation. The effectiveness concept was tested on survey data collected from 246 managers in northwest Russia. The result is that the subjective self-perceptions are a stronger determinant of the use of law than is the perceived institutional efficiency. Persons were to a lesser degree adopting law as an instrument conditioned on their calculation of the efficiency of courts and other institutions, but to a greater degree adopting law as a form of communication conditioned on their feeling of assuredness about their ability to communicate with legal terminology. Therefore there is a latent potential for improvement of legal efficacy in the enhancement of how individuals perceive themselves as knowledgeable users of law.

Keywords: Legal efficacy, legal transplants, self-efficacy, legal self-efficacy self-concept, sanctions, transition economy, Russia.

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Introduction

Recently a growing interest has been devoted to the legal restructuring of formerly communist regimes. Some countries have a particularly difficult development process due to the so-called transplant effect, according to which imported laws function less effectively than internally developed law. The effect has been noticed particularly concerning economic transactions. Transplanted law appears to create a vacuum between law on the books and law in action so that only a fraction of the possibilities of the new law are actually used for organizing economic transactions. As a consequence transplanted law leads to a particularly harmful form of legal evolution. In endogenously developed legal systems legal evolution tends to take place continuously and gradually, but in transplanted legal systems law often stagnates for longer periods. When change occurs it is erratic and radical. According to the idea of a ‘transplant effect’ the imported law is not accepted in the host country. This state of affairs is problematic. If new statutory law is ignored or not properly understood it may fail to become a part of the country’s socio-economic infrastructure. According to Berkowitz et al. deficiencies in legal efficacy depend at least partly on difficulties in some countries to accomplish a continuous legal evolution. Hence the transplant effect seems highly related to the actual use of legal norms and the ‘demand for law’ is frequently mentioned as a driving force in countries with healthy legal evolution.¹

The rationale of the legal efficacy concept in studies of the transplant effect is, with few exceptions, that law is effective when the professional and institutional services provided by lawyers, courts, and authorities can be acquired rapidly, accurately, and at low cost.² The employed definition of the legal system in many such studies share the emphasis on the difference between clients and professionals, that is, law is understood as services provided by professionals to laymen.³ According to this form of definition, law is effective when behaviour is in compliance with law, and compliance is described as though it was achieved mostly according to Austin’s command backed by threat model.

The present article criticises the most frequently applied ideas of legal efficacy in studies of legal transplantation. It builds on a recently developed legal efficacy concept that refers to law as the

application of set of communication opportunities in Luhmann’s sense. According to this effectiveness concept, a norm or a legal system is effective when the norm or the system is used as means for communicating about a matter. Communication in this and Luhmann’s meaning involves a reference to the context in which valid norms are produced and calls into play a system of normative expectations. Luhmann’s concept of law allows for a widening of the effectiveness concept to include other forms of legal application beyond those that involve lawyers or authorities. For example, law is applied when businessmen or businesswomen discuss a contract, even before it has been signed. By referring to a horizon of norms they align their respective expectations according to legal norms. They become aware that by signing a contract they are bound not only by the sentence *pacta sunt servanda* but may also be held accountable with authoritative law enforcement. The particular meaning of the legal communication signals to the contractual partners that they should prepare particularly well by informing themselves before signing the contract and afterwards they should navigate to avoid costly legal procedures if possible. In short, the parties automatically adopt expectations that relate to or are supplied by the legal system when they choose legal communication. Use of law is not delimited to the professional or institutional activities in which professionals serve laymen. Instead it is a highly distributed activity among a population that does not necessarily demand the lawyer’s detailed knowledge of law.

Hendley (1999) states: “...the appeal of law by itself cannot be assumed, either on an individual or societal level. Law’s potential to serve as a common language, facilitating market transactions and easing democratization, has to be demonstrated, not assumed.” The purpose of the present study is to show how Luhmann’s communication perspective on the legal system can be used for development of empirical measurements of legal efficacy. In this study an empirical survey of 246 Russian managers has been conducted. The purpose was to provide empirical evidence for our implicit hypothesis that only fractions of the conditions that impact on legal efficacy are captured by the conventional effectiveness concepts. Therefore our purpose is to show what factors mediate legal efficacy when effectiveness is defined as the use of law as a system of communications. The approach in this study is a micro-perspective, or individual-oriented perspective on legal efficacy in which the individual’s perception, knowledge, and use of law are measured in order to demonstrate how psychological indicators, relevant for the choice between ‘reden und schweigen’ through the legal conceptual system, explain the use of law. As a result, the present study attempts to measure the most fundamental form of relating to law, namely the choice between referring and not referring to law. Hence our approach measures the distributed use of law, rather than macro parameters such as the effectiveness of courts, design of laws, or the availability of lawyers.

\footnote{Torpman, J. & Jörgensen, F. Legal efficacy: Theoretical Developments on Legal Transplants, *ARSP* 91 (2005), 515-534}

Common Understandings of Effective Law Concerning Legal Transplants

Two assumptions are shared among most writing about effectiveness of legal norms. Effective law is frequently defined in terms of (1) the functioning of the professional and institutional framework, for example courts, law enforcement (police), other authorities, and lawyers. Certainly, the recent debate about legal transplantation and the transplant effect builds on the institutional and professional definition of law and legal efficacy. An interpretation of this way of defining legal efficacy from a legal philosophical perspective is that law is considered effective in the Austinian sense when (2) legal claims can be sanctioned effectively. Therefore, the “greater the eventual evil, and the greater the chance of incurring it, the greater is the efficacy of the command” signals a clear preoccupation with providing threatening enough sanctions to guide behaviour of the population. Equivalent with the idea of behaviour and sanction, studies in legal sociology, particularly the law and society tradition, have attempted to measure the effectiveness of laws as the gap between the law as a normative ideal and actual behaviour as deviations from the law. The issue is to establish what features law must possess and the social conditions that must be present if law should affect behaviour as intended. In this tradition the Austinian concept of commands supported by sanctions is still strong, and law is a command to do or refrain from doing some specific acts, and the distinguishing difference between law and other extra-legal norms is the particular threat of coercion attached to the legal order. According to this view the legislator intends to control behaviour of the population through issued norms, why the ultimate test of effectiveness should be conformance with the legislator’s intentions. Although other effectiveness concepts are more abstract and complex they frequently share an emphasis on norm compliance, such as that of Navarro and Moreso who equated effectiveness with observance by addressees. Legal efficacy can also be considered a meta-quality, embodied by other legal characteristics. Pistor (2000) i.e. lists (1) the rule of law rating provided by outside expert assessment (2) an index of the effectiveness of corporate and bankruptcy law in transition economies constructed by EBRD; and (3) survey data on the ability of the legal system to protect private property rights and enforce contracts, called the enforcement index. The latter is an exception from the rule. Therefore, the two points shared by most literature that attempts to describe or measure legal efficacy are the output of the legal system as professional legal services and that the effectiveness of these services is the relative and gradual compliance of the population.

6 Ibid, 526
7 See Pistor et al. (note 2)
8 Ingram, P. Legal Effectiveness, ARSP, 68 (1983), 484-503
9 Austin, J. The Province of Jurisprudence Determined: and The uses of the study of jurisprudence, 1954, 16
11 See Ingram (note 10)
The fraction of the law in transition literature, which focuses on such a phenomenon as legal transplants and the transplant effect, unanimously has adopted this approach for measuring legal efficacy. There is a recognition of the need for other conceptualizations, for example in the argument of Berkowitz, Pistor, and Richard “for the law to be effective, it must be meaningful in the context in which it is applied so citizens have an incentive to use the law and to demand institutions that work to enforce the law.”\textsuperscript{14} Despite the logical appeal of this plea, the meaningfulness of a particular law or norm is not a consideration for legislators as shown by for example Means. Means referred to the event when Colombia transplanted the Spanish commercial code of 1829 with no concern for the needs of the country.\textsuperscript{15} It is also not considered by researchers who continue to measure legal efficacy as compliance and law enforcement.

The study mentioned above by Berkowitz, Pistor, and Richard on the transplant effect is symptomatic for how legal efficacy, or legality in their case, tend to be measured in practice, i.e. in “order to measure legality, we first use the same survey data measuring the effectiveness of the judiciary, rule of law, the absence of corruption, low risk of contract repudiation and low risk of government expropriation observed during 1980-95 employed by LLSV (1997, 1998).”\textsuperscript{16} However, as pointed out by Trubek and Galanter\textsuperscript{17}, the official legal order is interacting with indigenous systems of norms why the improved functioning of courts, police, and lawyers is only a fraction of the solution to poor legal efficacy. Only a small number of all disputes are placed on the agenda of any court. Instead disputes are resolved by resignation, avoidance, exit, or self-help by one party. When contracts are concerned, dispute settlement would normally involve adjustments of the contract by the parties rather than seeking outside help. Consequently, full-blown adjudication is an extreme exception. Instead most legal application takes place among laymen who need normative structures primarily for establishing expectations more clearly and firmly, not for the purpose of going to court.\textsuperscript{18}

Bearing this observation in mind the common emphasis on professional services and public compliance with legal norms becomes even more problematic. Referring to Torpman & Jörgensen (2005), it is possible to infer that legal norms are expectations having effects even though compliance does not occur.\textsuperscript{19} Norms are expectations, which earn their particular meaning through the symbolic practices that give them validity (\textit{Legalität durch Verfahren}).\textsuperscript{20} The symbolic procedures indicate that certain expectations are produced through the legal machinery, why they are not under the influence of any single individual. It should be noted that establishing legal norms is but one of many forms of accomplishing the difference between normative and cognitive expectations.\textsuperscript{21} While cognitive expectations are defined by their tendency to be changed when disappointments are observed, normative expectations are beyond control of the

\textsuperscript{14} See Berkowitz(note 1) at 166.
\textsuperscript{15} Means, R. C. Underdevelopment and the Development of Law: Corporations and Corporation Law in the Nineteenth-Century Colombia, 1983
\textsuperscript{16} Berkowitz(note 1) The mentioned LLSV studies use the same method.
\textsuperscript{18} Luhmann, N. \textit{Rechtssoziologie}, 3rd ed., 1987
\textsuperscript{19} See Torpman & Jörgensen (note 6)
\textsuperscript{20} See Luhmann (note 20)
single individual. An observer of breaches of law reacts with indignation as a way of showing to him/herself and to others that the norms cannot and will not be changed as a result of the deviating behaviour. Although law does not guide behaviour in such a case, it guides the observation of the behaviour and the cognitive and emotional reactions to it by observers. Therefore the effects of norms go beyond behavioural commands to an addressee.

The legal system, having effects also when it is breached, consists of diverse forms of law that combine with other social subsystems to provide incentives for behaviour. It follows from this argument that the idea that law is effective only when it causes certain behaviour is void. The assumption that law has no effect on people’s behaviour when law is breached is not sustainable. Instead, the normative reaction in the minds of offenders themselves and their social environment is a normative reaction that symbolically reproduces the norm as a normative expectation in Luhmann’s terminology. Moreover, only a fragment of, or none of, an individual’s behaviour is determined uniquely by law. Instead, an act must be interpreted as the effect of many social systems simultaneously. Rather than determine action, law defines objects, such as property, which provided with traits can motivate action. Furthermore, law may confer abilities and status to a subject, without demanding any particular action and without threats of law enforcement. Thus, an individual who refers to a law that confers abilities is simply using a legal terminology and refers to the legal system as the symbolic procedures that authoritatively determine the meaning of the legal concepts. The many functions and forms of law suggest the need for alternative definitions of legal efficacy.

An Application or User-oriented Perspective on Legal efficacy

3.1 Validation of the Definition of Legal efficacy

A novel approach to legal efficacy was defined by Torpman and Jørgensen (2005) by interpreting Luhmann’s theory of legal application.\(^{23}\) While the classical legal ‘compliance paradigm’ refers to a level of legal application that requires that law is already referred to and possibly understood, the proposed concept does not make this assumption. As claimed by Torpman and Jørgensen, there is an element of choice antecedent to compliance with or deviation from a legal norm. Communication can be understood either as a legal or a non-legal message and this choice cannot be taken for granted. The ‘compliance paradigm’ displays different fit for different areas of law. For penal law the ‘compliance paradigm’ seems more suitable due to the compulsory nature of penal law. One cannot choose to abstain from applying penal law in a situation in which it should be applicable. The law forces itself upon the individual in a manner that is foreign to other legal rules. While non-compliance may be combined with some knowledge and acceptance of the validity of the penal law, which is breached, a wholesale rejection of law as such is not the case. Instead, psychic costs are paid when the deviant feels guilty and self-esteem is damaged. If an

\(^{22}\) Malcolm M. Feeley, The concept of laws in social science: A critique and notes on an expanded view, in K. Rokumoto, ed., Sociological Theories of Law, 1994

\(^{23}\) See Torpman & Jørgensen (note 6)
individual totally rejects penal law it is by declaring the system unjust or by defining himself or herself as a stranger to the unjust society. The element of choice is more frequently present when private matters are dealt with, i.e. a contract. A legal contract is used only if parties agree to it. Here rejection of law takes place at two levels. (1) The rejection of what the law says and (2) the rejection of law as a meaningful way of communicating about matters. When (1) occurs it is a conflict between parties about the meaning of law. This is a matter that can be presented to a court of law if no other resolution is found. If (2) occurs the parties are not communicating with each other by referring to law. One person may use a legal term as a description of a relationship but the other party may refuse to address a matter in this way. Instead the situation is referred to as friendship or neighbours cooperating or having a dispute. The first party suggests a reference to law but the second party seems deaf in that respect and refers to informal standards of conduct that are defined in social interaction among friends or neighbours. This situation is always possible. Even in commercial relations may law be avoided, not only as a way of sanctioning power balances but also as a way of defining and describing relationships. Therefore, the use of law in the most radical sense as communication tool for defining objects, relations, and situations can be accepted or rejected as a proposal to interpret a situation in legal terms. For the effectiveness of law we claim that the acceptability of law as a communicative proposal is of primary importance. When actors choose other means for communicating about matters, law is put out of use. When law is useless in this sense it is ineffective.  

