Dispute Prevention without Courts in Vietnam

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Vietnam's firms contract without the shadow of the law and only partly in the shadow of the future. Although contracting rests in part on the threat of loss of future business, firms often are willing to renegotiate following a breach, so the retaliation is not as forceful as in the standard repeated-game story and not as effective a sanction. To ensure agreements are kept, firms rely on other devices to supplement repeated-game incentives. Transactions with greater risk of reneging are supported by more elaborate governance structures. Also, firms scrutinize potential trading partners before beginning to transact.

1. Introduction

Ongoing relationships among firms serve to reduce the transaction costs of the market: the costs of locating trading partners, of negotiating and monitoring contracts, and of enforcing agreements and settling disputes. In an economy in the midst of deep reform, transaction costs are especially severe because the normal market-supporting institutions are still being built. We examine in this paper how Vietnam's firms use ongoing relationships to maintain agreements. For a snapshot of an economy in the process of building institutions, we use a 1995-97 survey of privately-owned manufacturing firms in Hanoi and Ho Chi Minh City.

The new ways of doing business in Vietnam have been devised at ground level. The bottom-up reform process has relied on *de facto* decentralization of economic activity while

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leaving in place the formal institutions of central planning. Although Vietnam's government has introduced few policies to foster the private sector, "the owners of private business have worked out their own ad hoc strategy for economic development which is popular, oral rather than in the form of written documents and has rapidly been diffused" (Hoang Kim Giao and Nguyen Dac Thang, 1995, p.27). This "ad hoc strategy" of the entrepreneurs is the subject of this paper. Williamson (1994, p.174) argues, "it is easy to assign too much weight to the institutional environment and too little to the institutions of governance. The exaggerated emphasis on court ordering (by the institutions of the state) over private ordering (by the immediate parties and affiliates to a transaction) is one illustration." We examine this "private ordering" in an extreme situation, where the rules of the game have developed spontaneously and the firms cannot fall back on the courts.

We showed in McMillan and Woodruff (1999) that contracting among the Vietnamese firms we surveyed is based on ongoing relations. The seller trusts the buyer, knowing the buyer has an incentive to repay in order to maintain its relationship with the seller. Taking the willingness to grant trade credit as a measure of the seller's trust in the buyer, we asked when the ongoing nature of a relationship assures the seller that the buyer will repay a debt. We found that the amount of trade credit granted varies with the buyer's ability to locate alternative trading partners, the seller's gathering of information about the buyer, and the seller's membership in a business network. In this paper investigate the workings of these exchange relationships in more detail. Our approach is primarily descriptive. We find that the mechanisms of dispute prevention and resolution are more subtle and intricate than in the standard story of the shadow of the future.[2]

To compensate for the inadequacy of the courts, the firms use repeated-game incentives. Contracting is supported by the threat of loss of future business. Interestingly, however, the

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[2] For the standard repeated-game model, see Telser (1980). The notion that repetition generates cooperation is subject to significant caveats. First, the future must not be too heavily discounted if cooperation is to be an equilibrium. Second, repeated games have multiple equilibria, so the theory does not predict cooperation but just says it is possible. Third, if the players cannot perfectly observe what each other is doing cooperation might break down. Fourth, whether it is rational to retaliate once a deviation has occurred, rather than renegotiating and starting afresh, is open to question. See Pearce (1992); see also Section 3 below.

managers told us they are reluctant to sanction trading partners. If a customer reneges on a debt they often allow payment to be delayed and forgive part of the debt. As a result the retaliation is not as immediate or predictable as in the simple repeated-game story and therefore not as effective a sanction. To ensure compliance, the firms rely on other devices that supplement the shadow of the future. The exchange procedure can be structured so as to forestall disputes. We find that more elaborate governance structures are used in transactions with a greater risk of reneging. Also, firms sometimes scrutinize prospective trading partners before beginning to transact, checking the firms' reliability via other firms in the same line of business or familial connections.

Relational contracting, then, depends partly on repeated-game incentives and partly on suitably designed governance structures. The decision to cooperate rests on a comparison between the immediate gains from cheating and the discounted future losses. A workable governance structure either gives an immediate incentive to live up to the agreement regardless of any future sanctions or at least reduces the gains from cheating below the costs in lost future business.

2. Growing Market Institutions

New start-up firms in Vietnam, as in the other transition economies, face severe obstacles (McMillan, 1997). They find it hard to sell their products and to buy inputs, because of problems of distribution caused by inadequate transportation systems and because of informational problems of finding suppliers and customers. Most have no access to formal financial markets. The absence of laws governing property rights adds to the hazards of investing. Corrupt bureaucrats often stifle the new firms through regulation, licensing, or even outright extortion. More than ten years into Vietnam's reforms, according to Levine (1998, p.22), "private enterprise remains shackled by official attitudes and policies," so entrepreneurs operate "in an environment of uncertainty, in which a scrappy, seemingly subversive approach is the best hope for success."

Despite these obstacles a private sector has not only emerged in Vietnam but is thriving (Freeman, 1996; Ronnås, 1996). Since Vietnam has undertaken virtually no official privatization of its state-owned firms, this new private sector consists of two kinds of enterprises: new firms that have entered since the reforms began and firms that existed under planning as collectives that

have transformed themselves into private entities. Although the resurgence of private sector activity began only with the reforms (*doi moi*) of the mid-1980s, private firms have become significant sources of manufactures. By 1993, according to official data, private factories were producing 29% of industrial output nationwide, concentrated in light industry and labor-intensive sectors such as food processing and garments. The limited data that exist suggest that the private sector generated most of the new jobs in the 1990s. The new firms arguably have been an impetus to Vietnam's impressive economic growth. In 1989 national income was growing at 8%; in 1990 and 1991, with the elimination of Soviet trade and aid, growth slowed to between 5% and 6%, but between 1992 and 1997 the annual growth rate was between 8% and 9.5%.[3]

