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The Puzzling Underuse of Arbitration in Post-Communism – A Law and Economics Analysis

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Abstract

The paper attempts to explain the failure of postcommunist traders exemplified by Balkan traders to make use of arbitration courts by means of the rational choice of forum approach offered by the law and economics movement. Conjectures about traders' behaviour derived by combining this approach with the constraints set by institutional features of Balkan countries, in particular Bulgaria and Croatia, are confronted with experience. As it turns out the successes yielded by the rational choice of forum approach are very limited. This may be a dissapointment to its most fervent advocates, but is nevertheless useful, because it suggests a more flexible approach.

JEL classification: K19, K41, P37
Key words: arbitration awards, court congestion, favoritism, appeals process, lawmaking

Zusammenfassung

„Warum sind die Dienste postkommunistischer Schiedsgerichte kaum gefragt? Eine ökonomische Analyse."

In dem Aufsatz wird der Versuch unternommen, die geringe Neigung der Kaufleute der postkommunistischen Länder, ihre Streitigkeiten durch Schiedsgerichte entscheiden zu lassen, mit Hilfe eines theoretischen Instrumentariums zu erklären, das der ökonomischen Analyse des Rechts entstammt. Diese hat sich mit der Frage befasst, unter welchen Umständen Konfliktparteien ein bestimmtes Forum für die Konfliktaustragung gegenüber anderen vorziehen. Die Anwendung dieser Ansätze auf die institutionellen Gegebenheiten bestimmter Balkanländer, insbesondere Bulgarien und Kroatien, führt zu Hypothesen, die einer empirischen Überprüfung zugänglich sind, dabei aber nicht sonderlich gut abschneiden. Dieses Ergebnis legt eine Erweiterung des Forschungsansatzes nahe.

JEL-Klassifikation: K19, K41, P37
Schlagworte: Schiedsspruch, Verfahrensdauer, Parteilichkeit, Berufungsverfahren, Rechtsfortbildung

1. Introduction

Contrary to a wide-spread view private action has been the predominating mode of law enforcement throughout most of human history. Pervasive government involvement in law enforcement is a rather recent phenomenon. Moreover, private lawmaking has played a significant role for the development of the European merchant classes. It is well known that for several centuries *lex mercatoria* developed mostly outside the sphere of public legislation and law enforcement, it was enforced by private courts, reputational concerns and ostracism[1]. These private (or semiprivate[2]) courts were the historical predecessors of modern arbitration courts. The adoption of the rules of *lex mercatoria* by state courts was a gradual process which extended over a long time. In England it started in the fourteenth century but was completed only in the nineteenth century. Merchants who failed to comply with the rulings of merchant courts found themselves cut off from valuable business opportunities because honorable traders often learned about their misbehaviour and refused to deal with them. Arbitration has been a wide-spread means of dispute settlement even though in most nations it was only in the second half of the nineteenth century that arbitral awards started to be enforced by state courts[3]. English and American state courts often were hostile towards arbitration. It was only in the early nineteenth century, a time of increasing court congestion, that they discontinued a long-standing practice of voiding arbitration clauses. As Benson (1990, p. 224f., 1995, p. 481f.) notes this hostile attitude certainly hampered the development of arbitration but failed to drive it out of the market. This was because reputational concerns were a powerful disciplinary devise which provided for a role of arbitration even after the fading and abolishment of guilds made it more difficult to organize a boycott.