Following the discussion in Torpman & Jörgensen (2005), individuals tend to accept legal communication if they believe they understand it and feel comfortable with legal terminology. The most fitting term in current research that connects the new theory of legal efficacy with current research in cognitive psychology is self-efficacy. People’s assessments of their own capabilities to achieve specific tasks, or self-efficacy, strongly influence human motivation and behaviour. In this sense it is reasonable to assume that self-efficacy is relevant for the choice to apply a legal perspective to a situation. Although there is presently no prior research on self-efficacy regarding the use of law, self-efficacy assessments mediate the influence on other predictors of behaviour on particular performance. Prior experience and performance help create self-efficacy perceptions, which are strong predictors of subsequent performance. Self-efficacy is a mediating mechanism of personal agency that mediates between the sources of its creation and subsequent outcomes. The predictive and mediational role of self-efficacy has received support from a growing body of findings from diverse fields and applications that pertain to business practice such as leadership, self-development programs, human capital, work

24 ibid.
25 Bandura, A. Social Foundations for thought and action: A social cognitive theory, 1986
27 Ibid.
training, education of entrepreneurship, growing start-up companies, internet involvement of SMEs, gender and goal setting, training proficiency, learning, task persistence, and goal directed behaviour. Self-efficacy research is prevalent in other fields such as psychology and physiology with applications to clinical problems such as phobias, addiction, social skills, and assertiveness to stress in a variety of contexts and to health. Self-efficacy has been found to be a much more consistent predictor of behaviour and behaviour change than any other closely related expectancy variable.

The present study may be understood as a study of legal self-efficacy, and is, as such, an application of a tried and tested theory of cognitive psychology on the use of law of individuals. As noted the self-efficacy effect has not been discussed concerning use of law, with the exception of the


31 Allen, M. W.; Ng, S. H., Leiser, D. Adult Economic Model and Values Survey: Cross-National Differences in Economic Beliefs. Journal of Economic Psychology, 26 (2005), 159-85. This is a comparative study involving eight nations which finds an association between human capital and government social capital on economic self-efficacy.


33 Lucas, W. A., Cooper, S. Y. Enhancing self-efficacy to enable entrepreneurship: The case of CMI’s Connections. Working paper, Sloan School of Management at MIT. (2005). This study analyzes the effect of education in entrepreneurship on entrepreneurial self-efficacy. Significant and positive connections are found.


35 Dholakia, R. R., Kshetri, N. Factors Impacting the Adoption of the Internet among SMEs. Small Business Economics, 23(4) November (2004), 311-22. This study analyzes the efficacy of self-efficacy on the involvement in internet among SMEs.


38 Bandura, A. Self-efficacy: The exercise of control, 1997


Torpman and Jörgensen study on legal efficacy which implicitly refers to it. Nor has it been studied empirically in previous research. Accordingly, there is no evidence available regarding the possibility that self-efficacy may be important for how individuals’ various forms of self-definition influences their choice to adopt or avoid law.

Legal self-efficacy may be particularly relevant for how laymen use law. Laymen’s use of law is quite different from that of legal professionals. Professionals are familiar with the exact wording, implications and meaning of single provisions. But laymen structure their relationships with their private and diffuse understanding of abstract concepts, i.e. rights, debt, contract, and property. Familiarity with the concepts makes communication through them more likely and consequently law will be more frequently referred to. According to the definition of legal efficacy by Torpman and Jörgensen, which can be referred to as an individual, or end-user approach to legal efficacy, law is effective when users feel confident in their ability to use legal terminology and in the acceptance of the communication as law. In order to test the validity of this definition we suggested the following proposition:

Proposition (1): The individual’s appreciation of his/her ability to use legal terminology for dealing with relationships positively correlates with the use of law.

3.2 An Empirical Comparison with the Classical Perspective

The classical definition of legal efficacy in legal sociological perspective is that law is effective when it is enforced, or alternatively law is effective when citizens comply with law and law is complied with if sufficient enforcement is available. It is possible to compare the ‘application perspective’ by Torpman and Jörgensen with the classical assumption if some practical simplifications are made. The application perspective suggested that effectiveness is the salience of a strong self-efficacy when dealing with legal terminology. And legal self-efficacy is the belief about ones ability to organize and execute the courses of action required to produce given attainments with regards to the use of law. If the individual believes in his/her ability to communicate with legal terminology, then it is foremost a perceived competency, but if some set of situations is perceived as well, then self-efficacy is the relevant concept. Consequently if the individual believes that he/she is capable of communicating through ‘legal language’ then the individual will tend to do so and law will be activated in social interaction. Furthermore, legal self-efficacy is not the outcome of or behaviour resulting from expectations. Instead it is an evaluation of one’s ability to mobilize to accomplish legal goals.

A self-description of the individual in this respect will reveal the tendency to perceive things from the legal perspective. Therefore a test for the validity of the definition of legal efficacy as the tendency to perceive oneself as legally capable in relevant situations should involve measurement of how individuals perceive themselves as participants in legal communication. As a contrast, the traditional definition can be represented with perceptions of law enforcement and law enforcement agencies. Consequently, in the traditional perspective, if courts are perceived as expensive, complex, impartial, time consuming, and verdicts not enforced then law is ineffective in the individual’s opinion. Likely, the individual’s perception will affect the willingness to comply

47 See Bandura 1997 (note 42)
with law and specifically it will affect the individual’s desire to submit issues to legal institutions. Although classical views on legal efficacy tend to address the objective effectiveness, a measure of perceived effectiveness of institutions makes possible observations of single individuals. Therefore, the classical view is represented in this study as perceived institutional effectiveness.

A direct comparison between these perspectives is possible. Is the self-perception of users a better predictor of legal use than is the users’ perception of the effectiveness of courts and jurists? It was expected at first in this study that these two factors correlate but that the legal self-perception of individuals provides more explanatory power than perceived institutional effectiveness for the frequency of legal application in society. Accordingly this study proposes to test the following:

Proposition (2): Both perceived legal knowledge and perceived ability to communicate with legal terminology correlate more strongly with the use of law than does perceived institutional effectiveness.

Method

Data Collection and the Survey

The survey was carried out by the first author and his Russian students among 246 enterprises between March and May 2005 in St. Petersburg, Pskov and Kaliningrad in Russia.49 St.Petersburg represented three fifths of the enterprises and Pskov and Kaliningrad one fifth each. Enterprises were represented from ten different industrial categories. Firms were of sizes 5, up to 7,000 employees, with average firm size 44 employees. The average time span of firm activity at the point of the survey was 9.5 years. 28 percent of the respondents were female, 72 percent male. 7 percent of firms were registered on a stock exchange. 8.3 percent were at least partially state-owned. Among the firms 18.1 percent were open stock companies (OAO), and 30.3 percent were closed (ZAO), the remaining 51.9 percent were of other legal structure or undisclosed. The mix between industry and services is 60 - 40, representative of the Russian economy as a whole. The survey instrument contained 200 questions on topics ranging from firm legal strategy to methods of financing the firm to client structure and trade credit. We approached CEOs and top managers in each firm at trade fairs and directly in offices. The response rate was 50 percent or above. The internal response rate in the questionnaires themselves was 80 percent or above. As explained below, the use of sanctions was used as an approximation of the use of law. A number of different sanctions were included. The purpose of the relatively broad coverage of law enforcement methods was to make certain that less legalistic enforcement of legal claims did not fall outside our measurement of use of law and to make comparisons between enforcement methods possible.

Table 1 in the appendix summarizes responses to the questions regarding use of law (here approximated with the application of sanctions). It is a list of percentages of enterprises having used or threatened to use each strategy during the past two years. Table 2 shows the average scores on measures of legal self-efficacy and institutional efficacy.

Procedure and Instruments

49Our gratitude to Vyacheslav Eropkin in Pskov, and Olga Belova and Elena Osipova in Kaliningrad for assistance with collecting the surveys. We would also like to thank the Swedish Institute and Inga-Lill Norlin for two generous grants supporting the data collection in Russia.
Indirect Measure of the Use of Law

Although the use of law according to the assumption of this study is the actual communication occurring in society with reference to legal meaning, a simplified approximation of this phenomenon was used. The indirect measure of the use of law was defined as the tendency to enforce a legal conflict once it had developed. Typically an enterprise has already identified a relationship as a legal conflict before taking measures to enforce its claim. For example it is possible for an enterprise to choose between enforcing and not enforcing a contract. However, the enforcement decision is a decision whether or not to have faith in the legal claim and the enforcement mechanisms available. This study proposed to measure the impact of diverse variables on this decision. Therefore, law enforcement may be used as approximation of the use of law, admitting however that it is a more restricted aspect of the use of law than discussed theoretically.

Participants responded to the following eleven items regarding their law enforcement activities:

1. Telling other enterprises about the behaviour of an enterprise that did not honour its agreement.
2. Forcing the enterprise to pay a financial penalty.
3. Stopping trade with the enterprise.
4. Filing a complaint against the enterprise with an antimonopoly committee.
5. Sending pretenzia or other notices suggesting a possible court action.
6. Filing a claim in court.
7. Reporting the enterprise to a local government organ.
8. Reporting the enterprise to a federal government organ.
9. Reporting the enterprise to a business association or a financial-industrial group.
10. Reporting the enterprise to social, religious, or civic organizations.
11. Reporting the enterprise to a private security organization or individuals or groups with the intention to collect debt.

Perceived Ability to Communicate with ‘Legal language’ and Perceived Legal knowledge

Participants responded to the following two items:
1. “I am confident in using legal terminology.”
2. “I know the legal system very well.” A scale between 1 and 10 was used, where 1 represented “I do not agree at all”, and 10 represented “I fully agree”.

Legal Proficiency

Participants responded to the following seven items:

50 These questions pertain to civil law promulgated in 1995, thus it had only been effective for about two years in 1997. In 1997 when the questions were first asked, the mean score out of six questions was 2.3 (38%). In 2005 (now 10 years after promulgation), the average knowledge of law was a mean of 4 out of 7 (57%). This increase in legal proficiency suggests that it takes time for the population to get acquainted with law, and also that present commercial law is in demand.
According to the law, must the following types of agreement be in writing?

Agreement to sell goods:

A. Written form is always required by law.
B. Written form is sometimes required by law.
C. Written form is never required.
D. I don’t know.

2. According to the law, must the following types of agreement be done in writing?

Agreement on collateral:

A. Written form is always required by law.
B. Written form is sometimes required by law.
C. Written form is never required.
D. I don’t know.

According to the law, which of the following types of pledges must be notarised?

Pledges of buildings:

Yes
No
Don’t know

in Russia. The first six questions are identical to the questions asked in 1997 for the article Kathryn Hendley, Peter Murrell & Randi Ryterman, Law Works in Russia: The Role of Law in Inter-Enterprise Transactions in Peter Murrell, ed. Assessing the Value of the Rule of Law in Transition Economies, Ann Arbor: University of Michigan Press, 2002. The seventh question is ours. Our gratitude to Professor Peter Murrell for allowing us to use them and a questionnaire.
According to the law, which of the following types of pledges must be notarised?

Pledges of vehicles:

Yes
No
Don’t know

5. According to the law, which of the following types of pledges must be notarised?

Pledges of inventory:

A. Yes
B. No
C. Don’t know

6. Suppose an enterprise is in the process of liquidation because the enterprise was seriously overdue in its payments of taxes to the government and on a loan to a bank. The loan was legally secured with collateral. According to the law, which of the creditors – the government or the bank – should be paid first from the proceeds of the liquidation?

The government should be paid in full first.
The bank should be paid in full first.
Both must be paid, if not in full, then in proportion to the size of the two debts.
The court must decide which should be paid first.
I don’t know.
7. When litigation occurs in court, is it necessary for the plaintiff and defendant involved to pay salaries of the judges and clerks as compensation for their time?

Yes

No

Perceived Institutional Effectiveness

Participants responded to the following items: E1. How effective are the laws that regulate commercial activity in order to ensure the protection of those issuing and taking loans? A scale between 0 and 10 was used, where 0 implied ‘they are not enforced’, and 10 was ‘they are completely enforced’. E2. Do the law enforcement agencies effectively enforce commercial legislation? A scale between 0 and 10 was used, where 1 implied ‘No, they do not at all’, and 10 was ‘yes they do’.

5.1 Perceived Ability to Use Law as a Predictor of Enforcement Behaviour

Table 2 in the appendix summarizes answers to questions regarding effective law enforcement and self-perceptions and table 3 below presents correlations for the sample of decision-makers concerning the individual’s perceived ability to use law and the tendency to proceed with enforcement. As expected the different means for enforcing a contract were correlated. Many enforcement types are complementary rather than contradictory alternatives. Both measures of perceived ability to communicate with legal terminology correlate with increased tendency to enforce contracts. Perceived legal knowledge is particularly strongly correlated with all but one of the enforcements measured in this study. It is possible that ‘telling other enterprises’ is not a very attractive method for enforcing contracts among those who feel familiar with law. Rather, telling other companies can be understood as a last resort and offspring of desperation. There is no noticeable difference between the tendency to use the most legalistic sanction in terms of using legal terminology, i.e. going to court, and less legalistic sanctions in this respect, i.e. reporting the enterprise to a business association or non-business organization.