We surveyed 259 managers of privately-owned manufacturing firms in Hanoi and Ho Chi Minh City in 1995-97 and conducted in-depth interviews with 17 Hanoi firms. The firms are mostly new and small. Most (60%) had been in existence for four years or less at the time of the survey. Their median number of employees is 32 and median annual sales US$56,000. We asked questions about their relationships with their oldest and newest customers, and their oldest and newest suppliers. For each manufacturer, then, we have information about two specific customer relationships and two specific supplier relationships.[4] The questionnaire addresses how the firms to gather information about these trading partners—both before and during the business relationship—and provides measures of the cost of searching for alternative trading partners should the relationship break up. The more detailed interviews focused on past disputes with trading partners and how they were resolved.[5]

Vietnam's initial economic reforms took place under a legal system designed for central planning, not a market economy. The government introduced legal reforms piecemeal. Though private activity was tolerated earlier, the legal basis for private business was not established until

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[3] For some background on Vietnam's economic reforms, see Dawkins and Whalley (1996), Fforde and de Vylder (1996), Naughton (1996), Riedel (1997), and World Bank (1995). The development of Vietnam's private industry was first examined in the pioneering study of Ronnås (1992, 1996), based on a 1991 survey.

[4] Some of the surveyed firms' trading partners are state-owned enterprises (27% of sales go to state-owned firms). Because dealing with a state-owned firm is different from dealing with a private firm and because we wish to examine the workings of the private sector, we delete such relationships from the data, so all the relationships are between private firms. Also we delete relationships that had been terminated at the time of the survey.

[5] The appendix and Table 2 give some information on the surveyed firms. The raw data are available at www-IRPS.UCSD.EDU/~cwoodruf/vietques.pdf, and the transcripts of the interviews are available from the authors.

1990 with the Law on Private Business and the Law on Companies, which recognized the long-term existence of companies, the legitimacy of profits, the equality of treatment before the courts, and the freedom to make business decisions within the law. In 1992 a new constitution gave formal rights and protection to private property. Some mechanisms for dispute settlement existed, including civil courts, and in 1994 economic courts and nongovernmental arbitration centers were established. Legal reforms do not gain force overnight, however, and the political setting of the reforms, with the state continuing to dominate, has hindered the growth of a market-oriented legal system. Fforde and de Vylder (1996, p.153) underline the continuing political problems of developing a credible legal system: "local [party] control over the state economic sector would have been greatly threatened by the development . . . of a rule of law in economic matters." Gillespie, writing in 1993, said, "written laws and regulations can only be regarded as general guidelines, establishing the rough ambit of bureaucratic discretion" (p.143). The World Bank (1995, p.45) found that improvements in the first phase of *doi moi* "have often taken the form of selective application of bad rules . . . rather than the establishment of good ones" and that dispute-settlement institutions remained undeveloped. Not until 1995, a decade into economic reform, were fundamental reforms of the civil and commercial code even considered. Writing good laws would not by itself remedy the problems. Since courts lack expertise and independence, the legal process in practice has little to do with formal rights as set out in commercial legislation. Pham Van Thuyet (1996, p.588) notes, "It will be some years before the revived court system becomes efficient because the laws are new to both the people and the judges, who, for the most part, lack appropriate training and experience."

The managers we interviewed said they did not believe the courts can help them. "They normally just create more problems . . . in Vietnam no one believes we have a good legal system" (case #3). Another said, "The court is weak and no entrepreneurs use it" (case #6). These comments are corroborated by answers to our questionnaire about how disputes are managed. Responding to a question about third parties that can enforce agreements with customers or suppliers, 89% of managers said, "there is no one." Only 9% said a court or other government

agency could help. Third parties are even less help for disputes over the quality of goods; only 2% of the managers said they would take such disputes to court or appeal to local authorities.

A few managers told us that they maintained good relations with the local authorities, not only for help in obtaining licenses and permissions quickly, but also because the local authorities sometimes intervene in disputes in discretionary ways. One (case #5) said he has good relations with the district People's Committee, and the committee would help him if someone tried to cheat him. Most managers, however, said they do not appeal to the authorities to help solve disputes. As one put it (case #9), the local authorities "just create problems for us rather than supporting us."

"We have no commercial law to settle disputes between enterprises. When businessmen sign contracts, they can't rely on legal texts, which allows them easily to cheat one another," according to Huynh Buu Son, a Ho Chi Minh City banker (Hiebert, 1994, p.135). For Vietnam's private sector to be as dynamic as it is, however, there must exist some means of contractual assurance. We now investigate how Vietnam's firms use relational contracting.[6]

3. Behavior during Contractual Disputes

In the absence of court enforcement, exchange mechanisms must be self-enforcing. The repeated-game sanction against reneging is the loss of future gains from trade if the partner quits the relationship in retaliation, so cooperation can emerge if the discount rate is not too high. One impediment to relational contracting in Vietnam is that discount rates are high. Most private firms are excluded from formal financial markets: just 21% of the firms we surveyed were receiving bank loans. Apart from reinvested profits, their sources of finance are cooperative credit circles, "mattress banks" or cash hoarded by relatives, and remittances from relatives overseas. Interest rates paid by private manufacturing firms in informal credit markets are as high as 4% to 7% per

[6] Even in economies that, unlike Vietnam, have functioning courts, interfirm relationships normally determine how deals are carried out and disputes are resolved; the courts are rarely used (Macaulay, 1963; Galanter, 1981; Williamson, 1985, pp.20-21). The difference is that in advanced economies the courts support the relationships. As Galanter (1981, p. 6) notes, the "principle contribution of courts is providing a background of norms and procedures against which negotiations . . . take place. This includes, but is not exhausted by, communication to prospective litigants of what might transpire if one of them sought a judicial settlement."

month (Freeman, 1996, p.191; Riedel, 1997, p.63). Entrepreneurs "expect a high rate of return and a quick recoupment of the expended capital" (Hoang Kim Giao and Nguyen Dac Thang, 1995, p.29). The high interest rates, actual or implicit, limit any forward-looking cooperation.