Contrasting this historical account with postcommunist experience, as for example Southeastern European experience, several differences appear as striking[4]. Arbitration courts do exist in most of Southeastern Europe but they are used infrequently. In Bulgaria, in which arbitration is more popular than in most other Balkan countries, the available data published by the two largest arbitration institutions suggest that the number of disputes settled by arbitration has so far been in the range of only a few hundred per year. In Romania activity seems to be in a similar range. The leading Romanian arbitration institution reported 351

[1] On the enforcement of *lex mercatoria* see Greif, Milgrom and Weingast (1994).
[2] „Semiprivate“ was maybe more appropriate if the court was located in a city which was effectively ruled by a merchants' guild.
[3] See Benson (1995).
[4] In Eastern Europe and the CIS matters are not much different.

awards in 2004[5]. This is a multiple of the arbitral awards recorded e.g. in Croatia or in some East Central European countries like e.g. Slovakia. The average number of arbitration awards rendered by the key arbitration institution in Croatia was only ten per year in between 1992 and 1999[6]. Nevertheless Croatia claims to be the leader in the region. If region means "Western Balkan" this may be true. Comparing these figures with the overall number of commercial disputes abjudicated by state courts it is obvious that the market share of arbitration has been less than one percent. Clearly arbitration has been of minor relevance even though in most if not all of Southeastern Europe arbitration awards are enforced by state courts. To be sure, enforcement by state courts is not worth much, their enforcement machinery is weak and tedious. However, in most Western countries arbitration awards were not enforced by government at all until the second half of the nineteenth century, but arbitration worked nevertheless and was widely used. In contrast to Western countries, the Southeastern European disregard for arbitration tribunals is not due to the superior quality of the services provided by their major competitors, the state courts. Elsewhere, e.g. comparing Germany and the USA, the market share of arbitration appears to be strongly contingent on the price and quality of the services provided by state courts. In Germany arbitration is much less popular than in the USA[7]; at least part of this difference may be due to the fact that German state courts abjudicate commercial suits more quickly than courts in numerous US states and that the costs which litigants need to bear tend to be lower in Germany as well. However, the services of Balkan judiciaries are for sure much worse than those of all US judiciaries, the slowness, unreliability and inefficiency of Balkan state courts is common knowledge. Historically as well as in the present, such deficiencies have often stimulated the growth of arbitration, but in post-communism this has so far failed to happen. Thus we are faced with a puzzle.

The paper explores only those potential resolutions for this puzzle which are in the realm of rational choice analysis. There may be other reasons as well, disregard for arbitration may be rooted e.g. in the attitudes, beliefs or prevailing self-image of the emerging class of traders but the paper will not try to analyze them. After confronting conjectures derived from rational choice analysis with experience, the paper stops with concluding that alternative

[5] These data are found on the internet pages of the respective Bulgarian and Romanian institutions.
[6] See Uzelac (1999, p. 67). Because this court does not publish any data observers depend on occasional reports by Croatian scholars.
[7] For some data indicating the limited relevance of arbitration in Germany see Lachmann (2002, p. 30).

"sociological" approaches deserve to be taken seriously. The latter have been occasionally mentioned in the literature, e.g. in his discussion of postcommunist arbitration already Triva (1991, p. 24, translation by B.S.) stressed that socialism fostered a culture of irresponsibility and dishonesty and proposed that this explains disinterest in arbitration. "Those compatriots of us who have been appointed as managers of companies continue to believe strongly that adroitness in outsmarting and overcharging one's businesspartners is the key to success. This conviction is reinforced by the continuous experience that they are not held responsible for their misbehaviour..."[8]. In Triva's view a predisposition to dishonesty implies that businessmen care little about fair and lawful dispute resolution and cultivating trust. In the rest of this paper this "sociological" view of the lacking demand for arbitration services will be referred to as the Triva-conjecture. For the student of Eastern European economic history the Triva-conjecture has a familiar ring. Historical examples suggest that the attitudes emphasized by Triva do not always lend themselves to rapid change. E.g. Pipes (1990, p. 205) reports that the Russian merchant class abandoned its traditional "Levantine" traits only towards the end of the nineteenth century, much later than the Russian nobility[9].

Most of the attempts at resolving the puzzle which are discussed in the paper are in the spirit of the standard economic analysis of judicial systems pioneered by Posner (2003) and Shavell (1995a, b). As so often in the economic analysis of law the basic ideas have been known to legal scholars long ago, but Posner and Shavell organized them in a more systematic way.