When it comes to the ‘most legal’ forms of enforcement, filing a claim in court and sending a pretenzia\(^{51}\), self-confidence with legal terminology was not correlated with using the sanctions but perceived legal knowledge was clearly correlated. Consequently, the individual’s view of himself as legally competent was a better predictor for the use of the most formal legal sanctions, but for the other sanctions the differences between strength of correlations were not striking between the two measures of perceived ability to use law. In table 4 we present the actual legal competency of the respondents correlated with their use of sanctions. Strikingly the actual legal knowledge has no determinable relationship with any of the uses of sanctions. Our data suggests that the respondents’ own beliefs about their legal knowledge are more distinguished predictors of sanction behaviour than is our measure of their actual legal knowledge.

The data clearly supports proposition 1. Most correlations were significant at the one percent level. Of the two items used for measuring the individual’s perceived ability to use law the most relevant one for this data set seems to be the second one, which is the perceived legal proficiency

\(^{51}\text{A pretenzia is a written warning to a trade partner that if no action is taken to correct a contractual breach, the next step will be adjudication.}\)
Table 3
Legal self-efficacy and the use of sanctions.

<table>
<thead>
<tr>
<th>Sanction</th>
<th>Perception of own ability to communicate with legal terminology</th>
<th>Perception of own legal proficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Telling other enterprises</td>
<td>-0.10</td>
<td>0.048</td>
</tr>
<tr>
<td>Forcing to pay a penalty</td>
<td>0.185**</td>
<td>0.230***</td>
</tr>
<tr>
<td>Stopping trade with the enterprise</td>
<td>0.147*</td>
<td>0.209**</td>
</tr>
<tr>
<td>Filing complaint with antimonopoly committee</td>
<td>0.107</td>
<td>0.138*</td>
</tr>
<tr>
<td>Sending pretenzia</td>
<td>0.041</td>
<td>0.119</td>
</tr>
<tr>
<td>Filing a claim in court</td>
<td>0.074</td>
<td>0.147*</td>
</tr>
<tr>
<td>Reporting the enterprise to a local government organ</td>
<td>0.101</td>
<td>0.140*</td>
</tr>
<tr>
<td>Reporting the enterprise to a federal government organ</td>
<td>0.160*</td>
<td>0.182**</td>
</tr>
<tr>
<td>Reporting the enterprise to a business association or a financial</td>
<td>0.133</td>
<td>0.185**</td>
</tr>
<tr>
<td>or individuals or groups with the intention to collect debt</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* significance at the 10 percent level
** significance at the 5 percent level
*** significance at the 1 percent level
<table>
<thead>
<tr>
<th>Sanction</th>
<th>Legal proficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Telling other enterprises</td>
<td>0.36</td>
</tr>
<tr>
<td>2. Forcing to pay a penalty.</td>
<td>0.062</td>
</tr>
<tr>
<td>3. Stopping trade with the enterprise.</td>
<td>0.039</td>
</tr>
<tr>
<td>4. Filing complaint with antimonopoly committee.</td>
<td>0.104</td>
</tr>
<tr>
<td>5. Sending pretenzia.</td>
<td>0.097</td>
</tr>
<tr>
<td>6. Filing a claim in court.</td>
<td>-0.067</td>
</tr>
<tr>
<td>7. Reporting the enterprise to a local government organ.</td>
<td>-0.082</td>
</tr>
<tr>
<td>8. Reporting the enterprise to a federal government organ.</td>
<td>-0.038</td>
</tr>
<tr>
<td>9. Reporting the enterprise to a business association or a financial-industrial group.</td>
<td>-0.061</td>
</tr>
<tr>
<td>10. Reporting to social, religious or other organization.</td>
<td>0.013</td>
</tr>
<tr>
<td>11. Reporting the enterprise to a private security organization or individuals or groups with the intention to collect debt.</td>
<td>-0.008</td>
</tr>
</tbody>
</table>
5.2 Perceived Effectiveness of Institutions

The classical perspective on effective law exclusively focuses on the institutional setting, omitting, or avoiding the perspective of the individual end-users of law. If institutions, such as courts and the police are efficient law is seen as comparatively useful. For the purpose of comparing the new communication-oriented idea of legal efficacy with the classical perspective, table 3 presents correlations between perceived effectiveness of institutions and actual use of sanctions once a legal conflict occurs. The result is noticeable. Individuals sanction contracts much more contingent on the self-efficacy related variables of table 3 than on the perceived institutional effectiveness indicators in table 5. The correlations with the perceived institutional effectiveness indicators are generally lower, but many of the correlations are insignificant. There is no support in our material for the idea that effective institutions foster a more legalistic way of transacting.

For the self-efficacy related items the support is more distinguished. The correlations between for example perceived legal knowledge and used sanctions are more frequently significant and relatively large. For example, while the perceived level of enforcement of laws is not significantly correlated with the tendency to file a claim in court, perceived legal knowledge is significantly correlated with the same tendency at the five percent level and the correlation is 0.147 at the 10 percent level of significance. The pattern is the same over the whole array of sanctions. While the perceived effectiveness of legal institutions does not significantly correlate with the company’s tendency to sanction a legal conflict the corresponding correlation between perceived legal knowledge and the sanctions are more significant and stronger.

This study supports proposition 2. There is little support for the obvious assumption that perceived effectiveness of legal institutions should influence the use of law. One of the two almost identical items measuring perceived effectiveness of law enforcement agencies is correlated negatively with reporting the opponent to a business association or a financial-industrial group, but the other item has no significant correlations with the different means of law enforcement. Our measure of perceived institutional effectiveness as law enforcement provides little or no explanation of the choice of law enforcement channels. However, the legal self-efficacy measures, the perception of one’s legal proficiency and the perceived ability to communicate with legal concepts are strongly and significantly correlated with several means of law enforcement.
Table 5
Legal self-efficacy, perception of institutional effectiveness, and the use of sanctions

<table>
<thead>
<tr>
<th>Sanction</th>
<th>Perception of own ability to communicate with legal terminology</th>
<th>Perception of own legal proficiency</th>
<th>Perception of effectiveness of law enforcement</th>
<th>Perceived effectiveness of commercial laws</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Telling other enterprises</td>
<td>-0.10</td>
<td>0.048</td>
<td>-0.025</td>
<td>0.21</td>
</tr>
<tr>
<td>2. Forcing to pay a penalty</td>
<td>0.185**</td>
<td>0.230***</td>
<td>0.118</td>
<td>0.169*</td>
</tr>
<tr>
<td>3. Stopping trade</td>
<td>0.147*</td>
<td>0.209**</td>
<td>0.064</td>
<td>0.121</td>
</tr>
<tr>
<td>4. Filing complaint with antimonopoly committee</td>
<td>0.107</td>
<td>0.138*</td>
<td>0.031</td>
<td>0.076</td>
</tr>
<tr>
<td>5. Sending pretenzia</td>
<td>0.041</td>
<td>0.119</td>
<td>0.141*</td>
<td>0.093</td>
</tr>
<tr>
<td>6. Filing a claim in court</td>
<td>0.074</td>
<td>0.147*</td>
<td>0.104</td>
<td>0.024</td>
</tr>
<tr>
<td>7. Reporting to local government</td>
<td>0.101</td>
<td>0.140*</td>
<td>0.037</td>
<td>0.063</td>
</tr>
<tr>
<td>8. Reporting to federal government</td>
<td>0.160*</td>
<td>0.182**</td>
<td>0.061</td>
<td>0.134</td>
</tr>
<tr>
<td>9. Reporting to business association</td>
<td>0.133</td>
<td>0.185**</td>
<td>0.079</td>
<td>0.108</td>
</tr>
<tr>
<td>10. Reporting to social, religious or other organization</td>
<td>0.153*</td>
<td>0.197**</td>
<td>0.067</td>
<td>0.103</td>
</tr>
<tr>
<td>11. Reporting the enterprise to a private security organization or individuals or groups with the intention to collect debt.</td>
<td>0.052</td>
<td>0.156*</td>
<td>0.043</td>
<td>0.041</td>
</tr>
</tbody>
</table>
* significance at the 10 percent level  
** significance at the 5 percent level  
*** significance at the 1 percent level

6. Discussion

Summary of Main Findings

By applying social cognitive theory and legal self-efficacy to legal behaviour in transition economies and the harsh institutional environment this study concludes that legal self-efficacy is a better predictor of the use of law than the objective measures concerning the legal system employed in numerous previous studies. The findings support the Torpman & Jörgensen theory of legal efficacy as individuals’ belief in their ability to communicate with law. In the context of legal transplants and economic development familiarity with legal concepts is conducive to legality, which in turn has a strong indirect effect on economic development. The definition of legal efficacy proposed by Torpman and Jörgensen suggests a higher emphasis on how law functions as a communication channel and as structure of social relations than did the traditional underscoring of effective courts, authorities and other juristic professional organizations. Specifically Torpman and Jörgensen proposed that law is effective if individuals in their communications with others refer to law. In this perspective law is understood as a system of communications, which either is or is not referred to in everyday communication. The operationalization of the discussed definition of legal efficacy in this study indicates certain self-perceptions as important determinants of the tendency to use law for communication. Two propositions were suggested:

Proposition (1): The individual’s appreciation of his/her ability to use legal terminology for dealing with relationships positively correlates with the use of law, was clearly supported by data. Admittedly the attractiveness of different forms of sanctions is a limited measure of the actual use of law. The actual use of law is a broader phenomenon in our perspective but the use of sanctions can be understood as a special case of legal use. Sanctions become relevant for example when a situation is defined in legal terms, and when a legally relevant conflict occurs. The application of sanctions may be preceded by legal communication and the conflicting parties have viewed their relationship in a juridical perspective.

As noted, the results were indicative of the relevance of the application perspective on legal efficacy. The subjective self-perceptions were strongly correlated with the use of sanctions. Perceived legal knowledge and self-confidence with legal terminology were

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1 This argument is in line with Berkowitz, see note 1.  
2 See Torpman & Jörgensen (note 6).
both correlated with most of the methods with which legal claims can be sanctioned. However what individuals actually knew about law, thus the ‘objective’ measure of legal knowledge as different from the individuals’ own subjective estimates, did not correlate significantly with any of the sanctioning methods and did not correlate significantly with perceived legal knowledge either. The latter suggests that individuals are inaccurate in their self-perceptions regarding legal knowledge, and that the way individuals view themselves in terms of self-confidence in using legal terminology is more a matter of the perspective the individuals adopt than of actual knowledge possession. Furthermore, this result underlines the fact that the subjective perceptions are truly subjective. The apparent result is that perceived legal knowledge and the self-confidence with legal terminology are both strong predictors of the use of law as defined and measured here.

Proposition (2): Both perceived legal knowledge and perceived ability to communicate with legal terminology correlate more strongly with the use of law than does perceived institutional effectiveness received support as well. The two items designed to represent the classical perspective on legal efficacy were (1) perceived law enforcement and (2) perceived effectiveness of law enforcement agencies. None correlated significantly with any of the sanctions with two exceptions. This fact may be interpreted as a striking questioning of the idea that the actual or perceived effectiveness of legal institutions (e.g. courts, authorities, police) should influence the choice between legalistic and less legalistic ways of transacting. When compared with proposition 1, which was strongly supported by data, our result is even more noticeable. The classical institution-oriented perspective and the novel approach of proposition (1) proved to be less complementary than was first expected in this study. A model that includes the self-perceptions of legal addressees appears as the more promising explanation for the choice to communicate using law. Consequently, in agreement with i.e. Hendley, Murrell, and Ryterman it can be claimed that perceived inefficiency of legal institutions does not encourage transactions supported by for example security firms or mafia as alternatives to legal institutions. Instead the root causes for the ineffectiveness of law in the post socialist economies are more profound than the inefficiency of courts and authorities. The present study suggests that self-descriptions of legal addressees form the basis for the implicit or explicit decision whether or not to communicate with legal terminology. This result does not contradict that measures of objective institutional criteria of effectiveness of courts and other agencies would correlate with the use of law. Our measures detected only perceptions of how legal agencies operates, not their actual operations. However, what people believe about courts, the police, and other authorities has relevance in itself. It is most likely a determinant which is more correlated with the use of law, than would be the actual organizational efficiency of authorities.

In an unreported correlation we found no significant correspondence between legal proficiency and self-appreciated legal proficiency. This difference of self-evaluation and objective evaluation is not uncommon, but further supports the thesis that people act on their beliefs and that good skill and knowledge is not enough to produce good results – one

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3 See Hendley et al. 2000 (note 54).
also needs self-assurance\textsuperscript{4}. And the concepts self-efficacy, by definition, contains a large portion of self-assurance.

People may have difficulties to define the legal system and for example not consider knowledge of the legal system as knowledge of other parts of the legal system than current legislation. In transplanted legal systems as is the Russian, people may tend to underestimate their knowledge of law due to their relative ignorance of the new transplanted law. Our data, however, did not support this idea. The lack of association between legal proficiency and the use of law could be attributed to that a possible cause of the application of most non-legal sanctions can be vicarious behaviour, which is modeled on others, and not a result of the detailed knowledge of current legislation. Sanctions have a significant signal-value to trade partners, and legal self-efficacy is much better correlated with signaling than legal proficiency.\textsuperscript{5}

6.2 Theoretical Implications

This study has assumed that the more confident a person is with using legal terminology for defining and communicating about matters the more prone will the person be to do so. The assumption stems from Hirschman’s classical work on loyalty, which has formed the basis for considerable amount of theory on customer loyalty and service quality.\textsuperscript{6} According to Hirschman’s original idea customers are loyal not by repetitive trading with a supplier, but by feeling confident in their ability to communicate with a supplier. Thus, what people believe about their abilities to communicate through a channel or a set of concepts, constitutes loyalty towards the supplier, but notably in this respect, loyalty also to the communication channel and the set of concepts they use. Similarly the legal efficacy concept developed by Torpman & Jørgensen assumed that law is effective when it is the basis for social expectations.\textsuperscript{7} When people feel confident with using legal terminology for communication they will tend to communicate legal meaning and when other people communicate with them through legal concepts they will tend to respond using legal terminology. They will not reject the idea of referring to law, although they may reject the legal statement and propose another legal interpretation of a relationship that is more favourable for them. This idea of referring to legal application as rejection or acceptance of communication stems from Luhmann’s communications approach to the legal system.

