

Table 3.2 The Promisor's Dilemma after private contracting: where the defector is liable in damages for lost profits

		Player Two	
		Cooperate	Defect
Player One	Cooperate	3, 3	2, 1
	Defect	1, 2	0, 0

are always better off when they cooperate, and their private incentives are fully aligned with their joint interests. As such, neither will defect.

The Prisoner's Dilemma game illustrates how profitable joint opportunities may be lost when contracts are not enforced. When the buyer pays the price and the seller refuses to deliver, or when the seller delivers and the buyer refuses to pay, the party in breach gets the opportunist's payoff and the innocent party gets the sucker's payoff. Future parties will anticipate this and refuse to enter into agreements. The result is a settled pattern of defection and mistrust in which bargaining gains are abandoned, unless the parties can bind themselves through enforceable bargains.

Beneficial reliance

When the parties refuse to rely on each other's promises, the bargaining loss can usefully be explained through the economist's indifference curves. An indifference mapping also highlights the deficiencies in the reliance and benefits explanations of contracting.

When presented with a choice between different goods (represented along axes of a diagram), a consumer will find himself indifferent between various bundles of goods. He might find that five apples and three oranges are just as good as four apples and four oranges. Or ten apples and no oranges. The line that connects all the points of indifference between one combination of goods and other combinations is called an indifference curve.

For our purposes, let us assume that the two goods are consumption today and consumption tomorrow of money. The indifference mapping will indicate the consumer's preferences as between present and future consumption.

In Figure 3.1, the consumer is given \$100 which he must spread over two time periods. The straight line between consumption of \$100 in the two periods is called the *budget line* and represents every possible combination of present vs. deferred consumption, given the consumer's fixed amount of money. The frugal ant takes a position at one extreme, saving in the present and spending the entire amount in the second period; while the grasshopper lives solely for today and spends the entire amount in the present period.

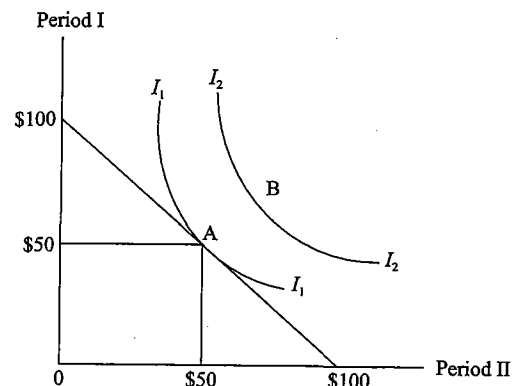


Figure 3.1 The saving decision

At the point of origin the consumer has no goods of either kind. We assume that he always wants more goods and that he will always prefer to be on the highest indifference curve (the one furthest from the point of origin). Given the choice between curves I_1 and I_2 he would, therefore, prefer to be on the latter. As this lies above the budget line, however, it is not a feasible outcome. He simply doesn't have the money. Instead, curve I_1 , which is tangent to the budget line at the point of intersection, represents the highest feasible indifference curve available to the consumer with a \$100 budget and, as it happens, this assumes equal consumption in the two periods, \$50 now and \$50 later.⁵

Charles Goetz and Robert Scott have employed an indifference curve model to explain how trust benefits bargainers (see Figure 3.2).⁶ Suppose that our subject – call him David – begins with an endowment of \$100 and reaches his highest feasible indifference curve at point $A_{50, 50}$, where he consumes \$50 now and \$50 later. David's Uncle Ebenezer tells David he wants to give him another \$100. If Ebenezer makes the gift in the first period, we assume (arbitrarily) that David will move to point $B_{100, 100}$, again dividing consumption equally in the two periods. However, Ebenezer does not have the \$100 in period 1, and can only promise to give David the money in period 2. If Ebenezer promises to make the gift and subsequently performs, and if David relies on the promise by consuming his entire \$100 in period 1 and the gift of \$100 in period 2, then David will be as well off as he would have been had Ebenezer made the gift in period 1.