Disputes with trading partners are not uncommon: 25% of the surveyed firms had experienced a customer failing to pay for a product after it had been delivered, and 6% said a supplier had failed to deliver goods without returning an advance payment. In most of the cases in which firms refused to pay in full (83%), the offending firm was no longer a customer. It is not surprising that a firm would refuse to do business with a trading partner that has broken its agreement. What is more interesting is that the firms often try to keep the relationship going despite the defection. Several managers said dispute settlement usually takes the form of negotiating with the customer or supplier to try to get restitution. They try to avoid breaking a relationship if possible. One (case #12) sent employees to visit a customer every day to ask for a late payment. "After a few weeks of negotiation, the firm got back part of the debt and stopped selling to this customer." Another (case #10) after some negotiation accepted 70% of the amount owed, and another (case #8), owed money by a firm in Taiwan, after protracted negotiations was paid a year late. What is important, another said (case #4), "is to forget about the debt and keep social relations with the customer. Don't sell any more, but still keep good relations and some time very cleverly get back the money." After a year and a half of "patient negotiations" this debt was repaid. Getting money back, this manager said, "is an art which is very difficult to explain." When asked how firms resolve disputes with suppliers over the quality of goods delivered, 58% said they "negotiate a partial settlement without outside assistance." Of those that said they had suffered from a customer’s not paying a bill, 44% had decided that the nonpayment resulted from the customer’s lack of funds and had renegotiated the deal and allowed the customer to postpone payment.[7]

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[7] In a study of bank lending to small US firms, Mann (1997, p.18) notes, of the use of collateral in securing loans, "the lender rarely can take advantage of [the collateral] without destroying the lender's most likely source of repayment: the business's ongoing revenue stream. . . . Once the stream of revenue from customers is destroyed, the lender's chances of complete payment are diminished considerably." Mann quotes a banker as saying, "I've never looked at collateral to repay the loan . . . if you have a good understanding of the cash flow of the business and the nature of the business, that's really where you can get paid back from.”

If the firm ex post either forgives part of the debt or allows payment to be delayed then it weakens its trading partner's ex ante repeated-game incentive to comply with the agreement. How can we explain these managers' "patience" with firms that owe them money?

One explanation for the firms' reluctance to sanction trading partners rests on their inability to perfectly monitor them. Suppose a customer could renege for one of two reasons: either it is behaving opportunistically or, having short-term financial difficulties, it is genuinely unable to make the payment. If the seller could distinguish the reason for the nonpayment, it should punish in the first case but not the second. Conversely, the seller's inability to distinguish the reason for the nonpayment can cause cooperation to break down. Punishing a firm that reneges through no fault of its own destroys the cooperative relationship; but not punishing a firm that is behaving opportunistically encourages further opportunism, also undermining the cooperation. With imperfect monitoring it can be rational to forgive some (apparent) deviations, provided they are mild enough (Green and Porter, 1984). Imperfect monitoring generates alternating periods of cooperation and noncooperation (as in the model of Green and Porter, 1984) or the complete breakdown of cooperation (as in the model of van Damme, 1989). Successful cooperation might therefore require that firms make monitoring efforts so as to recognize when a customer's failure to pay is opportunistic. Our respondents' testimony is consistent with this. One firm that grants trade credit to most of its customers (case #6) has set up a system to monitor them. The manager said it was expensive to establish this system but it is very useful as a form of security. Another (case #57), noting he has "no effective way to force customers to pay debts," does "nonstop investigating of customers, even the best customers." Several others said that, after they ascertained that a customer's failure to pay a bill was through no fault of its own, they helped the customer through its difficulties, eventually got the money back, and now still deal with the customer. This willingness to investigate the reason for the nonpayment and then to renegotiate arguably helps to maintain the system of relational contracting in the face of imperfect monitoring.

Another level to the interaction between retaliation and reputation is suggested by the interviews. Some managers expressed reluctance to sanction debtors because doing so would give

them a reputation among their other customers of being difficult to deal with. As one noted, "keeping a good reputation is the most important thing and . . . in Vietnam if you treat customers fairly when they have difficulties you will have that reputation. People will do business with you because they think you will not kill them when they have difficulties" (case #6). It is apparently not enough for the manager to determine whether the customer deliberately defected. It must also be clear to his other customers or potential customers that the customer did in fact cheat. Our managers therefore are hesitant to sanction those who owe them money.[8]

An alternative way of getting a debt paid, less innocuous than negotiating with the debtor, is hiring a private debt-collection agency or, in the extreme, criminals. One of our interviewees said he once hired what he called a "bounty hunter" to collect an unpaid debt; the debt was paid in full. This comment is an exception. Our interviewees only rarely mentioned using private agencies or criminals to collect bad debts. In answer to the question of how disputes over debts are resolved with customers, less than 1% said they had recourse to a private agency specializing in such cases. This could be because criminals are not often resorted to; or it could be that it is common practice but the interviewees were reluctant to tell us about it. It appears, though, that criminals are less used to enforce contracts in Vietnam than in some other transition countries like Russia (Greif and Kandel, 1995). One respondent (case #1) actually gave a relational-contracting rationale for shunning private agencies. Owed money by a wholesaler, he considered hiring outside agents to collect his debt but decided against it because it would have harmed his relationship with his other customers. He said, "in order to keep long-term relationships with other customers, the firm must be very careful in dealing with disputes."