\textsuperscript{4} See Bandura 1997 (note 42), 83.
\textsuperscript{5} It deserves to be mentioned here that the use of sanctions depends on many other factors than managers’ characteristics. The most notable are; amount of customers, size of the customer company, the frequency of trade, the level of impersonality of trade, the amount of competitors, and the business cycle in each branch of trade. There may also be regional variations. Some branches of trade are very litigious and prone to trade sanctions where as others are more or less void of such behaviour.
\textsuperscript{6} Hirschman, A. O. Exit, Voice, and Loyalty: Responses to decline in firms, organizations, and states, 1970
\textsuperscript{7} See Torpman & Jørgensen (note 6)
The communications framework leads to fruitful conclusions. While the conventional approach to the study of legal transplants’ inadequate effectiveness, particularly the transplant effect, has claimed that the formal institutions of the receiving country are the ‘narrow section’ for effective law; this study has found that the claim is questionable. Not even when the tendency to approach a court of law is treated as the main form of legal application could the classical approach be supported by the data of this project. On the contrary, the hitherto untreated features of legal application, i.e. self-descriptions of individuals, form a better predictor of legal behaviour. This fact raises the questions: Why is the individual’s conception of himself as a competent user of law so important for his/her decision to use law? Why is one’s opinion of oneself more important for this decision than perceived institutional effectiveness?

The competence of the individual should be important but it is possible to find professional help. Why does this possibility not increase the individual’s desire to use law? One possibility is that the choice made by the individual is not a conscious choice. The hypothesis that behaviour is not conscious or calculated is supported by a growing psychological literature. It is true that the issue is complex and that the leading paradigm maintains the position that behaviour is mostly under conscious control. The growing evidence that behaviour is selected through automatic processes in which attitudes, thoughts and behaviour are activated on the mere presence of an object without consciousness or awareness invites the interpretation of our results in terms of automatic stereotype activation. Thus, when an individual decides whether or not to interpret a situation in legal perspective the choice is made on the basis of automatically produced perceptions and feelings, notwithstanding that the ultimate decision appears to be conscious. Even when the individual adopts a calculative rationality for his/her choice the pre-processing of information is automatic to a large degree. Automatic influence on the individual is especially effective when the individual was not aware of the potential for any such non-conscious influence. Our results regarding the use of law seems irrational in one aspect, namely a person may choose to apply a legal perspective although he/she recognizes that legal institutions are inefficient when the person feels highly efficacious in using law. The latter should not in itself determine motivation to use law, for despite good legal knowledge and ability for example a poor functioning court could ruin the attempt to determine a relationship with legal means. Persons do not rationally calculate the outcome of legal use if poor functioning legal institutions are ignored. Consequently, the choice to use law appears more driven by the application of a persons identity to a situation than as a rational calculation.

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9 Both the self, other citizens and authorities may appear in the form of stereotypes for the individual. These culturally inherited, or communicated, images are assumed to affect behaviour automatically according to the argument made here about local conditions. For example: Why do university students time after time occupy the same seat in a classroom? What conscious calculation drives this behaviour?
The self-concept, of which self-efficacy is a part, is a knowledge structure that helps people organize and give meaning to memory and behaviour. As such it mostly comprises direct self-descriptions and such elements as institutional legal structure can be self-descriptive for an individual only as a result of collective identification at the societal or national level. It is typically not an important aspect of an individual’s identity. Thus, a person may describe him/herself as a good researcher, a poor football player, and a caring father, but only to a much lesser extent as a citizen of a state with inefficient courts. These descriptions serve both as guides for (automatic) behaviour choice and as motivators. Other information which is not self-descriptive of the individual is also motivating, but only if it has relevance for the self either through perceivable consequences for the individual or through values that the individual hold. Thus, the individual is motivated to use law if ‘being legal’ gives rise to positive effects for the self-concept, for example by making positive interpretations of the self possible through self-verification. The individual is motivated to avoid law if it has connotations that are unfavourable or unsuitable for the self in a situation. There is solid evidence in psychology that support the primacy of the self-concept as motivator, for instance information may be stored better in memory when it is self-relevant and self-relevant information may be more systematically linked to other information. This reasoning and our results suggest that the instrumental perspective on the use of law is questionable. Inefficient institutions do not deter the use of law if law has desirable consequences for the self-perception of the individual or the organization, which chooses to refer to law in communication.

How do we explain the decisive self-perceptions in psychological terminology? As noted above the most fitting psychological concept is self-efficacy, which means beliefs about one’s ability to organize and execute courses of action necessary for attainment of a goal. Self-efficacy thus relates to personal control and agency, why it is related to the likelihood that a person will strive to achieve certain goals, persist in their effort, and succeed in their attempt. While self-efficacy is only the belief about one’s ability to do something, there is considerable support for a positive correlation between self-efficacy and performance. Self-efficacy is related to a number of behaviours and abilities, for example training proficiency, learning

13 See Bandura 1997 (note 42) and Maddux, (note 51)
16 Martocchio, (note 41)
task persistence\textsuperscript{17}, and goal directed behaviour\textsuperscript{18}. Persons with high self-efficacy view situations as presenting attainable prospects. They visualize success scenarios that provide guides for winning performance. Those who judge themselves of low self-efficacy inversely view situations as risky and cannot seem to visualize positive scenarios.\textsuperscript{19} It is not surprising therefore that a measure of self-efficacy, for which our measure of self-confidence in using legal terminology is valid, and use of law will show a strong dependence. However, this project measured several forms of enforcement of which some are not particularly legal, for example enforcement through religious organizations, why it is possible that the self-perception of one’s ability to use legal terminology and of oneself as knowledgeable of law are connected to broader categories of self-efficacy. Note that correlations were positive for the sanctioning through religious organizations as well, and that religious organizations are far from a legal organization. It is possible that self-confidence in using legal terminology is a special case of self-confidence in verbal argumentation in general. Thus, the individual’s perceived ability to argue convincingly may be a background variable that explains the effect of self-perception on the diverse forms of sanctioning of conflicts. Higher ability in that case would bring about higher potential for any sanctioning that demands communication skills and the legal form is only one special case. Many of the enumerated sanctioning forms relates directly to law why it is likely that legal self-efficacy plays an important role for sanctioning behaviour and that it guides the choice between applying law or not to a situation.

Although our results seem to be a confirmation of the effects on self-efficacy on behaviour, it is still possible that different respondent answered the questions from different perspectives and that this dual perspective is hidden in our data. Responding decision-makers were often members of large corporations why it is likely that they responded not solely from an individualistic perspective, but as representatives for the corporation. If this is true, the more relevant interpretation could be that they acted on the level of collective self-construal and that their collective, as different from their individual, self-efficacy was affecting their behaviour. Regarding the use of law it can be argued that law requires a certain level of impersonality between people and this can be more easily achieved when the collective level of self is active, and therefore the use of law may be more distinctly correlated with collective self-efficacy than with individual self-efficacy. Our data could not shed light on this distinction and is open for investigation in future studies.

However our data confirmed that a definition of legal efficacy with emphasis on the distributed use of law is potentially useful. The previous findings about the importance of adapting transplanted law to local conditions may be interpreted as adjusting law to the

\textsuperscript{17} See Bandura (note 42)
\textsuperscript{18} See Judge (note 87)-92
identities of the population so that they may perceive that they are competent in using legal terminology.

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Appendix

TABLE 1
Answers to questions regarding use of law enforcement methods

<table>
<thead>
<tr>
<th>Sanction</th>
<th>Percentage of enterprises having applied or threatened to apply the sanction (of those reporting)</th>
<th>Mean value of perceived effectiveness of sanction on a scale between 0 and 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1. Telling other enterprises about the behaviour of an enterprise that did not honour its agreement</td>
<td>54</td>
<td>5.3</td>
</tr>
<tr>
<td>S2. Forcing the enterprise to pay a financial penalty</td>
<td>47.1</td>
<td>5.5</td>
</tr>
<tr>
<td>S3. Stopping trade with the enterprise</td>
<td>76.0</td>
<td>6.9</td>
</tr>
<tr>
<td>S4. Filing a complaint against the enterprise with an antimonopoly committee</td>
<td>8.4</td>
<td>5.4</td>
</tr>
<tr>
<td>S5. Sending pretenzia or other notices suggesting a possible court action</td>
<td>57.4</td>
<td>5.8</td>
</tr>
<tr>
<td>S6. Filing a claim in court</td>
<td>42.5</td>
<td>6.0</td>
</tr>
<tr>
<td>S7. Reporting the enterprise to a local government organ</td>
<td>13.3</td>
<td>5.5</td>
</tr>
<tr>
<td>S8. Reporting the enterprise to a federal government organ</td>
<td>11.0</td>
<td>5.8</td>
</tr>
<tr>
<td>S9. Report the enterprise to a business association or a financial-industrial group</td>
<td>7.1</td>
<td>5.3</td>
</tr>
<tr>
<td>S10. Reporting the enterprise to social, religious, or civic organizations</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>S11. Reporting to a private security organization or other physical persons or group of persons in order to extract unpaid debt</td>
<td>26.1</td>
<td>5.9</td>
</tr>
</tbody>
</table>
Table 2 presents data from the questions about the effectiveness of law enforcement and agencies, as well as perceived knowledge of law, and perceived ability to communicate with legal terminology. Respondents were asked to rate between 0 and 10 to what extent they considered laws enforced, themselves as legally competent etc., where 0 was ‘I do not agree at all’ and 10 was ‘I fully agree’.

**TABLE 2**

Answers to questions regarding effective law enforcement and self-perceptions

<table>
<thead>
<tr>
<th>Question: On a scale between 0 and 10</th>
<th>Average scale score, on a scale of 0-10.</th>
</tr>
</thead>
<tbody>
<tr>
<td>E1. How effective are the laws that regulate commercial activity in order to ensure the protection of those issuing and taking loans?</td>
<td>3.9</td>
</tr>
<tr>
<td>E2. Do the law enforcement agencies effectively enforce commercial legislation?</td>
<td>3.4</td>
</tr>
<tr>
<td>SP1. I am confident in using legal terminology</td>
<td>5.5</td>
</tr>
<tr>
<td>SP2. I know the legal system very well</td>
<td>5.1</td>
</tr>
</tbody>
</table>
Legal Self-efficacy and its Latent Causes: Human Legal Capital, and Access to Information.

This study reveals that legal self-efficacy as well as access to and search for internal and external information concerning business risks each bring a significant reduction of business risk in two separate but interrelated channels. The direct channel of risk mediation is that of legal self-efficacy, while the indirect channel of risk mediation is that of information acquisition from texts, media and human sources. Both channels confirm previous findings by Jörgensen (2008) and Cho and Lee (2006). The results indicate that risk reduction can be achieved not only through legal human capital but also through behaviour related to the search for and finding of information. Previous research on contractual assurance and risk reduction has focused on the improvement of legal institutions such as courts and legal texts to address the problem of contractual assurance. This study takes an opposite approach of addressing the legal consciousness and behaviours of the end users of law. The policy implications are that managers can be taught to improve their legal self-efficacy or they can use risk-reducing behaviour to mitigate business risks.

An ongoing concern for enterprises is the reduction of business risk. Businesses face a multitude of risks and uncertain outcomes. One role of the legal system is to reduce business risk. Previous research in law and economics and particularly law and finance has pinpointed the institutions of the legal systems and found that their characteristics play a significant role for business risk in terms of, for instance, capital structure. This study turns this narrow approach around and focuses on the role of the human psyche – legal self-efficacy and the access to and search for information both internally from previous experience, as well as beyond the individual such as books, magazines, and films with legal information for the reduction of business risk. The legal consciousness of businesspeople has a more significant impact on economic transactions than has been previously recognized. Prior research on the interaction between law and business has failed to systematically study the interrelationship between legal consciousness and business risk. As a result, there has been no standardized concept for measuring legal consciousness among individuals. This study devises the concept of legal self-efficacy and demonstrates two channels through which this self-efficacy mediates business risk.
One reason to undertake this study, which suggests how businesspeople can use both attitude and behaviour to reduce risk perception and as a result take more risks, is Schumpeter’s observation that society will enjoy more innovation if managers are more optimistic and take more risks (Schumpeter, 1950). New innovations will create more jobs and provide for growth in countries that suffer lower growth due in part to poor legal systems. Risk reduction is well received in developing countries where businesspeople face higher business risk than in similar countries with better legal systems and higher access to external capital.

Legal self-efficacy as a phenomenon can be a supplement to the Coase theorem in the prediction of transactional behavior of businesspeople because of the endowment effect and transaction costs in real life, among other things. The aim of this study is to show that legal self-efficacy can serve as a foundation for the reduction of business risk using two channels. Another aim is to present self-efficacy as a concept that can be used for systematic research to discern how legal self-efficacy and specific behaviors can aid businesspeople to reduce business risks. Although the concept of legal self-efficacy is tested only in relation to two business risks in this study, it may be applicable to various risks in future studies. Much of the research in law and economics and law and finance concerns the reduction of transaction costs. The risk reduction as described by legal self-efficacy can help businesspeople reduce transaction costs, such as enforcement costs and legal fees. The efficiency of private contracting might be a function of legal self-efficacy and risk-reducing behaviors which this and previous studies (Jörgensen, 2008) demonstrate.