Now suppose that Ebenezer promises and David relies in period 1, but that Ebenezer fails to perform in period 2. David will now be at point $C_{0, 100}$ and worse off than if he had not relied. Had he refused to trust his uncle, he would be on indifference curve I_{100} ; instead, he is now on

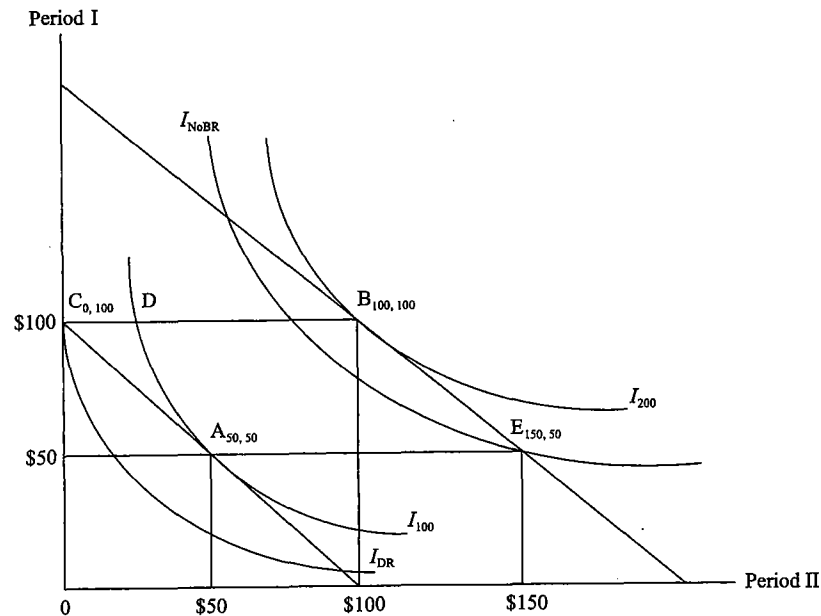


Figure 3.2 Detrimental and beneficial reliance

indifference curve I_{DR} ; and the difference represents his detrimental reliance loss. To compensate David for the loss, Ebenezer would have to give David reliance damages of $\$CD$ (which as I have drawn it looks to be about $\$25$) to bring him back to indifference curve I_{100} and leave him as well off as if the promise had never been made.

Once bitten, twice shy. The next time Ebenezer makes a promise David does not rely. In period 1 David consumes $\$50$, just as he would have had the promise not been made. If Ebenezer fails to perform, David will consume $\$50$ in period 2 and no harm will have been done from a reliance perspective. But now suppose that Ebenezer does perform in period 2, and that David finds himself at point $E_{150, 50}$. He is better off than he would have been had Uncle Ebenezer not performed, but not as well off as he would have been had he relied and Ebenezer performed. He would then have been on indifference curve I_{200} ; but now is only on indifference curve I_{NoBR} .

The difference between indifference curves I_{200} and I_{NoBR} represents how a promisee may be made better off by relying when promises are performed. He can adjust his behavior in expectation of performance, and Goetz and Scott call this *beneficial reliance*. The Goetz–Scott analysis usefully highlights the deficiencies of the reliance and benefits theories we saw in

the last chapter. Reliance theorists incorrectly assume that the only kind of reliance is detrimental (and if they had the courage of their convictions they would ban contracting entirely). What they forget is beneficial reliance, where promisees adjust their behavior in expectation of performance and promisors do, in fact, perform. Similarly, benefits theorists look only to the benefit received by the promisor and ignore the benefit the promisee derives from credible promises. Reliance and benefits theorists both miss the crucial contribution of promises and contract law, as reassurance devices that promote promisee reliance.

Moral philosophers who are unaccustomed to looking at problems from the economist's *ex ante* perspective, and who tend to ignore the incentive effects of legal rules, typically examine the question of promissory obligations from an *ex post* perspective, where the promise has been made and the promisee has relied to his detriment. Since they do not see the *ex ante* side of things they miss the element of beneficial reliance, which is the whole point of the institution. Sadly, the same mistake is made by academic lawyers such as Patrick Atiyah who are unfamiliar with the economic analysis of law.

But why stop at beneficial reliance? The ability of promisees to adjust their behavior seems an instrumental good, desirable only so far as it promotes a higher good. We prize beneficial reliance not because we like reliance, but because it permits the parties to exploit joint projects that make them better off. It fosters the creation of wealth and results in a more prosperous society. This might not come down to a simple utilitarianism, but the overlap is sufficiently close that most scholars in the law-and-economics tradition subscribe to utilitarian moral theories, to the extent that they stray beyond a purely positive view of their discipline.