In summary: the high discount rates in Vietnam narrow the scope for cooperation. Even when contracting is supported by the threat of loss of future business, this sanction is not as direct

[8] A third explanation for the firms' reluctance to sanction trading partners who break an agreement rests on the offended firm's incentives once the breach has occurred. Cutting off the relationship ensures the debt will never be paid; maintaining the relationship leaves open the possibility that it will be at least partially paid. One manager (firm #61) said that when one of its customers could not pay on time, he "had only one route which was to postpone the payment and help the customer to resolve his problem in order to get the money back." Sanctioning may not be a subgame perfect strategy, in other words, as it hurts the firm doing the sanctioning as well as the firm being sanctioned. However, the theory of renegotiation in repeated games offers no clear indication of what rational behavior consists of in such circumstances (Pearce, 1992, p.166).

as in the simple repeated-game story. The weak retaliation could tempt firms to breach agreements. To ensure compliance, therefore, trading partners must rely on devices other than the shadow of the future. We next examine three mechanisms to prevent disputes arising. One is structuring the exchange so as to give each trading partner an immediate incentive to live up to the agreement (Section 4). Another is the threat of community sanctions, with other firms blacklisting a firm that breaches an agreement (Section 5). The other is scrutinizing any potential trading partner before beginning to transact or while transacting (Section 6).

4. Governance Structures

A standard solution to the high transaction costs of the market is vertical integration (Williamson, 1985). The inadequacy of Vietnam's financial markets probably makes this remedy unavailable to most private firms. Since few of the firms in our sample have access to bank loans and there is no equity market, the firms expand incrementally, by reinvesting their profits. To buy out a customer or supplier in order to solve a specific-assets problem would mean expanding in a discrete jump, for which financing would typically be unavailable.[9] Merger by pooling of assets and pro rata ownership is an alternative to takeover by one of the firms. But a merger requires a lot of trust, especially when the legal institutions are inadequate for enforcing the terms of the merger, so fears of reneging by the prospective partner might rule out such a merger.

In the absence of formal legal enforcement or vertical integration, informal means of enforcing contracts are needed. If the sanction that would follow a deviation is weak, firms may need to structure their exchanges so as to reduce the gains from deviation. Careful structuring of the agreement is more important in some transactions than others, as transactions vary in the extent to which the firms are exposed to a risk of reneging by their trading partners. In transactions involving a risk of reneging, firms can be expected to develop elaborate governance

[9] An exception to this is a manufacturer of notebooks (case #3). Its main supplier of paper is a state-owned enterprise. In order to avoid being subject to changes in its supplier's policies and "to keep stable production" it built a small workshop to make paper for itself. However, the paper it makes in-house is of low quality and it uses it only in its lower-end production for sale to "provincial customers."

structures (Williamson, 1985, Ch.3). In this section we use the survey data to ask if more elaborate governance structures are used in transactions with greater risk of reneging.

Reneging risk is affected by both the nature of the goods being produced and the thinness of the market. First, some types of goods are produced to order; a firm that has sunk resources into producing to order is subject to holdup by its customer. Second, if the market is thin a firm may sell a large fraction of its output to a single customer, again subjecting itself to holdup. Third, in order to reach customers the firm may have to sell across long distances, bringing reneging risks. One manager (case #4) said he prefers not to sell to customers outside the province because "it is very difficult to have accurate information about them." Also, sales over large distances would typically involve less frequent deliveries than local sales and therefore a higher effective discount rate and a greater likelihood of reneging.

The columns in Table 1 provide measures of the reneging risk in relationships. Production to order (rather than for inventory), heavy reliance on a single customer, and sales outside the manufacturer’s city increase the reneging risk. Goods are produced to order in 46% of the manufacturer-customer relationships in the sample. Manufacturers sell half or more of their production to 37% of the identified customers. The data show a preference for transacting locally: 60% of sales are made to firms located in the same city.

The governance structures we consider are written contracts, the timing of payment for goods, and the use of intermediaries. Each of these may affect the ability to sustain cooperation between two trading partners. The t-tests in Table 1 examine the extent to which these governance structures are used to support transactions with higher risks of reneging.

Despite their inability to rely on the legal system, our firms often use written rather than oral contracts. Written contracts specifying quantity and quality are used in 53% of the customer relationships. Written contracts appear to be used in more complex transactions. Even if there is no legal benefit from a having a written contract, writing things down helps provide clarity in complex exchanges. Moreover, in the event of a dispute, having a written contract can help establish to other firms which of the parties breached the agreement, meaning that community sanctions (as will be discussed in the next section) can be directed at the firm that actually caused

the breach. One manager (case #14), who said the local authorities and the courts are ineffective in resolving disputes, which are best solved by "direct negotiation," nevertheless said good written contracts "can protect the company from unnecessary disputes."

Written contracts tend to be used in transactions with a risk of reneging (see Table 1). Manufacturers say they have written contracts for 75% of sales to customers involving goods produced to order, compared to 35% of transactions where goods are sold from inventory (t = 6.82). Written contracts are also more likely when more than half of the manufacturer's sales are made to the customer (80% vs. 39%, t = 6.62) and when the customer is located in a different city (77% vs. 38%, t = 6.53). Thus, where the reneging risk faced by the manufacturer is greater, contracts are significantly more likely to be written.

If the buyer pays part of the bill in advance the manufacturer's risk is reduced (and the buyer's increased). Advanced payment can act as a hostage exchange, balancing the gains from defection (Williamson, 1985, Ch.7, 8). In 35% of the customer relationships some portion of the payment is in advance.[10] The data indicate that advanced payment is used to balance the risk between buyers and sellers. Customers are significantly more likely to pay something in advance when the manufacturer produces to order (42%) rather than to inventory (30%, t = 2.01). Advanced payments are also significantly more common when the manufacturer sells half or more of his output to that customer (49% vs. 28%, t = 3.51), and when the customer is located outside the manufacturer's city (43% vs. 30%, t = 2.18).