Legal self-efficacy is both a concept and a tool that can help develop models that better explain the interaction between economic actors and legal norms. For many years, law and economics scholars have worked with norms but not taken advantage of systematic research by social psychologists who have gone far further than LEN (Law and Economics) scholars in conducting and devising rigorous tests (Feldman & MacCoun, 2003, p. 360). This is perplexing, since the uses of cognitive psychology are quite evident in economics (Kahneman & Tversky, 1984; Tversky & Kahneman, 1981). The challenge for LEN scholars is to exploit social psychology in a manner that improves validity and realism in models while at the same time maintaining formal tractability and heuristic value (Feldman & MacCoun, 2003, p. 381).

When a legal system cannot provide adequate risk attenuation in terms of contractual assurance and protection against government nationalization, businesspeople are left with few options to attenuate business risk. One of them is to involve a lawyer to protect the interests of the enterprise; another is to acquire legal self-efficacy (Jörgensen, 2008). This study tests if there is yet another way to achieve a reduction of risk perception: to search for internal and external information about a particular decision that involves business risk. It also tests if legal self-efficacy has a direct effect on the reduction of risk perception in relation to business risk. Businesspeople need to take risks, as society will benefit from their endeavors.

1. Business risk and risk perception

A business risk is a condition or issue that may have a negative impact on the operation or prosperity of a given business. Sometimes referred to as company risk, a business risk can be the
result of internal conditions, as well as some external factors that may exist in the wider business community. For the purposes of this study business risk is related to the protection of private property rights. Client risk means that the further the distance to the client, the higher the risk of default on payment, as the availability of effective sanctions diminishes for a client in a remote location, as in a foreign country. The risk of government nationalisation of a business, for instance, is a sort of property risk.

Business risks are either actual or subjective. Actual risks can be assessed by objective analysis, perhaps by a team of experts. Subjective risks are those, which individuals distinguish in, given situations affected by bounded rationality, lack of total information, and possible errors of calculation. Subjective risk consists of two distinctive elements, uncertainty and significance of consequence (Cox, 1967; Taylor, 1974). “Uncertainty about the outcome can be reduced by acquiring and handling information. Uncertainty about the consequences can be dealt with by reducing the consequences through reducing the amount at stake” (Taylor, 1974, p. 54).

Every decision maker has his or her own set of frames of problem perception in risk calculation. This study brings to attention the legal frame of legal self-efficacy. Self-efficacy has a significant effect on the individual’s risk assessment (Krueger & Dickson, 1994; Locander & Hermann, 1979). A person equipped with legal self-efficacy is more likely to frame a decision of risk with legal terminology. This individual calculation is the foundation of the individual’s decision as to whether or not to engage in a certain behavioural pattern (Dowling & Staelin, 1994). Legal self-efficacy has been demonstrated to have a significant effect on the protection of private property rights and legal activism (Jörgensen, 2008; Jörgensen & Svanberg, 2009). Self-efficacy in an individual’s attitude has been demonstrated to have a reducing effect on individuals’ risk perception as well as an enabling effect in relation to specific tasks.

This study goes one step further than previous studies in finding mechanisms of risk reduction in relation to business risks by establishing two separate channels of risk mediation from a combination of two models (Conchar et al., 2004; Cho & Lee, 2006). The relationship prescribes that two separate searches of information, internal and external, be employed to reduce risk perception in relation to a specific decision. The study also seeks to test if legal self-efficacy is correlated to these two risk reduction behaviours to find out if there is any causality between them. If there is a correlation, there is a dual causality between the two risk-reducing behaviours and legal self-efficacy, implying that risk reduction can not only be achieved by two separate channels – the direct legal self-efficacy channel and the indirect channel over the two risk-reducing behaviours – but that they reinforce each other.

The findings of this study have both theoretical and practical implications in the research fields of law and economics and law and behavioral economics, as well as law and finance. The Coase theorem, the centerpiece of law and economics, is used as a starting point for a critical discussion that among other things reviews the concept of legal effectiveness which in the literature is defined only in terms of external legal institutions. Legal self-efficacy is introduced as a concept of individual legal effectiveness. Section one includes a brief review of the research findings of these four areas. Section two introduces legal self-efficacy. In section three, previous research on risk, business risk, and the two channels of business risk mediation are introduced. Section four
includes methodology and results. The paper closes with the final and fifth section presenting a discussion and the possible theoretical implications.

1.1 Previous research in law and economics

Law and economics scholarship has created a portal for psychology to access legal doctrines in a way never before considered relevant (Feldman & MacCoun, 2003, p. 361). This study uses this portal to find two channels that connect legal consciousness to the reduction of business risk. The study is a response to previous work in law and economics that has excluded the legal consciousness as an independent variable. An example of the neoclassical approach is the recent research on law and finance (LLSV, 1997, 1998; Levine, 1996, 1997, 1998) which has been able to establish that investor protection aids investment in minority positions in companies, and that the quality of established law has high explanatory power for financial market development across countries. Another finding is that legal family has an impact on investor protection. It is also a response to Feldman and MacCoun (2003) who call for research on how and when norms operate in relation to economic behaviour, as well as how internalisation of norms occurs.

The Coase theorem is a nucleus of law and economics modelling (Jolls, 2004). It has had an enormous impact on economics scholarship. The theorem states that when trade in an externality is possible and there are no transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of private property rights. Bargaining between parties will achieve allocative efficiency by minimising transaction costs. This can only occur in a world of zero transaction costs and perfect contractual commitment. The allocative efficiency therefore hinges on a theoretical assumption that cannot be achieved in the real world. The work of Allais (1952) and Ellsberg (1961) points out that the fundamental assumptions of neoclassical economics are unrealistic and cannot in themselves provide the models that predict human behaviour in relation to law and economics. The Coase theorem is correct in theory but the conditions of reality make it invalid (Hoffman & Spitzer, 1993; Jolls, Sunstein, & Thaler, 1998). Coase admitted that the world of zero transaction costs is only hypothetical and thus unrealistic. Kahneman, Knetsch and Thaler (1990) empirically assess the Coase theorem and find that its theoretical prediction is hampered by what is known as the endowment effect (Thaler, 1980, p. 44), so that the theorem loses its validity in this context. Korobkin (1998) concludes that the endowment effect better describes contract law default rights than does the Coase theorem. The knowledge about the endowment effect is helpful when understanding the limits of the conventional normative analysis of law (Jolls, 2004, p. 10).

Previous studies partially describe businesspeople’s use of law. The individual can decide to engage, avoid, or resist law in communication with other people (Ewick & Silbey, 1998). The decision to do so is a function of legal self-efficacy and the expected utility of applying a legal perspective to the problem at hand. A sample of the studies that capture businesspeople’s relation to law in various settings include Macaulay (1963), Ellickson (1991), Hendley (1999), Hendley and Ryterman (2000), and Cooter (1994). Empirical evidence suggests that business is not structured via law but through social relations. Macaulay and Ellickson’s studies describe how businesspeople avoid the use of law, preferring the usual handshake to the involvement of lawyers. Bernstein (1992) and Axelrod (1984) both describe how reciprocity and reputation
function as mechanisms of efficient trade, norms that can only work in close-knit groups or in situations where reputations can be monitored.

The legal practice in the diamond industry is described by Bernstein (1992). Disputes are resolved using an elaborate set of rules understood by the chosen participants, complete with characteristic institutions and sanctions to handle disagreements among industry members. Cooter (2000) goes so far as to state that only when norms are internalised do they ensure a self-enforcing mechanism. Macneil (1985) demonstrates the value of relational trading, for instance, to trade without litigating, as continuous trade and interdependence is an effective means of avoiding litigation. The cornerstone of relational trading is that it is repetitive and is, as such, similar to the tit-for-tat strategy1. Long-term relationships are more conducive for business than court adjudication. Hendley et al. (2000) describes the transactional strategies of Russian businesses, which include all three in relation to the exercise of law.

Bounded rationality describes the limitations of human beings in assessing all information relevant to making rational contract decisions. Opportunism refers to the human motivations that seek to exploit vulnerabilities created by the contract by not fulfilling contractual obligations. Bounded rationality can be divided into two categories: judgement errors (such as discrimination) and heuristics bias (the departure from maximum utility). Bounded rationality derives from cognitive errors that arise from biases in judgement and from efforts to economise on decision costs (“heuristics”). Bounded rationality derives from “framing effects”; that is, a person’s reaction to choice may depend on how that choice is framed or envisioned. Loss aversion and endowment effects are examples of bounded rationality. Loss aversion is a departure from expected utility theory. People are loss averse when they dislike losses more than corresponding gains. Other factors affecting individual transactions are utility maximisation, opportunism, and bounded rationality of the actors. These realities surrounding transactions need to be taken into account to achieve a realistic view of the transaction.

The goal of behavioural law and economics is to account for the imperfections of the human mind, which psychology in many ways is more successful in systematically researching. Behavioural law and economics involves both the expansion and the assimilation within law and economics of behavioural insights drawn from various fields of sociology and psychology. There have been several interesting attempts by scholars in behavioural law and economics to present the effects of bounded rationality on human interaction with law (see e.g., Parisi & Smith, 2005). Yet the field is extremely fragmented and there are hardly any common definitions of psychological terms and concepts, making systematic research more difficult.

1.2 Legal self-efficacy

Self-efficacy is the faith in one’s ability to do something in a specific field. There is significant support for a positive correspondence between self-efficacy and performance (Stajkovic & Luthans, 1998). Persons with a high level of self-efficacy view circumstances as presenting

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1Tit for tat means "equivalent retaliation". If player A rats on player B, then player B will retaliate with the same or maybe another measure to hurt player A. In game theory it is a highly effective iterative strategy in e.g. the prisoner’s dilemma. In business a tit for tat strategy can be considered buyer A purchases sub-quality products from seller B. Buyer A retaliates by not paying, or delaying payment for the product from B.
achievable scenarios. They envisage success scenarios that provide guides for winning performance. Those who judge themselves as having low self-efficacy conversely view situations as perilous and cannot seem to visualise affirmative prospects (Krueger & Dickson, 1994).

Self-efficacy has been demonstrated to be a strong predictor of behaviour in various fields. Self-efficacy is a mechanism of personal agency that mediates between the sources of its creation and subsequent outcomes (Maddux et al., 1986). The foretelling and mediational role of self-efficacy has received support from a growing body of findings from diverse fields and applications (Barragan et al., 2007). Self-efficacy has been proven to be effective in exercise (Lee et al., 2007), personal and social development of youth (Johnson et al., 2007), knowledge sharing (Lin, 2007), and computer use at work (Ng, 2006).

Intellectual capacity and self-efficacy are found to have a significant correlation (Bosma & Boxtel, 2007). Students’ self-efficacy is found to be a useful predictor of perceived competence in science (Beghetto, 2007). Self-efficacy reflects beliefs about one’s ability to organise and execute courses of action necessary for attainment of a goal (Maddux & Gosselin, 2003). Self-efficacy relates to an individual’s beliefs about personal control and agency. Efficacy beliefs heighten the likelihood that people will strive to attain certain goals, be persistent in their goal-directed behaviour, and be successful in their pursuit of these goals (Judge & Bono, 2001).

Bandura posits that there are four sources of self-efficacy: experience, modelling, social persuasion, and physiological factors. ‘Mastery experience’ is the most significant factor deciding a person’s self-efficacy. Simply put, success augments self-efficacy, while failure lessens it. Modelling, or vicarious experience, is founded on the comparison between the individual and someone else. When one sees someone achieve something, one’s self-efficacy will be augmented; when one sees another not succeeding, self-efficacy will decrease. Social persuasion concerns the encouragement or discouragement from peers. People in an individual’s surroundings can boost or lower self-efficacy by persuasion. In terms of physiology, people tend to exhibit symptoms of distress in stressful situations. These symptoms can be interpreted negatively by persons with low self-efficacy and as normal to people with high self-efficacy. A sound body helps a person feel more self-efficacious whereas an unhealthy body can deter a person from having high self-efficacy (Bandura, 1977).

The theoretical foundations of legal self-efficacy as a concept of distributed legal effectiveness are laid out by Torpman and Jörgensen (2005). According to their definition, the effectiveness of law is a direct consequence of businesspeople’s ability to use legal terms and in their acceptance of law as a means of communication. Legal effectiveness is thus a function of the distributed acceptance of law as a way to structure business transactions. Two subsequent studies have empirically validated the concept (Jörgensen & Svanberg, 2009; Jörgensen, 2008).

A layman’s understanding of legal concepts such as rights, debt, obligation, and contracts may not always be in line with the textbook definitions. A precondition of the use of legal terminology is familiarity with legal terms. It is reasonable to assume that self-efficacy (and therefore familiarity with basic legal concepts) is relevant to the choice to apply a legal perspective to a situation. Prior practice and performance help create self-efficacy perceptions, which are strong predictors of subsequent performance (Pajares & Kranzler, 1995).
2.1 Legal self-efficacy as a frame and heuristic

Legal self-efficacy is an attitude that can be seen as a “standard decision procedure” or heuristic. The reasons why some people have legal self-efficacy and others do not can depend on previous experience with law and the four ways in which one achieves self-efficacy: performance accomplishments, vicarious experience (modelling), verbal persuasion, and physiological states (Bandura, 1977). The cognitive theory of choice under uncertainty offers two sorts of insights of some relevance to analysts interested in the regulation of risk. The first is that people take shortcuts (use heuristics). This can lead to mistakes about variables. The second is that people approach risk in ways that depart from the norms and assumptions of conventional decision analysis (Noll & Krier, 1990). Legal self-efficacy is facilitative and enables the individual with the means to construct meaning and negotiate relations with other enterprises; it also helps the individual frame a conflict about private property rights in a legal perspective. Law shapes the individual’s expectations, calculations of action, and understandings (McCann & March, 1995).