Credible commitments

The institutions of promising and contract law promote beneficial reliance by imposing a cost on the faithless promisor. A breach of promise is a moral wrong, and the promisor suffers a reputational loss. The moral obligation of promising may thus be employed to make a statement of intention more credible. "You say you will come to dinner – but do you *promise*?" Unless backed by the force of law, however, a promise might not suffice, for talk is cheap and often unreliable. A bare promise, said Thomas Hobbes, is "but words, and breath," with "no force to oblige, contain, constrain, or protect any man."⁷ To invite promisee reliance, the promisor might therefore have to show a willingness to incur contractual sanctions for breach.

Without contractual sanctions, markets might collapse in what George Akerlof has described as a "market for lemons."⁸ Suppose that there are only two commodities: good used cars and defective used cars ("lemons"), with an equal number of both kinds. The seller can tell which car is which, but not the buyer. Could he distinguish them, the buyer would be

willing to pay \$10,000 for a good car and \$1,000 for a lemon. Not knowing the quality of the car, the buyer would still be willing to pay \$5,500 for it if he thought he stood an equal chance of getting one as the other (there being an equal number of both). However, this ignores the game-theoretic nature of the problem: sellers not only know the quality of the car but also have the choice whether to sell or not. A seller who values a good car at \$10,000 will not sell it for a market price of \$5,500. Instead, he will sell only lemons. Buyers will recognize this, and will rationally refuse to pay more than \$1,000 for a car. The market for high-quality cars will disappear and only lemons will be sold.

Akerlof's lemons problem arises whenever a promisee is asked to rely on a promise and reassurance techniques such as contractual warranties are unavailable. This will happen in commercial contracts and in many other bargains as well. Those who think that marriage is a special bond which is threatened by the morals of the market-place sometimes say that "marriage is more than a contract: it is a covenant." But marriage is more than a covenant: it is a contract. Or, rather, it is less than a contract, since in all but two states the parties cannot waive their right to a no-fault divorce.⁹ Because of the threat of a break-up, marriage has been weakened as the Akerlof model predicts. Since the passage of no-fault laws, people have been less willing to get married and, once married, to have children.¹⁰ These trends might be reversed were the marriage contract more strongly enforced. Giving the parties the right upon marriage to waive no-fault divorce rights would make the exit option costlier for parties who exercised that option. A husband who sought to abandon his wife could not divorce her without her consent and would find himself paying her to secure it. As fault becomes costlier, there will be less of it, and fewer divorces. Small faults will annoy less. Blemishes that seem oppressive when exit is costless will be far less troublesome when one realizes that the marriage will last. An expansion of free bargaining rights, in which no-fault divorce waivers are made enforceable and marriage vows are made more credible, would therefore protect marriage.

The problem of trust is one of credible commitments, in which promisees must determine which promise can be believed. Bare promises, which are not legally enforceable, might not do the trick, since low-quality promisors could easily mimic high-quality promisors. The promisee will then discount all promises and the bargain will be lost. But this means that good cars will not be sold at their true value in used car markets. High-quality sellers have, therefore, an incentive to reveal the car's true quality, and Michael Spence has shown how they might do so by their willingness to bear the cost of signaling (or information revelation).¹¹

When *signaling costs* are the same for both faithful and faithless promisors, the willingness to bear them does not permit promisees to tell them apart. For example, a bare promise costs neither promisor anything, and the result is a *pooling equilibrium* in which the two promisors cannot

be distinguished. Because neither promise is credible, nobody would bother to promise. Suppose, however, that signaling costs are differentially borne by faithful and faithless promisors: signaling is costly for both, but much more costly for the faithless promisor. Where these costs exceed his expected gains from the bargain, he has no incentive to signal. But the faithful promisor, with his lower signaling costs, will be willing to bear signaling costs when these are exceeded by the bargaining gains. Game theorists call this a *separating equilibrium*: only the faithful promisor has an incentive to signal, and when he does so his promise is credible. The promisors sort themselves out into two separate groups and the promisee can tell them apart.

The kind of signaling costs Spence had in mind were educational. Schooling is costly, but more costly for slow learners who have to expend more mental toil. Academic credentials might thus permit employers to distinguish on the basis of intelligence and mental grit. Better credentials mean a higher salary, but not enough to make a difference for the slow learner. Spence signaling also explains how contract law can solve the credible commitment problem. The willingness to bear the risk of liability for breach of contract might constitute a signal that credibly identifies the faithful promisor, transforming a pooling into a separating equilibrium. The signal is costly, since breach will impose a financial burden in the form of damages. But these costs will be lower for high- than for low-quality promisors, for whom default is more likely. The sanction of damages may thus provide the crucial test that separates faithful from faithless promisors.