Intermediaries might be expected to play a role in transactions with reneging risk. Because their dealings are more frequent and they are more visible in the marketplace, intermediaries might find it easier to develop a reputation for honest dealing than manufacturers (Biglaiser and Friedman 1994). Anecdotal evidence reveals some creative uses of intermediaries to contract with customers over long distances. For long-distance transactions, according to two interviewees, the bus driver who delivers the product commonly acts as the customer's representative, transferring the customer's money to the producer and in effect being a financial intermediary, the guarantor of

[10] Paying in advance appears not to be driven by liquidity needs. Advanced payment is more likely to be received by larger firms than smaller firms. Neither the age of the firm nor its access to bank loans is correlated with receiving advanced payments.

payment. Another mechanism for achieving compliance over long distances was revealed in interviews we conducted with several wholesalers in Hanoi's Dong Xuan market. The wholesalers said buyers from Ho Chi Minh City generally purchased goods in groups of five or so. The groups function only as a conduit of information. Members are not jointly liable for each other's behavior; if one group member failed to pay, the others would not be precluded from purchasing in the future. The other group members were expected, however, to provide information about how to find the defecting member, which would be used by family members or friends of the wholesaler living in Ho Chi Minh City, who would try to collect the debt for the wholesaler.

Despite these anecdotes, the data indicate few intermediaries of the conventional sort have developed in Vietnam. Only 21% of the customers and 18% of the suppliers of the surveyed firms are wholesalers. Only 13% of sales on average go to wholesalers. Most goods do not pass through intermediaries but go directly to consumers, other manufacturers, or retailers. The data offer only weak support for the prediction that wholesalers are used for transactions with reneging risk (see Table 1). The manufacturers are somewhat more likely to use wholesalers when goods are produced to order (25% vs. 16%, t = 1.59) and for sales made outside the city (24% vs. 18%, t = 1.19), but neither effect is statistically significant.[11]

To summarize: the data indicate that transactions with greater risk of reneging (as measured by producing to order, trading over long distances, or being dependent on a single customer) are supported by more elaborate governance structures (using written contracts or paying in advance). Wholesalers are not much used to reduce reneging risks, perhaps reflecting the fact that at the time of our survey Vietnam still had some distance to go in the marketization of its economy.

[11] The lack of a significant association between the use and location of a wholesaler does not mean that wholesalers play no role in trade over distances. As with the traders at Hanoi's Dong Xuan market, the wholesaler may be located in the same city even though the final customer is located in a distant city. We have no information on where the wholesaler's customers are located.

5. Community Sanctions

A more potent sanction for nonpayment of a debt than bilateral sanctioning—the creditor refuses to deal any more with the debtor—is community sanctioning—other firms are told of the bad debt and blacklist the debtor (Milgrom, North, and Weingast, 1990; Kandori, 1992). Some managers said there was communication about disputes. An aluminum-goods producer said that when he meets fellow producers informally they discuss, among other things, the reliability of particular customers. Another manager, making steel products, said he meets other business people every day to exchange information about customers and market opportunities. These regular meetings, he said, "create an ethic in doing business which helps the market work." The prospect of damaging its dealings with other firms is a further possible reason, beyond the governance structures discussed in the previous section, for a firm to live up to its agreements.

In response to the question, “If a customer cheated you, would all of the other manufacturers of the products you produce hear about it?”, 55% said they would. However, just a third (35%) of those responding affirmatively said other businesses would refuse to deal with a customer who had cheated the respondent.[12] Similarly, 51% of managers said that, if one of their suppliers cheated another firm, they would hear about it, though only half (54%) of these said they would refuse to deal with such a supplier. Just 19% of the firms, therefore, said other firms would blacklist a customer who cheated them, and 28% said they would stop buying from one of their suppliers if they heard it had cheated another firm. Community sanctions are sometimes invoked, but usually a firm need not fear widespread sanctions if it violates an agreement.

Despite the fact that community sanctions are not a threat in most transactions, there is some evidence that they do support transactions with reneging risk. In McMillan and Woodruff (1999) we find that talking with other suppliers of their customers on a regular basis is positively associated with granting trade credit to customers, which suggests the ongoing gossip is an significant source of information and possibly also provides a route to community sanctioning. Firms selling more than half of their output to a single customer, as Table 1 shows, are more likely

[12] Managers responded to these questions “agree,” “disagree,” or “indifferent.” The percentages given are those responding “agree.” To the first (second) question, an additional 32% (42%) responded “indifferent.”

to say other manufacturers would both learn of and refuse to deal with a customer who cheated them (23% vs. 14%, t =1.74). Production to order is also associated with the willingness of other manufacturers to sanction those who cheat, though the effect is not significant (20% vs. 13%, t =1.42). Community sanctions do appear to support sales over long distances. For 23% of the relationships with distantly located customers, managers said that other manufacturers were willing to punish defectors, compared to 13% of customers located in the same city (t = 2.19). The prospect of community sanctions overhangs transactions subject to reneging risk.

The collective action required to enact community sanctions might need some organization, which might explain why most firms in Vietnam are not faced with the prospect of their use. Trade associations provide contract-enforcement services in more advanced economies like the United States, Japan, and Mexico (Bernstein, 1996; Schaede, 1999, Ch.5; Woodruff, 1998). Imperfect information might impede the use of community sanctions. When a dispute occurs, it might not be clear to outsiders which of the disputants is at fault, so other firms might be reluctant to implement sanctions. Those firms that are expected to take part in the community sanctions might reasonably question the credibility of the firm that is claiming it has been cheated. Trade associations or other intermediaries, by investigating the offended firm's complaint, could lend such credibility.[13] In Vietnam, however, trade associations do not seem to play a major contracting role. While 47% of the surveyed firms belong to a trade association, only 28% of these (or 13% of the total) say that among the services the association provides is "information about the trustworthiness of customers or suppliers" and only 13% (or 6% of the total) say "contract and/or dispute resolution."

To summarize: Although the prospect of community sanctions affects a minority of transactions, they are available where they matter, in transactions involving a risk of reneging.

[13] Trade associations in Mexico use a quasi-judicial procedure to check a member firm's claim that it has been cheated before asking its other members to ostracize the offender (Woodruff, 1998). Similarly, the medieval law merchants studied by Milgrom, North, and Weingast (1990) sought evidence that a violation had in fact occurred before enacting community sanctions.