It is important to understand the perceptive quality of legal self-efficacy, and that the individual’s discernment of institutions, rules, and sanctions plays a larger role in behaviour than do the inherent qualities of institutions themselves (Opp, 1985; Denzau & North, 1994). Legal self-efficacy is also a measure of how much an individual has internalised legal norms. Internalised legal norms are closely related to emotions, that is, non-legal sanctions of the individual on himself, such as shame, guilt, and remorse (Frank, 1987; Huang & Wu, 1994). Emotions are the sanctions that internal norms impose on the individual. This is helpful in enforcing second- and third-party sanctions as well.

2.2 Legal self-efficacy as risk-reducing belief

Legal self-efficacy is an attitude that diminishes the perceived risk in a situation of economic transactions under hazard. The reduction is that of subjective perceived risk, not of objective (absolute) risk. Risk perception is the subjective judgement that people make about the probability of an event and the ability to handle that event. Objective risk differs from subjective risk in that objective risk is actual probability of an occurrence and actual probability that the consequences can be handled. Self-efficacy in general is a risk-reducing belief related to a specific area, but the mechanism of this reduction is seldom related to the field of risk research, which offers its own explicit models of mechanisms of risk reduction.

This paper connects the two strands of research and tests how two risk-reducing mechanisms relate to legal self-efficacy. The reduction occurs through two different channels. The first channel links legal self-efficacy directly to risk behaviour. The second channel – the framing model of risk reduction – operates through two risk-reducing behaviours, the searches for internal and external information in a process called framing. The two channels are separate but
interrelated. The hypotheses of this paper test both channels separately and examine how legal self-efficacy is related to framing.

2.3 Legal self-efficacy as individual legal effectiveness

This paper is in part a response to current research on legal effectiveness as an external phenomenon. Previous research on external legal effectiveness by economists and, in a few cases, legal scholars have one-sidedly treated legal effectiveness as an external phenomenon, as though it emanates solely from formal legal institutions. This section briefly presents previous research on external legal effectiveness and explains the benefits of legal self-efficacy as a measure of internal legal effectiveness.

The rationale of the legal effectiveness concept is, with few exceptions, that law is effective when the professional and institutional services provided by lawyers, courts, and authorities can be acquired rapidly, accurately, and at low cost. The formal legal system is here associated with the transaction costs to businesses. The concept is a reaction to previous studies of legal effectiveness based on the characteristics of external institutions such as creditor rights, speed of court rulings, and effectiveness of law enforcement agencies (see e.g., Pistor, 2000; LLSV, 1997, 1998; Botero et al., 2003; Buscaglia & Uhlen, 1997; Church et al., 1978; Mahoney et al., 1985). According to the definition used in these studies, law is effective when behaviour is in compliance with law, and compliance is described as if it is achieved mostly through the model of Austinian command backed by threat.

Legal self-efficacy is an individual’s own assessment of how comfortable he/she is with the use of legal terminology in communication with other people. The concept is an application of the legal effectiveness concept developed by Torpman and Jörgensen (2005). Legal self-efficacy is the distributed legal effectiveness assuming laymen as end-users of law. A layman’s application of law demands some basic knowledge of what law is, the boundary of law, and the ability to assess the result of its application. This requires some fundamental cognitive ability and familiarity with law as well as trust in the use of the legal system, not dissimilar from the Hirschman concept of exit-voice-loyalty, which shows that consumers are loyal to a product if they feel that they can communicate with the product (Hirschman, 1970). The most valid estimation of legal effectiveness in a population ought to be closely related to legal self-efficacy, as law has effect in society only if legal communication is accepted as law with its inherent meanings and expectations (Torpman & Jörgensen, 2005).

As a result of the development of the concept of legal self-efficacy as a form of internal legal effectiveness, it becomes clear that the concept also has useful applications in understanding the impact of legal transplants in a general population with a particular focus on legal application (Jörgensen & Svanberg, forthcoming). Foreign law has been transplanted throughout history. The previous concepts of external legal effectiveness, including adherence to established law, fit
poorly with the transplanted law, especially when it derives from another legal family and was imposed’ a short time before. This is one of the reasons for the resilience of legal systems.

In legal environments that cannot provide contractual assurance, legal self-efficacy might act as a substitute where the individual businessman can reap benefits from trade despite a poorly functioning legal system. The inconsistent rule of law in Russia is a perfect case in point to test the theory of legal self-efficacy. Russia has a history of controversial attitudes to private property and the matter is still far from settled. There is extensive dissatisfaction in wide swaths of the population in Russia regarding the distribution of private property, in the wake of the privatisation carried out in the 1990s.

3. Business risk and the channels of risk reduction

The introduction above notes that a business risk is a condition or issue that may have a negative impact on the operation or prosperity of a given business. The two risks chosen for this study are property risk and client risk. The client risk increases with the distance between the producer and client. The property risk cannot be eliminated in Russia, a factor which we clarify below. This section begins with a brief review of these two business risks.

3.1 Private property rights in Russia and the CIS

Russia has a distrust of private property that can be traced back to medieval times. Whereas in Western Europe private property rights are considered indisputable civil rights and a natural part of the constitution of each country, without any serious political challenge, Russia has never viewed private property rights as an elementary civil right. Property rights have instead existed at the caprice of the government, Czarist or Communist, which could grant individual ownership rights to private property. Ownership rights could easily be revoked by the Czar or the Party, with only a restricted right of appeal (Pomeranz, 2004).

After the fall of Communism, Russia has been a leading country in terms of the absolute size of privatisation. This process has been controversial, since the process of privatisation was the most rapid and perhaps worst planned of all of the former planned economies. The discontent among the general population with the results of privatisation cannot be underestimated. Denisova et al. (2007) analyse an EBRD 2007 survey on the support for revision of privatisation in 28 post-communist countries. Eighty percent of the respondents favoured some kind of revision, but one third of the respondents supported total nationalisation. The main conclusions of this analysis were that endowed individuals are the most against revision and those who have negative personal experiences of privatisation are most in favour of revision, owing to a belief in lack of fairness. Lack of higher education was also a predictor for support for revision. An earlier survey of Russia’s population in 2006 found that 52 percent of respondents concurred with the statement “the majority of private assets in the country should be nationalised”.

“In your opinion, what should be done with most privatised companies? They should be…”
As reported in Denisova et al. (2007) p. 28.

Re-nationalisation is not only confined to the energy and media sector. Many privatisation reversals have occurred in the financial sectors as with PromStroyBank and Guta Bank, in manufacturing, such as the OMZ (United Machine Factory), Siloviye Mashiny (Power Machines), and the largest car factory, AvtoVAZ (Denisova et al., 2007), as well as YUKOS, Sibneft, the Industrial Construction Bank of St. Petersburg, and Irkut. In all, there are approximately 20 firms anticipating the results of pending court cases. The trend of nationalisation began in Russia in 2004. The tendency is that infrastructural companies such as Russian Railways and in the energy sector consolidate their suppliers to the point where it becomes unclear whether Russia is truly a market economy (Kommersant, 2007).

Putin, on the one hand, adamantly promised that there would be no nationalisation of companies, while on the other hand he actively pursued nationalisation policies. The Land Code of 2001 gave businesses an opportunity to buy the land on which they are located, or lease it from the local government. There is, therefore, a double policy of nationalisation and expanding the importance of ownership for businesses. The average businessman cannot expect to be confident of his rights to his business and the land that it sits on (Sonin, 2003).

Legal self-efficacy can be expected to have an impact on the perception of such property rights, an immediate relationship that can be called the direct channel of legal self-efficacy. The following hypothesis captures this relationship:

H1: There is a positive and significant relationship between legal self-efficacy and the protection of property rights.
3.2 Customer risk: Credit risk and effectiveness of sanctions

Two major components of customer risks are credit risk and effectiveness of sanctions for a defaulting customer. Customer risk in terms of credit risk can be mitigated by information about a customer prior to and during a trade relationship. When a customer is in default, the effectiveness of various methods of sanctions to recover trade credit also mitigates customer risk. Both risks vary, depending on the physical distance to the customer.

The role of information in customer risk assessment has increased with the growth of the complexity of risk factors that can have an impact on the extension of trade credit. Currently speed, accuracy, and cost are the primary factors in the decision to ‘buy vs. make’. This makes the customer risk assessment an issue for the whole development of the economy. In the emerging economies, as in the CIS countries, public records and general information structures are underdeveloped and access to data is difficult. This lack of information significantly increases credit risk, making personal visits and physical proximity to a potential customer all the more important in Russia as contrasted with more developed economies (Bartels & Hirt, 2001, p. 71).

In countries with a poorly functioning legal system, the role of direct sanctions to recover debt from defaulting customers takes on added importance. There are at least eleven types of sanctions against customers in default (Jörgensen & Svanberg, 2009, Table 3). Physical distance has a direct negative impact on the instigation and perhaps effectiveness of these sanctions. Filing a claim in court, or sending a pretenzia (a written warning about court adjudication if conditions are not met) is not affected by distance to the customer, given that the contract stipulates adjudication in the town of the supplier, as is common practice to compensate for the credit risk that the supplier takes. The effectiveness of sanctions such as telling other enterprises, reporting the enterprise to a local or federal government organisation, reporting the enterprise to a business association or a financial-industrial group, or reporting the enterprise to a private security organisation or individuals or groups who can collect debts are all affected by the physical distance to the customer. Businesses may not consider it worthwhile to report a defaulting customer to a local government department on the other side of the globe.

The importance of physical proximity to a customer to acquire information and be able to efficiently apply sanctions effectively limits the range in which companies do business. As this study shows, this effect can be partially compensated for by legal self-efficacy. Businesspeople with legal self-efficacy are more likely to apply sanctions to clients in default (Jörgensen & Svanberg, forthcoming). Legal self-efficacy can also be expected to have an impact on the perception of customer risk, a relationship that is another direct channel of legal self-efficacy. The following hypothesis captures this relationship:

H2: There is a positive and significant relationship between legal self-efficacy and customer risk.
3.3 Previous research on risk

This section presents the two major theories on risk, the psychometric model and cultural theory.

Risk has been researched with the focus on either the source of the risk or the individuals subject to it. The psychometric model, based on psychology and decision research, states that perceived risk is a function of the risk attributes, such as old versus new risk, voluntariness, etc. (Sjöberg, 2002). Both large-scale societal risks, such as nuclear power, and personal risks, such as being a victim of a car accident, have been studied (Fromm, 2005). With the aid of the psychometric model and factor analysis, the number of factors that explain variance in how different risks are perceived is narrowed to three: unknown risk, dread, and a factor related to the number of people exposed to the risk (Slovic, 1987). (For an in-depth review of the research results and methods of the psychometric model, see Boholm, 1998). This model also differentiates between laypeople and experts. There is no clear definition of an expert, and many of those named as experts make judgements outside their own area of expertise (Fromm, 2005).

Cultural theory, on the other hand, has its roots in social anthropology and sociology. It posits that risk is socially constructed. It further holds that there exist four categories of people with their own biases and world-views (Wildawsky & Dake, 1990): egalitarians, individualists, hierarchists, and fatalists, and, as a consequence, each social group may have its own sets of risks. Cultural theory has received significant criticism from Löfstedt and Frewer (1998), among others. The measurement of risk should be done from an inclusive perspective, using the characteristics of the individual in relation to a defined risk or set of risks. This is a more realistic and credible method as it mimics real-life situations and the dependent variables are more limited. The present study is an example of this inclusive perspective.

Previous research has identified several other factors, both individual and organisational, that affect risk behaviour. Individual characteristics include the individual’s labelling of situations (Douglas, 1985; Dutton & Jackson, 1987). Lindenberg (1990) stresses the role of “framing effects”; the preferences and action space available to a manager depends on the way a situation is framed. In many disputes, people may choose between several different types of norms (Felstiner & Sarat, 1980-81; Engel, 1980, 1984). Claims, during both formation and processing, may be framed or transformed in ways that reject law or include it (Merry, 1990). The probabilistic estimates of the extent and controllability of risk and the confidence in the risk estimates (Baird & Thomas, 1985; Duncan, 1972), knowledge (Monroe, 1976; Rao & Monroe, 1988), and the ability to perform under risky conditions are also documented individual effects (Allman, 1985; March & Shapira, 1987). Risk or loss aversion is another individual characteristic (Kahneman & Tversky, 1979; Zinkhan, Joachimsthaler, and Kinnear, 1987), as is intolerance of uncertainty (Kahn & Sarin, 1988; Raju, 1980), and uncertainty evasion (Hofstede, 1980).

In addition to research on individual traits affecting risk behaviour, there is research on organisational traits and their role in risk behaviour. Organisational traits include the role of leaders in modelling risk-related behaviour in organisations and in lending their personal authority to the relation to risks (Jacofsky, Slocum, & McQuaid, 1988; MacCrimmon & Wehrung, 1986; Nutt, 1986; Schein, 1985).
3.4 Models of risk

Modelling risk in business decisions is a long-overdue project. The two predominant models, psychometric and cultural theory, have not produced very good results for decisions in businesses. This is part due to the fact that they were designed for the prediction of other types of risk. Little empirical research has been done on entrepreneurs’ decision-making, risk perception, and risk propensity among potentially risky entrepreneurial ventures (Forlani & Mullins, 2000), yet risk is a central element of decision contexts, including entry into new ventures or markets (Dickson, 1992; Timmons, 1994).