Substitutes for contract law

Remedies for breach in contract are not the only devices that promisors might employ to reassure promisees about performance. In addition, the credible commitment problem might be addressed through (1) piece-work contracting, (2) reciprocal altruism, (3) internalized norms, (4) union strategies and (5) non-contractual bonding. Where the normal writs of the common law do not run, in international law for example, these might be the only available reassurance techniques. Even in common law jurisdictions, the promise might be too vague to be easily enforced (or to trust to a jury). In addition, contracting is sometimes costly, and substitutes might then be cheaper. In spite of this, people do rely on contractual fetters, particularly for significant transactions, and this demonstrates that for a crucially important set of bargains, substitute reassurance strategies cannot take the place of contract law.

Piece-work contracting

In piece-work contracting, an employee is not paid a regular salary; instead, he is paid per unit of output. Piece-work compensation breaks

up a long-term contract into small, discrete lumps, and may commend itself when it is impossible to monitor employee performance and a regular salary would invite shirking. The same strategy may be employed in other cases where the promisee is unwilling to bear the risk of making a major reliance investment. For example, the buyer might purchase goods on a per-item basis over time, rather than in gross all at once.

However, there are two difficulties with piece-work strategies. First, promisee reliance might be required even in a piece-work contract. On a per-item basis, buyers might still worry about contract remedies for breach of warranty. Second, the whole point of the relationship between the parties might be to induce the promisee to make major reliance investments. When the goods are expensive to manufacture and idiosyncratic so that no one save the buyer will want them, then a piece-work approach will not promote sufficient promisee reliance. A custom-made piece of expensive, heavy equipment, made to the buyer's specifications and of use to only him, will leave the manufacturer high and dry if the buyer throws up the bargain halfway through. Because of this, the manufacturer will not wish to enter into the relationship without an *ex ante* promise of contract remedies for breach of the entire undertaking.

Reciprocal altruism

Reciprocal altruism is related to piece-work strategies, since in both cases a long-term relationship is broken into discrete elements which are made the subject of separate contracts. The difference is that reciprocal altruism provides an explanation for how trust might develop for the entire undertaking, beyond each individual contract. In reciprocal altruism, a party's cooperative behavior in one move signals a willingness to cooperate in the future and invites a cooperative response in turn.

The Prisoner's Dilemma game we examined above was a one-period game. There was no expectation that the parties would play against each other in repeated games. Otherwise the nature of the game would change, since the parties could signal information about future cooperation by refraining from defecting in a prior move. Once the parties begin to cooperate, they might easily continue to do so. What might result is a pattern of reciprocal altruism through which parties in repeated transactions are able to extract bargaining gains without a formal long-term contract.¹²

The idea of reciprocal altruism was discovered by biologist Robert Trivers and used by evolutionary biologists to explain patterns of cooperation among animals.¹³ The extension to game theory came in a famous round of computer-simulated negotiations two decades ago.¹⁴ Game theorists around the world were invited to submit strategies in repeated Prisoners' Dilemma games. In each round, one strategy was matched against another, and at the end total scores were added up. The overall winner was a strategy called "tit-for-tat" (TFT), which resembles the eye-for-an-eye norm of the

lex talionis. In TFT, a party begins with a cooperative move and thereafter mimics the other player's last move. If the second party always defects (ALL-D), the first party will cooperate on his first move and defect thereafter; if both parties adopt TFT, they will both cooperate on every move. The advantage of TFT is that, while not excessively forgiving, it does not carry a grudge. The defector is immediately forgiven once he begins to cooperate. TFT is also a simple strategy that is easily communicated to the other party. It does not defeat every strategy, however. Played against ALL-D, the TFT player will cooperate and receive the sucker's payoff in round 1, while the ALL-D player will receive the opportunist's payoff. Thereafter, both parties will defect in every subsequent game. Having won round 1, the ALL-D player will beat the TFT player. But while TFT does not beat every opponent, it generally outperforms rival strategies when there is a broad mix of strategies and a large number of rounds.¹⁵ TFT exploits bargaining gains which nastier strategies such as ALL-D sacrifice, and permits the parties to move from a dominant strategy of joint defection in the one-period game to joint cooperation in repeated games. What Axelrod's experiment showed is that, even without contractual fetters, the prudently cooperative TFT strategy encourages the development of trust when a Prisoners' Dilemma game is repeated numerous times.