6. Scrutinizing Potential Trading Partners

Apart from structuring transactions so as to give incentives to live up to the agreement, a firm can reduce the likelihood of disputes by choosing its partners well. In game-theoretic terms, players may have different types, making it necessary to screen potential partners at the start of a relationship (Sobel, 1985; Wilson, 1985). The managers told us they carefully investigate potential trading partners before beginning relationships. "The good customer is not one who pays a high price for your product," said one (case #3), "but one who is honest and well implements the commitment with you." Many of the interviewed managers said they had never had a dispute with a customer because of the effort they had put into checking (as case #9 put it) their "financial capability and personality."

To begin a relationship from scratch, each party needs to be able to locate a potential trading partner and to identify its reliability. Managers research potential trading partners before the relationship begins, and continue to gather information during the course of the relationship. This activity absorbs a significant amount of the manager's time. The managers reported that on average 16% of their work time was spent searching for new customers and 16% dealing with existing customers, compared with 48% dealing with production issues. Gathering information is not merely a matter of locating a partner able to make a desired input or wishing to buy the firm's product. The crucial information that is sought, to judge from our interviewees' responses, is the reliability of the potential trading partners.

Business contacts are a source of initial information, used in 28% of customer relationships and 42% of supplier relationships. Family and social contacts are also information sources: they were used to initiate exchange in 25% of customer relationships and 24% of supplier relationships. A manager said that before beginning trading he investigates trading partners "carefully through friends, relations, other suppliers and customers" (case #9). The manager of a bicycle-frame manufacturer said that he locates firms producing inputs he needs through informal talking in the many small shops on the sidewalks of Hanoi selling drinks (case #4). The manager of an animal-feed producer said he uses three methods to evaluate a customer's reliability before offering it trade credit. Many of his customers are small shops located in

residential areas. He sends staff to talk with the customer's neighbors, as "the neighbor in a small residential community is one of the best sources of information about that entrepreneur." This manager also asks other producers about the customer's reputation (firm #75). Gossip matters in this economy.

We use two survey questions to identify relationships arising from business and social connections. The managers were asked how their firm first made contact with a particular trading partner. If the interviewed manager previously worked at the customer's firm or if the customer's manager was a friend before the trading relationship began then we interpret the relationship as being embedded in a network. Managers were also asked about the sources of initial information about the trading partners. If the respondent said that the initial information on the trading partner came from either "other businesspeople who make similar products" or "other suppliers" we interpret this as indicating a network relationship. Customers who are owned a "family member or friend" or customers identified through information from family members are defined as being in social networks. In total, 46% of customer relationships and 58% of supplier relationships arise from either business or social networks.

Does network membership support transactions with higher risks of reneging? In McMillan and Woodruff (1999) we find that, if a customer was initially located via a business network (but not a social network), the manufacturer is more likely to grant it trade credit. As Table 1 shows, networks are significantly more likely to be used when goods are produced to order (57% vs. 37%, t = 3.28). A customer buying half or more of a manufacturer's sales is also more likely to belong to a network, though the effect is not significant (52% vs. 42%, t =1.45**.** Networks apparently do not support long-distance trade; customers outside the manufacturer's city are no more likely to come from network connections (47% vs. 44%, t = 0.34). These results change little when social and business networks are tested separately. The data somewhat weakly indicate, then, that social and business networks reduce reneging risks.

We find no evidence that ethnic networks play a role in supporting exchange. In the precommunist Vietnam of the 1960s, business among the ethnic-Chinese merchants "was based upon personal relationships and word-of-mouth agreements," according to Barton (1983, p.53).

If a merchant was untrustworthy, "it would be impossible for him to do business. Once the fact that a merchant had failed to honour his word became known, other merchants would simply refuse to do business with him." Barton says that these relationships were specifically ethnic-Chinese and that the inability of the ethnic-Vietnamese merchants to establish trust explained their "lack of success in competing with the Chinese" (p.49). In 1990s Vietnam, by contrast, our data show relationship-based contracting is widespread and is not necessarily dependent on clan or family ties; as noted, social connections were used to initiate just one quarter of the ongoing customer relationships in the survey. We asked managers what languages they speak: 18% said they speak Chinese. When we use this response together with using family connections to indicate a Chinese ethnic network, we find no significant effect on production to order or the other reneging-risk variables.[14]

Given Vietnam's underdeveloped market institutions it is understandable that firms use nonmarket means—ties of family or friendship—to undergird market relationships.[15] But what is also noteworthy about the foregoing numbers is that, while pre-existing business or family connections sometimes help to get a trading relationship started, they are not essential. No prior connections existed between the manager and the firm that was to become its longstanding trading partner in about half of the cases.[16]

A substitute for network connections is the firm's own research. Managers said they learn about a potential trading partners' reliability by directly visiting its factory or store. One said, "The best way to assure the quality and reliability of the supplier is to visit his site to investigate, measure, and test the quality of the materials." Another said, "The way to evaluate suppliers' reliability is to visit them frequently and test what they make." In 16% (26%) of the relationships

[14] Ethnic Chinese own 17% of small private firms and 28% of medium and large private firms in Ho Chi Minh City (Hoang Kim Giao and Nguyen Dac Thang, 1995, p.31). The influence of the ethnic Chinese has been reduced, according to Hiebert (1994, p.124): "Over a decade of discriminatory policies [i.e., between the mid-1970s and the mid-1980s] appear to have eliminated some of the Chinese business edge and given Vietnamese businessmen time to begin competing in trading and small-scale industry."

[15] Such ties are used even in the United States. In a study of New York City garment firms, Uzzi (1996) finds that interfirm relationships, which facilitate the exchange of goods that are difficult to price or to enforce contractually, often start from third-party referrals and are often based on social relations outside business.