Risk is a characteristic of decisions, defined here as the degree to which there is insecurity about whether potentially considerable and/or disappointing outcomes of decisions will be realised. Sitkin and Pablo (1992) propose a model of risk propensity and risk perception as the determinants of risk behaviour. They posit that risk propensity dominates both the actual and perceived characteristics of the situation as a determinant of risk behaviour. They derive their conclusions from a comprehensive review of previous research, which suffered from fragmented and overly simplified models of individuals, organisations, and problem-related characteristics. This research also produced contradictory results. These characteristics of inadequate models only indirectly influence risk behaviour, which are mediated by risk propensity and risk perception. Self-efficacy and greater wealth position has been demonstrated to have a risk-reducing effect using the Sitkin and Pablo model (Cho & Lee, 2006).

An attempt using previous research to explain risk behaviour relevant to business decisions is made by Conchar et al. (2004). Conchar et al. (2004) reviews the current literature on risk behaviour in order to formulate an integrated framework for the conceptualisation of perceived-risk processing in three steps – framing, assessment, and evaluation – explained below.

3.4.1 Framing

This initial step involves searching for internal and external sources of information related to the risk and the decision about risk, as well as the choice of alternatives. Each situation of a decision about risk can contain a number of alternatives; each alternative produced is the result of the twin search for internal and external information. The result of this search is a set of alternatives from which to choose. An individual's attitude to the use of legal terminology is related to the framing of a decision of risk about a larger decision involving the protection of private property. An individual who has internalised legal self-efficacy will be more likely to frame alternatives in a legal context. The first source of information is previous experience of similar situations. When a prior situation has been successfully encountered using a certain heuristic, more likely than not, that heuristic will be used again, for good or ill, depending on the similarity of the situations.
Table 1.

<table>
<thead>
<tr>
<th></th>
<th>My knowledge about the legal system derive mostly from</th>
<th>My impressions about the how the legal system works derive mostly from</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>yes percentage</td>
<td>yes percentage</td>
</tr>
<tr>
<td>My practical experience</td>
<td>165 68.2</td>
<td>31 12.8</td>
</tr>
<tr>
<td>Foreign movies</td>
<td>6 2.5</td>
<td>5 2.0</td>
</tr>
<tr>
<td>Domestic movies</td>
<td>2 0.8</td>
<td>2 0.8</td>
</tr>
<tr>
<td>Soap operas on TV</td>
<td>3 1.2</td>
<td>5 2.0</td>
</tr>
<tr>
<td>Newspapers</td>
<td>86 35.5</td>
<td>62 25.5</td>
</tr>
<tr>
<td>Books</td>
<td>45 18.6</td>
<td>26 10.7</td>
</tr>
<tr>
<td>My friends</td>
<td>38 15.7</td>
<td>38 14.4</td>
</tr>
<tr>
<td>My colleagues</td>
<td>75 31</td>
<td>64 26.3</td>
</tr>
<tr>
<td>Other</td>
<td>11 5.3</td>
<td>11 5.3</td>
</tr>
</tbody>
</table>

3.4.2 Internal information search

This behaviour includes information stored in memory on risk learning and previous experience with risk pertaining to the current situation (Punj & Staelin, 1983; Brucks, 1985). Product loyalty as demonstrated in Roselius (1971) is closely associated with Hirschman’s (1970) study about exit-voice-loyalty, which finds that brand loyalty depends on customers’ impression that they can communicate with the product. Prospect theory posits that people assign value to gains and losses relative to some individual reference point (Tversky & Kahneman, 1992). Reference points serve as a benchmark with which to weigh risk in a situation of similar nature in previous experience. Relevant experiences can serve as benchmarks and help inform individuals when making a decision about risk. Cox (1967) writes that past experience, habits, and reference to similar situations influence perceived risk. An individual’s comfort with the use of law can be the result of previous successful uses of law. The individual can be satisfied with this internal search for information and may not need to consult external sources. If this consultation is made, the sources tend to be those most accessible.

3.4.3 External information search

The external sources of information include social references (Miniard & Cohen, 1983; Bearden & Etzel, 1982) or market information such as company web sites, advertising, salespersons, or
product brochures (Beatty & Smith, 1987; Agarwal & Teas, 2001). There may be several references of both external and internal natures, including target references or aspirations, regret references, average experienced outcomes, social expectation references, and best-possible references (Yates & Stone, 1992). Social expectations such as peer pressure are examples of common external pressures, which can occur in an external information search. Cho (2006) empirically validates that both external and internal sources of information are related to framing in a choice about risk.

Incidentally, Bandura’s (1977) model of sources of self-efficacy coincides with Conchar’s (2004) theory on risk-reducing behaviour, except for physiological factors. The search for information in this model coincides with three of the four sources of self-efficacy mentioned above. Internal information search has much in common with mastery experience in that previous experience is a benchmark for future performance. Modelling and social persuasion coincide with the external information search.

### 3.4.4 Risk assessment

In the risk assessment stage, the information collected in the previous stage is assessed in individual and situational contexts. This is the subjective estimation of the probability of various events. It is necessary to assess the individual’s subjective evaluation of risk (Von Neumann & Morgenstern, 1947). Risk is subjective, multidimensional, and contextual in nature (Bauer, 1967; Vann, 1983). Perceived risk is the result of a combination of context-dependent importance weights, the inherent risk in a specific situation, and the influence of individual factors (Conchar, 2004, p. 430).

This phase includes both personality traits and situational related variables (Dowling, 1986; Hansen, 1976). The individual assigns a probability to each explicit risk situation. It is the subjective probability of a certain event, as opposed to objective probability, which is the probability of an occurrence based on either computation or by actual observations of a large number of similar events taking place in similar conditions. Subjective probability often differs significantly from objective probability, either because the person cannot compute the actual probability, because the person feels lucky or ill-fated, or because they think they can control the game.

### 3.4.5 Risk evaluation

At this step the information on the set of alternatives from the previous two steps is weighed and compared. The subjective probability of the set of events is multiplied with the subjective perceptions of loss or gain and this calculation is combined with the current status of available assets. Individuals engage in mental accounting – perceived risk evaluation (Thaler, 1991). A good metaphor for this is when a poker player is willing to risk more when he/she is ahead because incurred losses will be less damaging (Thaler, 1991). Risk evaluation occurs relative to an evaluation standard, financial, social, physical, or convenience. Initial entitlements matter in the risk situation, and are not dissimilar to the endowment effect (Tversky & Kahneman, 1991, p. 1039).
3.5 Conceptual framework

The relationship that this study proposes rests on the following propositions:

(1) Legal self-efficacy affects individuals’ perception of risk in a context related to the protection of property rights using a direct channel. Legal self-efficacy is mediated via an indirect channel by framing, applying risk-reducing behaviour in the form of searches for internal and external information relevant to the situation of risk. Perceived risk is indirectly mediated in three separate but interrelated phases: framing, risk assessment, and risk evaluation.

The relationship builds on the findings of Sitkin and Pablo (1992), which risk behaviour hinges on two factors: risk perception and risk propensity. The two channels of risk mediation presented in this paper omit risk propensity for several reasons, the main one being that the causality of risk propensity has not been clearly established. It also further develops channels of risk perception beyond Sitkin and Pablo (1992) in that it includes framing in terms of risk-reducing behaviours and the subsequent steps of risk assessment and risk evaluation.

3.6 Hypotheses

The combined risk model of Conchar et al. (2004) and Cho (2006) posit that risk-reducing behaviour occurs in the form of searches for internal and external information. The behavioural origins of legal self-efficacy and this risk model coincide in terms of previous experience, including internal information, vicarious experience, and social experience, and external information. Self-efficacy also includes physiological factors, which are not included in this study. The purpose here is to see how well self-efficacy and risk-reducing behaviour coincide. We test the indirect model in the following four hypotheses. The first two test the two-directional causality between legal self-efficacy and framing.

3.7 The indirect channel of risk behaviour – the framing model

The significance of the relation between legal self-efficacy and the two search behaviours is tested in these two hypotheses:

H3: There is a positive and significant relationship between the search for internal information and legal self-efficacy.

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2observed experience of others.
H4: There is a positive and significant relationship between the search for external information and legal self-efficacy.

The following two hypotheses test the relationship between framing and client risk:

H5.1 There is a positive and significant relationship between the search for internal information and client risk.

H5.2 There is a positive and significant relationship between the search for external information and property risk.

These next two hypotheses test the relationship between framing and the protection of property rights:

H6.1: There is a positive and significant relationship between the search for internal information and the protection of property rights.

H6.2: There is a positive and significant relationship between the search for external information and the protection of property rights.
Figure 1. The relationship between Legal Self-efficacy and Business Risk
4. Method and Results

The survey was carried out by the author and two Russian students between March and May 2005, canvassing 246 enterprises in St. Petersburg, Pskov, and Kaliningrad in Northwest Russia. The respondents from random samples of 146 businesspeople attending several trade fairs at Lenekspo in the Petersburg Sports and Concert Complex in St. Petersburg, and a random sampling of businesspeople in Kaliningrad (50) and Pskov (50). We approached CEOs and top managers in each firm at the trade fairs and directly in their offices. The response rate was 50 percent or better. The internal response rate in the questionnaires themselves was 80 percent or better. The whole sample is a mixture of a convenience sample and a random sample; it was random in terms of choice of respondents within the groups of businesspeople, but the quantity is not quite sufficient for it to be considered a pure random sample. The aim was to get a sample large enough to draw some valid conclusions with regard to businesspeople in Northwest Russia.

Enterprises from ten different industrial categories were represented. Firms had from 5 to 7,000 employees, with an average firm size of 44 employees. The average timespan of firm activity at the date of the survey was 9.5 years. Twenty-eight percent of the respondents was female, and 72 percent male. Seven percent of firms were registered on a stock exchange, and 8.5 percent were at least partially state-owned, while 18.1 percent were open stock companies (OAO), and 30.3 percent were closed (ZAO). The remaining 51.9 percent were of another legal structure or undisclosed. The mix between industry and services was 60-40, representative of the Russian economy as a whole. The survey instrument contained questions on topics ranging from firm legal strategy to methods of financing the firm, client structure, and trade credit.

The constructs of legal self-efficacy included “I am confident in using legal terminology” (the standard measure of legal self-efficacy) and “I know the legal system very well”. The answers were provided via Likert scales from 0 “I do not agree at all” to 10 “I fully agree”.

I am confident in using legal terminology

<table>
<thead>
<tr>
<th>I do not agree at all</th>
<th>I fully agree</th>
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<tbody>
<tr>
<td></td>
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3My gratitude is expressed to Vyacheslav Eropkin in Pskov, and Olga Belova and Elena Osipova in Kaliningrad for assistance with collecting the surveys. I would also like to thank the Swedish Institute and Inga-Lill Norlin for two generous grants supporting the data collection in Russia.
I know the legal system very well

I do not agree at all  
I fully agree

The literature consists of four publications issued in Russia.

Rossiskaya gazeta, the official Russian daily newspaper issued by the government of the Russian Federation, publishing most new laws, making it a favourite among those who need to keep up with current legislation. RG is a key source of information about politics, economics, and law, rather like Izvestiya and Kommersant.

Ekonomika i zhizn' (Economy and Life) is a weekly journal focusing on the economy with articles by specialists.

Sobranye zakonodatel'stva RF (Legislation of the Russian Federation) is issued by the Office of the President of the Russian Federation, and contains federal laws, decrees from the president, government decrees, and news from the constitutional court.

Vestnik Vyshego Arbitrazhnogo Suda (Bulletin of the Supreme Court of Arbitration) is the official gazette of the Russian Supreme Court of Arbitration.

The last three are not publications the ordinary citizen subscribes to; rather they are relevant for those who have a special interest in the official publication of the latest laws and decrees.

4.1 Tests of hypotheses

The testing of hypotheses begins with the direct channel between legal self-efficacy and risk behaviour, followed by the testing of the second channel: legal self-efficacy and external and internal sources of information. The final hypotheses concern the relationship between framing and risk behaviour.

A Friedman test of all variables included in calculations in this paper shows that variables are normally distributed at the 1 percent level of significance.
Legal self-efficacy and customer risk

H1: Legal self-efficacy and the share of remote customers in a company’s set of clients are positively and significantly correlated with internal and external information.

Legal self-efficacy and the correlation to the share of customers out of town/same town contribute with this portion of present customers.

0.167 *** (0.010) Df: 191 when controlling for size.

Legal self-efficacy and the protection of private property rights

H2: Legal self-efficacy and the attitude to the protection of private property rights are positively and significantly correlated.

The question was: What is the likelihood that your firm will be nationalised within the next few years?

Legal self-efficacy and attitude to the protection from nationalisation of own enterprise,

0.226*** (0.001) Df: 187 when controlling for size.

The following tests the indirect channel of legal self-efficacy and risk behaviour.

The indirect channel

The hypotheses set out below test the dual causality between legal self-efficacy and the risk-reducing behaviours of internal and external search. By demonstrating that legal self-efficacy and risk-reducing behaviour correlate, we find two things. First, legal self-efficacy is connected to behaviour that reduces risk. The two-way causality reinforces the belief that legal self-efficacy has impact on indirect behaviour that reduces risk, and the behaviours in their turn reduce risk perception. Second, we demonstrate that risk behaviour such as client risk and protection of private property is mediated to legal self-efficacy via risk-reducing behaviours such as searches for internal and external information. Legal self-efficacy as a reduction of risk perception is mediated by risk-reducing behaviours.