In practice, parties who have repeated business dealings (called relational contractors) tend to fall into a pattern of reciprocal altruism. Consider the relationship between a large law firm and one of its major business clients that generates millions of dollars a year for the firm. There might be no formal long-term arrangement between them, but only a series of repeated one-shot retainer agreements setting out a specific task to be performed by the firm and the fee to be paid by the client. On any day, the size of the firm's billings is dwarfed by the expected value of future business dealings, since clients seldom transfer their business from one firm to another. What gives the relationship stability is not the individual contracts but rather the personal relationships and trust built up over the years between firm and client.

Long-term relational dealings are often self-enforcing,¹⁶ in the sense that the parties never have an incentive to breach. Where the parties expect to continue dealing with one another in the future, like the law firm and its business client, both might find that the expected value of the long-term business relationship exceeds the gains from breach at every step of the way. The immediate gain from breach is dwarfed by the loss of long-term relational gains, and the parties continue indefinitely in their relationship.

Taking this one step further, the possibility of exploiting promissory gains explains why some friendships are formed in the first instance. This is obviously true of the professional friendships within a firm, but it is also true of the social networks and clubs that serve as voluntary insurance organizations. The relationship of trust lets the parties rely on each other in a way they could not do with strangers. Reciprocal altruism also

helps to explain why clans and ethnic loyalties persist. Ethnographers and economists have noted that an ethnic group might come to dominate a particular trade – Jewish diamond merchants in New York, for example – because of reputational advantages within a group.¹⁷ Outsiders will find it hard to compete with members of a group who can seal million dollar deals among themselves with a handshake. What binds the parties is not only personal friendship but also a heightened sense of kinship duty.¹⁸ We distinguish between strangers and brothers, as *Deuteronomy* does in banning usury with the latter but not the former.¹⁹

Internalized norms

The example of kinship preferences suggests a third way in which a promisor might credibly signal his commitment. When norms of reciprocity are *internalized*, the promisor cannot breach without experiencing psychological discomfort, and this reduces the likelihood of breach by increasing its costs. If the promisor can credibly signal that he has internalized such norms, he can more easily persuade promisees to trust him and to benefit from the gains of joint cooperation.

Internalized norms are the self-policing mechanisms of what anthropologist Ruth Benedict called a guilt culture.²⁰ When an internalized norm is breached the individual assumes the perspective of an external judge and condemns himself for the fault, even if no one else observes it. When he felt such guilt, Sir Thomas Browne said, “There is another man inside of me that is angry with me.” By contrast, in a shame culture such as Benedict’s Japan the sanction for breach is a reputational loss when other people notice the fault and revise their opinion of one.²¹

In Homeric Greece, the sense of shame (*aidōs*) was an all-powerful incentive to bravery. When Andromache implores her husband Hector to abandon the battle, he replies that he would feel nothing but shame if he did so. But later Greeks wondered if shame was quite enough, since the unobserved fault escapes sanction. Because of this, Democritus sought to redefine *aidōs* as a feeling of guilt for personal lapses, even if no external shame attached to one’s action. Similarly, in *Crime and Punishment* guilt is the crucial moral hurdle for the modern amoralist (Raskolnikov) who lacks the introspection to accept responsibility for his sins.²²

Reciprocal altruism strategies may thus be seen to rest on a shame culture that awards goodwill points to those who are seen as trustworthy and stigmatizes those who are observed to misbehave. By contrast, in guilt cultures what matters is the signal to oneself through a sense of diminished worth.²³ We see our lives from the outside, like a movie in which we are the hero and have all the best lines. Self-love is one of the most powerful emotions, and we cannot observe ourselves departing from our self-image without severe emotional distress. So strong is the need for self-esteem that we employ sophisticated and powerful excuse mechanisms to

block negative self-signals. But these are never entirely effective, and impose their own costs since they blind a person to his faults.