[16] That is, in 54% of the customer relationships and 42% of the supplier relationships. Ronnås (1992, 1996), in his 1991 survey, similarly found that most firms found their suppliers and customers through some kind of search process rather than through personal connections.

managers say they visited the customer (supplier) at least three times before the initial transaction. Once trading begins, experience with the trading partner provides information. Firms test each other at the start of a relationship. One manager (case #4) reported that one of her customers intentionally delayed payment, increasing his debt to see how much credit he could get and how much trust he could put in her. After a few episodes of testing, they decided to have a "genuine long-term relationship." Another interviewee (case #3) said that when he started in business he initially selected customers based on recommendations from his friends about reliability. But this was only the first step. "People show their personality through their actions in difficult times," so after a few transactions this manager selected a few customers to concentrate on. Some managers said they continuously monitor the activities of their trading partners. Thus both visiting potential trading partners before starting a relationship and experience in dealing with them can substitute for the information that might otherwise have come through network connections.[17]

To summarize: Producing to order is significantly correlated with having used social or business networks to get information about the trading partner, but no such correlation shows between our other measures of reneging risk and using networks. Although business contacts or family ties between the contracting parties sometimes help to get an interfirm relationship started, they are not essential. Interfirm relationships develop quite readily in response to the need for some contracting assurance. Experience in dealing with a trading partner substitutes for pre-existing network connections. The relationships are quite fluid.

7. **Conclusion**

Vietnam's firms contract without the shadow of the law and only partly in the shadow of the future. Our survey data and interviews show how ongoing relationships work in Vietnam. Disputes are prevented in the face of ineffective laws partly by the threat of loss of future

[17] A firm might be more willing to subject itself to reneging risk once the relationship has lasted for some time. For example, it might abandon alternative suppliers after establishing a working relationship with one supplier, so that relationship duration should be positively associated with having no alternative supplier of the input. There is weak support for this in the data. Established suppliers are the sole source of an input in 26% of the cases, compared to 16% of newer suppliers who are sole sources (t = 1.47). But a thin market might generate both a long relationship and a lack of alternative suppliers, so the thin market rather than a growing willingness to trust the supplier might be the source of this correlation.

business. However, a firm suffering a breach of contract often maintains its relationship with the debtor, negotiating "patiently" and trying to get at least part of the debt paid. It might investigate the reason for the breach and be willing to renegotiate if the breach was beyond the offending firm's control. And it is sometimes hesitant to sanction a trading partner for fear of damaging its own relationships with its other trading partners. The retaliation is therefore not as forceful as in the standard repeated-game story. To ensure agreements are complied with, the firms rely on additional devices. The governance structures the firms have developed for themselves are consistent with transaction-cost economics. Transactions involving greater risk of reneging (as measured by producing to order, trading over long distances, or being dependent on a single customer) tend to be supported by more elaborate governance structures (using written contracts, paying in advance, or trading through intermediaries). Transactions with reneging risk are also subject to community sanctions. Firms scrutinize potential trading partners before beginning to transact, sometimes using business or social networks to check their reliability. Relational contracting, then, rests not only on repeated-game incentives but also on governance structures.

In economies with well-functioning legal systems, interfirm relationships supplement the courts in facilitating contracting, as is by now well understood.[18] What is striking about Vietnam is that it shows that the repeated-game incentives, together with governance structures and pre-trade investigation, can support business activity even in the absence of workable laws. More than 90% of the managers surveyed said the courts are of no use to them in enforcing contracts or resolving disputes. Deal-making rests on the firms' own devices.[19]

The ability of Vietnam's firms to operate in the absence of strong laws does not mean, however, that contract law is unimportant. The success of the relational contracting might be in part a consequence of another transaction cost, the high cost of search for alternative trading

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[18] See for example Baker, Gibbons, and Murphy (1994), Galanter (1981), Grief (1997), Macaulay (1963), Mann (1998), and Williamson (1985, Ch.3).

[19] In other transition economies relational contracting has developed. In Bulgaria, for example, managers surveyed by Koford and Miller (1998) said that ongoing relationships were needed because of the absence of commercial law. Many firms had been deceived by unscrupulous firms, which appeared in great numbers early in the transition. Firms began carefully evaluating business partners. They tried to find firms that were reliable and then worked with them on a continuing basis. Supplier relationships gradually developed. Most firms eventually acquired a core group of partners with whom they traded frequently. Payments were timed so as to reduce the incentive for default.

partners. If search costs effectively lock firms into their current trading partners, the firms will make efforts to sustain their existing relationships. As market institutions develop so that search costs fall, the cost of breaking a relationship will also fall and firms will become less willing to cooperate with each other (Kranton, 1996; Ramey and Watson, 1996). As market information improves in Vietnam, the need for workable laws of contract and courts able to enforce them will become more pressing. Furthermore, relational contracting cannot support certain kinds of transactions: those involving large enough sunk costs that one party's temptation to renege outweighs any reputational considerations. Investments that are large and have a long-delayed return require legal protection to prevent the government or other firms from appropriating the quasi-rents. Despite the success of relational contracting, legal reform remains necessary.

Our findings have implications for the sequencing and the content of policy reforms. Building a modern legal system takes a long time. In the early stages of reform, fostering market actors such as trade associations and wholesalers that disseminate information could promote extra-legal means of contract enforcement. Trade associations and wholesalers serve contract-supporting functions in other economies, by keeping records of contract violations and by serving as guarantors of the quality of goods (Biglaiser and Friedman, 1994; Bernstein, 1996; Woodruff, 1998). In Vietnam, firms seemed to make little use of wholesalers at the time of our survey, and trade associations mostly had not started supplying contract-supporting services. There could be a role for policy to help initiate such activities.