H3: There is a positive and significant relationship between the search for internal information and legal self-efficacy.

Filing a complaint against the enterprise with an antimonopoly committee and legal self-efficacy:

0.220*** (0.004) Df=165.

Forcing the enterprise to pay a financial penalty:

0.194** (0.012) Df=168.
The last two hypotheses test the relationship between framing via the search for internal and external information and risk behaviour.

H4: Legal self-efficacy is positively correlated to access to external information and therefore facilitated search for information in legal sources.

This concerns the correlation between legal self-efficacy and the sum of the consulted legal sources (Rossiskaya gazeta, Ekonominika i zhizn’, Sobranie zakonodatel’stva RF, Vestnik Vyshego Arbitrazhnogo suda), as well as other sources.

Legal self-efficacy and access to text legal sources: 0.206*** (0.001) Df = 138.

H5.1 There is a positive and significant relationship between the search for internal information and client risk.

Stopping trade and client risk: 0.164** (0.037) Df = 137.

H5.2: There is a positive and significant relationship between the search for external information and attitude to the protection of property rights.

The search for external information is a combination of three sources: the available legal literature, as noted above, various impressions, and knowledge of the legal system. The other sources in terms of impressions and knowledge are foreign movies, domestic movies, and soap operas on TV, newspapers, books, friends, and colleagues: 0.159** (0.025) Df : 195.

H6.1: There is a positive and significant relationship between the search for internal information and the protection of property rights.

Stopping trade with a customer: 0.169** (0.037) Df : 153.

H6.2: There is a positive and significant relationship between the search for external information and the protection of property rights.

The search for external information comprises a total of three sources identical to the one above: available legal literature as noted above, other sources of impressions, and knowledge of the legal system. The second and third sources in terms of impressions and knowledge respectively of external information are foreign movies, domestic movies, soap operas on TV, newspapers, books, friends, and colleagues. 0.149** (0.038) Df : 194

5. Discussion and theoretical implications

The study demonstrates both the significance and usefulness of legal self-efficacy and the significant risk reduction resulting from access to and search of legal information. Legal self-efficacy has a significant impact on the reduction of business risks; the two first hypotheses are confirmed as positive and significant direct effects on customer risk and attitude to the protection of private property. The indirect channel – the framing of risk – is also confirmed. Search behaviours are positively and significantly correlated to both legal self-efficacy and risk
behaviours of customer risk and protection of private property. The internal information search shows that legal self-efficacy positively correlates with two types of sanctions: filing a complaint against the enterprise with an antimonopoly committee, and forcing the enterprise to pay a financial penalty.

The indirect channel is confirmed for client risk as well as the protection of property rights by the same types of searches for information. The internal information search demonstrated that the relational, or tit-for-tat strategy, of stopping trade with a client was most effective. The external information is a combination of elements: legal texts, personal impressions, and knowledge. Sources of external information are foreign movies, domestic movies, television soap operas, newspapers, books, friends, and colleagues. These identical results for two risk behaviours suggest that the relational option – stopping trade with a customer – has a particular impact on risk behaviour. Stopping trade is the preferred strategy when dealing with business risk. This is in line with the results discussed by Macneil (1985) concerning relational trade as noted in the introduction. The best sources for external information when dealing with business risk are other people, movies, media, and legal texts.

The role of the media for informing people depends on the level of the confrontational presence of law in some one’s life. The role of media for legal consciousness depends on the recipient (Gies, 2003, p. 49). Furthermore, the role of media in moderating legal consciousness is a subtle process. The legal consciousness may, in the interview situations of Gies (2003), have had a subtle presence. However, in my survey the subscription to five specific legal journals, in addition to impressions and knowledge from many sources, are proven to have a significant impact on risk perception. Mass media has in itself no serious impact in the external search for information that can provide risk reduction.

The indirect mediation of risk reduction via risk-reducing behaviours has a weaker impact on the reduction of risk perception than does the direct channel of legal self-efficacy. The indirect channel is mediated by external information – the combination of legal texts, movies, etc. – since it correlates both with legal self-efficacy and the risk behaviour. Stopping trade was demonstrated to directly reduce risk. It did not correlate with legal self-efficacy. Instead, filing a complaint against the enterprise with an anti-monopoly committee and forcing the enterprise to pay a financial penalty correlate positively and significantly with legal self-efficacy. This does not invalidate the indirect channel; instead it shows the strong value of access to external legal information to both boost legal self-efficacy and reduce risk perception when engaging in risky business behaviour.

This study confirms the two channels of risk concept which can be used for systematic research to discern how legal self-efficacy and specific behaviours can aid businesspeople to reduce business risks, thereby shrinking transaction costs and increasing business opportunities. The study is a response to previous scholarly work in law and economics that ignored the legal consciousness as an independent variable. It is also a response to Feldman and MacCoun (2003), who call for research on how and when norms operate in relation to economic behaviour, as well as how internalisation of norms occurs. My response is that norm internalisation in terms of legal self-efficacy has a double effect on risk reduction. Risk reduction occurs through two separate but interrelated channels. There is a direct channel through legal self-efficacy that directly
diminishes business risk. The indirect channel reduces business risk by behaviours such as access to written legal sources and human and relational trading. One result of this response was the creation of a concept that addresses the need for measuring individual legal effectiveness. Another finding is that these two channels of risk reduction could improve the research fields of law and economics and law and finance by using the current theory of self-efficacy provided by cognitive psychology to explain transactional behaviour. Previous theories produced by the neoclassical school of economics have mostly failed to produce models with predictive value (Rostain, 2000).

Legal self-efficacy and the two channels presented in this study present one solution to the problem of poor creditor protection in the less favorable legal families such as Eurasian and French, as presented by La Porta et al. in several studies. Analysing the legal consciousness of the end users of law has the distinct advantage over a one-sided analysis of the institutions of law, both in that individual effects can be measured more exactly, and the relationships with other individual effects can be assessed. To measure legal self-efficacy and compare it to investor protection in the various legal families, similar studies in the common law, German, French, and Scandinavian legal families to assess legal self-efficacies can better explain business risk behaviour.

The hypotheses on risk-reducing behaviour and legal self-efficacy were affirmed and we can therefore assume that the attitude of legal self-efficacy can be substituted or complemented by risk-reducing behaviours to achieve a similar risk-reducing result. The two channels of risk reduction can be used by scholars to identify risk-reducing behaviours that mitigate risk perception. The specific behaviour of searching for information about law among friends, media, and texts had applicability on both business risks, as did the strategic behaviour in relational trading of stopping trade with a customer. This behaviour mitigates risk as it eliminates further contact with a possible source of risk. One curious result is that legal proficiency is not correlated to risk reduction or legal self-efficacy. A common misperception is that legal proficiency per se is a sort of risk reducing quality for businesspeople. Knowing the law doesn’t automatically imply a reduction of perception of business risk. The individual perception of one’s own knowledge of the law however, does.

The two channels of risk devised in this study can be used to explain behaviours that involve decisions of risk in relation to matters like property rights. Although the channels are tested only in relation to two business risks in this study, such testing may be applicable to other risks. Much research in law and economics and law and finance concerns the reduction of transaction costs. The risk reduction as described by the two channels used here can help businesspeople reduce transaction costs in terms of lower enforcement costs and legal fees. The channels may help to explain the effect of legal self-efficacy on the individual’s interpretation of the rules of investor protection when investigating the problem of investor protection from the receiver end. The efficiency of private contracting might be a function of legal self-efficacy and risk-reducing behaviours, which this and other studies (e.g., Jørgensen, 2008) demonstrate. The behaviour of stock traders and buyers and sellers of property includes strategic moves, for instance, into a new market.
The policy implications of this study are that legal self-efficacy and risk-reducing behaviour can be taught to businesspeople and used as a complement to the employment of lawyers when transacting. A common reduction of risk perception among businesspeople can lead to increased innovation and hopefully an improvement in the standard of living. Legal self-efficacy and risk-reducing behaviours are not substitutes for, but complements to an improved legal system in terms of better functioning courts and effective laws that are accepted and used by the population.

The theoretical implications of these two channels are that legal self-efficacy and risk-reducing behaviours can reduce the perceptions of business risk. This should be taken into account when designing programs to improve business conditions in a country. The channels are based on empirical research that demonstrates the heretofore unvalued significance of the legal consciousness in relation to business risks and property rights. Risk reduction can be achieved by employing the two most efficient risk-reducing behaviours and improving legal self-efficacy. This study shows that they are likely to strengthen each other. The two channels can be tested on a variety of business risks and behaviours; the relation is a complement to previous models in law and economics and law and finance, as well as in legal sociology such as prospect theory, the endowment effect, the expected utility hypotheses, and bounded rationality.

There are limitations to this study both in terms of the generalizability of the results – the sample was from one country only – as well as the risk-reducing behaviours. Such behaviours can differ as risk perceptions and strategies may differ between legal systems. It should also be noted that legal self-efficacy does not significantly reduce risk perception on all possible risky transactions. One possible affecting variable could be the efficacy of abstract reasoning. The proposed channels do not purport to be a model as such. The results presented in this study are findings from a single empirical study and therefore do not aspire to present a full model. There can be hidden variables, which could provide the same results as those of legal self-efficacy, perhaps psychological traits of the individual, such as locus of control, intelligence, and the ability to think in abstract terms. The latter two may likely have an impact on legal self-efficacy.

Future research on legal self-efficacy could focus on decisions that involve business risk. A comparative study between different legal systems could demonstrate the importance of legal self-efficacy in different legal systems and families. Every contractual environment has its own unique features. The same should hold true for risk-reducing behaviours. Finally, this study did not delve into the four sources of self-efficacy, another investigation that could be of value.
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TNS Media Intelligence, 5th of June 2009


Wall Street Journal  http://www.business.uiuc.edu/orer/V4-3-2.pdf


Statistics appendix
This appendix presents the most essential characteristics of all included variables of the three papers which used the survey: 1) the Law Businessman and the Trade Credit Decision, 2) Legal Self-efficacy and Managers’ Use of Law, and 3) Legal Self-efficacy and its Latent Causes: Human Legal Capital, and Access to Information.

The following brief comment on statistics presents the conditions of collecting the data and the characteristics of the data.

The characteristics of the data sample
The target population was managers in Northwest Russia. The data sample was comprised of 246 respondents from a group of about 500 of Russian CEOs in three regions: St. Petersburg, Pskov and Kaliningrad. Three fifths of the sample is from St. Petersburg, one third from Pskov and one third from Kaliningrad. Managers were approached in person by the author at two trade fairs in St. Petersburg and by three students among random businesses in Pskov and Kaliningrad. The sample biases are discussed below.

Contingency of strata sample
Managers are a subsample, or stratum, of the population in Northwest Russia. Responses from each and every single manager were non-contingent from every other manager in that managers responded to the questionnaire independently. Managers were not asked questions about any specific event, for instance, about, court use, prison sentence, public hearing, or any other event other than the visit to a trade fair.

Non-response bias
The response rate was 246 out of 500 or approximately 49 percent. The reasons behind non-responses may include the questionnaire’s length (about 200 questions with a minimum response time of 15 minutes). In the surveys themselves, more than 80 percent of the questions were answered.

Selection bias
The stratum was managers in Russian businesses. The one selection bias was presence at trade fairs for three fifths of the sample. The other two fifths were not selected from trade fairs; respondents were chosen based on the availability of respondents in each city.

Randomness of strata sample
The 246 managers were not selected in any kind of order, whether of size of firm, age, appearance, location, or any other category. They were selected from three venues: two trade fairs in St. Petersburg and from random businesses picked according to availability in Pskov and Kaliningrad.

Coverage bias
Common coverage errors such as the availability of technology such as telephones or internet connections were avoided in the face-to-face methodology.
The nature of Pearson correlations

Pearson correlations or more correctly “Pearson’s Product Moment Correlation Coefficient” require that data is parametric, that is, normally distributed and of at least interval level. Likert scales as used in this survey are interval level variables with the interval 0 to 10. All variables are normally distributed at the 5 percent level.

The tests for normality of distribution of the variables (see Table 1) reveal that there is a problem with skewness and kurtosis (the values are higher than 3 or lower than -3) with sanctions (9) reporting the enterprise to a business association or a financial-industrial group and (10) reporting the enterprise to social, religious, or civic organisations.

The statistics of variables from the survey research in Russia are presented in table 1 on the next page in order to demonstrate the validity of the statistics in the papers.

III. The Law Businessman and the Trade Credit Decision.
IV. Legal Self-efficacy and Managers’ Use of Law.
V. Legal Self-efficacy and its Latent Causes: Human Legal Capital, and Access to Information.

The questions from the survey that correspond to the statistics below are available from the author on request.

4There is a contention as to whether Likert scales are nominal or interval or continuous variables. There is reason to consider the Likert scales used in this thesis are interval variables, as the interval is greater than five. One examples of a paper that uses Pearson correlations in conjunction with Likert scales is Hamidi et al. (2008), and Tabachnick et al. (1983). The latter state, “It should be apparent that the distinction between continuous and discrete variables may be impossible to make in the limit. If you add enough digits to the digital clock, it becomes for all practical purposes a continuous measurement, while time as measured by the analogue device can also be read in discrete categories, say, hours. Continuous measurements may be rendered discrete simply by specifying cutoffs on the continuous scales”.

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Table 1. Mean, Standard Deviation, Skewness and Kurtosis of all included variables

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<th>Question</th>
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