Guilt cultures may, therefore, enjoy a bargaining advantage over shame cultures. When breaches are undetectable or when performance standards are hard to measure, reputational signaling will not deter breaches so well as internalized guilt sanctions. This explains why promisors might want to internalize cooperative norms and make fixed preferences of them. Economist Robert Frank pointed this out with a tongue-in-cheek question: if *homo economicus* had a choice, would he want a conscience?²⁴ Only if he sincerely wanted to be wealthy, answered Frank. We are less likely to trust those whom we sense are dishonest and more likely to repose confidence in those who evince some sympathy for their fellows. Up to a point, virtue is its own reward.

A sense of personal guilt imposes a cost, to be sure, since it constrains future choices. It makes it painful to betray one’s family, and those who have gone through a divorce might have wished that it were easier to do so. But if it were painless to leave one’s spouse, marriage rates would be lower, since a man would find it harder to persuade a lady to trust his promises. Binding oneself through fixed preferences restricts future choices, but permits one to exploit bargain opportunities that would otherwise be lost.

Not everyone will find the trade-off desirable. The playboy must avoid entangling alliances to move easily from one woman to another. The result is a separating equilibrium, in which some people invest in stable cooperative preferences and others do not. The latter keep their options open, but sacrifice the long-term relationships that depend on trust. They also impose costs on promise-keepers, since promisees will sometimes fail to trust them because of the difficulty in distinguishing between true and false promises.

How can promisees distinguish between faithful and faithless promisors? What the promisee needs is deception-detection equipment, where he tests promisors for signs of reliability. But how is this done? The answer is written on our faces, the most public part of our body, where our emotions register for all to see. Facial signals reveal our deepest feelings to others, and permit them to make reliable inferences about our future behavior.²⁵ The rare person whose face never changes expression seems less than human. If he is not severely depressed, he is taken to signal complete indifference to other people.

We may express our sentiments in other ways, of course, but what is special about facial expressions is that they are so hard to mimic. We show our anxiety when lying, for example, and our blushes are therefore a useful commitment device. They increase the likelihood of detection and strengthen the incentive to tell the truth. Others will repose greater confidence in us, and this will permit us to extract increased gains from joint cooperation. Were it otherwise, thought La Bruyère, we might get away

with everything. "If a person could blush on command, what crimes, not merely hidden, but public and known, would he not commit?"²⁶

We may signal reliability in a variety of ways. Gossip is a trust-enhancing device that forges bonds within a group.²⁷ Revealing a confidence about oneself gives the listener the power to betray the teller, and by sending a strong signal that he trusts the listener the teller invites return trust. Even a joke might serve as a trust-building device. Sudden genuine laughter is written on our faces by muscles over which we lack full self-control. The counterfeit laugh, produced for purely strategic purposes, is a pale imitation, and easy to distinguish from true laughter.²⁸

Union strategies

In union strategies the promisor's incentive to defect is addressed by aligning his interests more closely with those of the promisee, in the manner of medieval princes who sealed a treaty with a marriage. A more modern example would be the buyers and sellers who transform their relationship into a joint venture in which they share project profits. At the limit, the parties might merge. For example, General Motors purchased one of its suppliers, the Fisher car design business ("Body by Fisher"), after the latter hectored GM with demands for opportunistic contract renegotiations at a time when GM was hard pressed to refuse.²⁹ After the merger, the costs of supplier opportunism disappeared.

Family enterprises are another example of a union strategy, since families enjoy significant bargaining advantages over more impersonal businesses. At one time it was feared that family farms would be replaced by "agribusiness," the free market version of the collective farm. However, farming requires an extraordinary degree of loyalty at crucial times, such as when the harvest must be brought in and everyone must work very long hours. Shirking at this time could mean the loss of millions of dollars if the crops might be lost to a frost. Few employees can be trusted in these circumstances, but with family it is different. Therefore, the family farm remains the most common farming organization – even if the optimum size of the farm has greatly increased because of technological improvements and the number of farms has declined.

Non-contractual bonding

The final substitute for contract remedies is *bonding* or hands-tying.³⁰ Here, the promisor narrows the range of his future options by making it more difficult or expensive to breach. As Jon Elster has noted,³¹ the self-binding promisor is like Ulysses, who wished to hear the song the Sirens sing. The difficulty was that everyone who heard the song was so enchanted that they sailed right up to the Sirens and perished on the reefs. Ulysses solved the problem with the first example of hands-tying. He ordered his

crew to lash him to the mast and to stop up their ears with wax. As they rowed past, he heard the music but they didn't. They also didn't hear his pleas to be untied so he could direct them to the rocks. So they rowed safely on.