New market-oriented commercial laws should be introduced in Vietnam in a way that respects the currently functioning relational mechanisms. The model of Baker, Gibbons, and Murphy (1994) shows it is possible for imperfect formal contracting to crowd out relational contracting and cause a welfare loss. Hay, Shleifer, and Vishny (1996) argue in general that legal reform should "facilitate and support the existing contractual arrangements and market transactions." They say that "a good goal for commercial laws is to keep up with good business practice," so as to "essentially legalize already existing market transactions, thus enabling private parties to rely on the legal system to resolve disputes in their already ongoing activities." Similarly, Greif (1997) notes that "introducing a legal system may undermine the implicit

understanding that governs transactions under informal contract enforcement. The possibility of following the letter of the law may increase transactions costs." New laws should be written so as not to supercede the functioning relational mechanisms but instead to cover areas that the existing relational contracting fails to address (such as large investments with long-delayed returns). Introducing new laws insensitively in Vietnam could cause harm if they were to disrupt the gainful trade that currently rests on the relational contractual practices we have analyzed.

Appendix: The Survey and Interviews

The surveyed firms were drawn from a list of privately-owned manufacturers provided by the Vietnam Chamber of Commerce and Industry. The 149 Hanoi surveys and the 17 interviews were conducted in 1995 and 1996; the 110 Ho Chi Minh City surveys in early 1997. The firms range in size from five to 300 employees, with a mean of 52. Their median annual sales are US$56,000. They manufacture heterogeneous products, with the largest number producing clothes, footwear, and leather goods (17%); metal parts and products (12%); and wood products and furniture (12%). The remaining industries are shown on Table 2. Some (11%) are old, having been set up between 1948 and 1965. But almost 80% were started since the main reforms began in 1986. Most that existed before the reforms were originally collectively owned and were highly restricted, being required to sell all of their output to a specific state-owned enterprise: until the late 1980s, these firms were essentially part of the planned economy. Many of the collectives converted themselves to private ownership under *doi moi*.

Though the private sector still represents less one-third of Vietnamese industrial output, private firms tend buy from and sell to each other: 73% of sales go to and 68% of supplies are purchased from other private firms. State-owned trading partners represent a larger percentage of sales and purchases in Hanoi than in Ho Chi Minh City. (Transactions with state-owned trading partners are excluded from the data presented above, so that all dealings in the data are between private firms.) One-quarter export some of their output, which suggests the firms in our sample are more successful than the average manufacturing firm.

Ownership of the surveyed firms is most commonly by the top manager and his or her family (63%), though in some cases the owner is another private individual (19%) and some remain collectively owned (26%, almost all in Hanoi). Family financing was the most common source of start-up capital (66%), but some firms had received financing from partners or by issuing shares (47%) or from friends (10%), and a minority had obtained loans from a state bank (7%) or a private bank (3%). (These numbers add to more than 100% because many firms used more than one source of start-up funds.) Some other basic data on the surveyed firms are given in Table 2.

Although firms in Hanoi and Ho Chi Minh City operate under the same formal institutional structure, for historical reasons the market is said to be more developed in Ho Chi Minh City (Hoang Kim Giao and Nguyen Dac Thang, 1995). By at least some measures our data corroborate this. Firms in Hanoi rely more heavily on the state-owned sector. Private firms represent a substantial majority of our firms' trading partners in Ho Chi Minh City (83% of customers and 75% of suppliers) but a minority in Hanoi (49% of customers and 46% of suppliers). Among domestically-owned private-sector trading partners, production to order is more common in Hanoi (32% vs. 26%). There is little regional difference in the propensity to trade in other cities or to sell half or more of production to a single customer. Written contracts are more common in Ho Chi Minh City (40% vs. 25%), indicating a formalization of transactions.

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TABLE 1
Governance Structures and Relationship Risk

	% of Customer relationships	Production to order	Production to inventory	50% or more of sales	Less than 50% of sales	Outside city	In same city
% of relationships involving		46.0%	54.0%	36.9%	63.1%	39.8%	60.2%
Written contracts	53.2%	74.6%	34.6%	79.5%	39.0%	76.8%	37.6%
			(6.82)		(6.62)		(6.53)
Advanced payments	35.3%	42.1%	29.9%	49.4%	27.7%	43.4%	30.0%
			(2.01)		(3.51)		(2.18)
Trade with wholesaler	20.5%	24.6%	16.4%	21.3%	20.1%	24.2%	18.0%
			(1.59)		(0.23)		(1.19)
Community sanctions	16.9%	20.2%	13.4%	22.5%	13.8%	23.2%	12.7%
			(1.42)		(1.74)		(2.19)
Networks	45.7%	57.0%	36.6%	51.7%	42.1%	44.4%	46.7%
			(3.28)		(1.45)		(0.34)

Note: Relationships limited to those begun in 1989 or later. t-values in parentheses.

TABLE 2
Summary of Survey Data

	Total	Hanoi	Ho Chi Minh City
Number of firms	259	149	110
Size			
Average employment	52	53	52
Median employment	32	33	30
Average sales ($US)	$315,000	$170,000	$509,000
Median sales ($US)	$56,200	$47,300	$62,300
Age			
1-4 years	60%	52%	72%
5-8 years	17%	11%	26%
>8 years	22%	38%	2%
Industries:			
Clothing and footwear	17%	19%	15%
Metal	12%	17%	5%
Wood products	12%	11%	14%
Food	10%	7%	14%
Construction materials	9%	10%	8%
Paper and packaging	8%	7%	10%
Handicrafts and art	5%	8%	1%
Other	26%	21%	33%
% of sales to private sector firms:	73%	61%	89%
% of sales to customers located:			
Within same city	57%	58%	57%
Outside city, in Vietnam	23%	23%	22%
Exports	20%	19%	21%
% of supplies from private sect firms:	68%	52%	88%
% of supplies from suppliers located:			
Within same city	54%	58%	48%
Outside city, in Vietnam	32%	39%	24%
Imports	14%	3%	28%
Ownership--% of capital owned by			
Manager or family	63%	56%	71%
Other private individuals/firms	19%	15%	25%
Collectively owned	16%	27%	2%
Start-up finance--% of firms using			
Own or family finance	66%	70%	60%
From partners/issuing shares	47%	50%	45%
Loan from bank	10%	12%	7%
Loan from a friend	7%	10%	2%