By binding himself in the first period, Ulysses was able to exploit an opportunity in the second. This is just what promisors would want to do, by removing the possibility of a future breach so as to induce promises to rely. Like Ulysses, the promisor seeks to restrict his future freedom of action in order to take up an opportunity. And, like Ulysses, he might have to bind his hands through non-contractual means where a contract cannot be written. One extreme example was the exchange of hostages through which medieval princes sometimes sealed their treaties, with the grimmest of sanctions levied against promise-breakers.³² In our day, promisors might adopt similar if less painful reassurance techniques, making default more painful by offering promisees a bond against default. For example, borrowers might physically transfer consumer goods to lenders as a pledge. Alternatively, borrowers might retain possession of business assets but give the lender the right to step in and seize them on default. This is often a powerful signal of the borrower's credit-worthiness, as default would put him into bankruptcy.

Since all these substitutes are available, are the institutions of contract law less important than has been thought? The classic conception of contract law has quite properly been faulted for failing to take account of the ways in which parties might cooperate without formal agreements.³³ But, as bargainers still employ contractual reassurance techniques, bargaining substitutes have manifestly failed to take the place of contract law, and this for three reasons.

First, the substitutes might be costlier than contracting. Piece-work contracting sacrifices the beneficial reliance that a long-term contract might elicit when one party is asked to make a major preliminary investment in the project. And the business mergers of a union strategy might sacrifice the efficiencies associated with deconglomeration and result in a bloated firm. Similarly, extra-contractual bonding strategies might require a party to leave productive assets unused.

Second, substitutes for contract law might simply be unavailable in a wide range of bargaining circumstances. For example, the parties might be too geographically dispersed for relationships of trust to arise without contract law. Alternatively, they might be strangers with no basis for a reputational ranking.

Third, habits of mistrust might be too deep-seated to foster beneficial reliance without the external sanction of contract law enforcement. The kind of pre-contractual society where promisors must fall back on their families was described by Edward C. Banfield in *The Moral Basis of a Backward Society*. Banfield wrote of a society so riddled with envy – an Italian town he called "Montegrano" – that any form of economic progress

was unthinkable. The Montegrane thought that every politician was on the take, that every priest was corrupt, that every employer cheated his employees. Only the most basic forms of economic cooperation, within the circle of the family, were possible.³⁴

For such societies, contract law and an honest and independent judiciary to enforce contracts, are critical to economic development. Contracts make possible economic cooperation across families, clans and ethnic groups. They permit the stranger, the immigrant, the member of an outcast tribe, to burst the bounds of prejudice and form new ties with others. Free contracting produces a more diverse society, and also a wealthier one.

Summary

The institutions of promising and contract law permit promisors to commit credibly to perform their promises. This promotes promisee reliance and permits both parties to share in the contractual surplus. There are other techniques of promisee reassurance, but none that can take the place of contract law.

4 Fidelity to promising

We have obligations to mankind at large, which are not in consequence of any special voluntary pact.

Edmund Burke

Unlike rival theories, the economic account of contract law rests on a conception of promising as an institution, and it alone explains why the institution is desirable. By invoking the institution we persuade others to rely on our promises and enter into joint projects with us. But economic explanations are incomplete if they cannot tell us why promisors ought to respect promissory institutions. What is needed is a connecting factor that links promisors to promising and explains why, having invoked it, they cannot walk away from the institution.

While reliance, benefits and will theories cannot explain why promissory institutions should exist, they might nevertheless be thought to suggest a connecting factor that yokes us to it. If the institution is already a feature of our society, might some form of the reliance, benefits or will theories account for personal duties to adhere to its rules? In the end, however, theories that do not concede the institution's value cannot supply the fidelity requirement that obliges us to support it.

Respect, gratitude and consent

For each of the three rival theories of promising, there is a closely related connecting factor that links an individual to the institution. For reliance theories, there is a requirement of *respect* owed to the institutions with which one comes in contact; for benefits theories, there is a debt of *gratitude*; and for will theories there is obligation to comply with the rules of institutions to which one has *consented*.

Respect, gratitude and consent theories do not assume that promissory institutions are valuable and cannot explain why they ought to exist. The indifference of such theories to the economist's beneficial reliance would seem enough to condemn them. In one respect, however, they are more