2. Attempts at Resolving the Puzzle

2.1 Lack of Knowledge

It has been suggested that few traders are aware of the opportunities offered by arbitration courts[10]. During communism arbitration proper did not exist except in foreign trade, it was outlawed, although its reintroduction was advocated occasionally, this occured e.g. in Bulgaria[11] and in Yugoslavia. In Yugoslavia some courts purporting to offer arbitration services for domestic disputes actually were set up in the sixties, but effectively they remained, as Dika (1999, p. 36) put it, "parastatal" until the disintegration of the Communist

[8] For an early analysis of how Yugoslav socialism promoted such attitudes see e.g. Lydall (1986).
[9] He traces these "Levantine" traits to the insecurity of property rights. It was only in the eighteenth century, that government started to respect merchant's property rights, up to then they "had to conceal their wealth" (op. cit. p. 217).
[10] See e.g. Dika (1998).

Party in the late eighties. According to some sources, the arbitration court of Zagreb in actual fact may have been sort of an exception because the Communist Party rarely or never took an influence on its decisions. However, it had not much to decide. Anywhere else arbitration proper was a new and unfamiliar concept in postcommunism[12]. The requirement that traders need to have proper knowledge about arbitration because in the absence of this knowledge dispute resolution by arbitration cannot acquire much relevance, is more demanding than it may seem. This is because arbitration tends to be used primarily if it is considered already in the very moment in which traders conclude a contract. The contract needs to contain an arbitration clause and this arbitration clause must fulfill certain requirements to be valid and effective, e.g. it needs to specify a workable procedure for the selection of an arbiter. Thinking about arbitration later, after the conclusion of the contract, is likely to be too late. If the dispute has already arisen one side to the dispute often is unready to agree to arbitration because it expects to be the loser. As a result it will usually prefer state courts, because state courts are slow and dragging matters out often appears as desirable to the likely loser. So, arbitration will play a real role only if considerable numbers of traders have become used to pondering about potential legal controversies at the very moment in which they are soliciting business. In the early nineties this sort of legal thinking presumably was far from their mind. However, it is less obvious that fifteen years later those whose business survived have not yet learnt from experience. And simply assuming persistence of plain ignorance over more than a decade is certainly not in line with the beliefs held by theorists who think of private enterprise as a creature which tends to adjust quickly to all new circumstances and opportunities offered.

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[11] See e.g. Brajkov (1976).

[12] Communist governments installed various sorts of allegedly non-governmental tribunals, among them were the *sudi udruženog rada* (courts of united labor) in Yugoslavia or the *drugarskite sădilišta* (comrade courts) in Bulgaria. After 1974 Yugoslav arbitration courts were conceived as a subspecies of *sudi udruženog rada*. These tribunals were directed by the communist party and were dubbed nongovernmental only because of the fiction that the communist party was not part of government. In actual fact the party instead was at the very heart of government. These tribunals thus do not disprove the proposition, that under communism law was thought of as the exclusive domain of government and the communist party. For an analysis see e.g. Bender and Falk (1999). The proposition that the Zagreb arbitration court actually was rather independent is due to Uzelac (1998).

2.2 The Shortage of Lawyers and of Adequate Legal Advice

The missing explanation or at least part of it may be supplied by the shortage of lawyers resp. the shortage of sufficiently competent lawyers[13]. In most Balkan countries except Yugoslavia the number of law students and jurists was sharply reduced under communist rule. As a result early postcommunism featured a huge excess demand for lawyers. Unfamiliar concepts like arbitration are likely to be advertised by lawyers to the extent necessary to make them popular only if they need to solicit additional business. If lawyers become too numerous to earn their living by representing their clients in state courts they tend to react by diversification, they expand into consulting and open up other lines of business which create additional demand for their services, among these other lines is dispute resolution by arbitration. As soon as this occurs knowledge about arbitration is likely to become more widely disseminated[14].

However, doubts remain whether this is really the decisive factor which explains the slow spread of arbitration in the postcommunist Balkans. Most of post-Yugoslavia has not suffered from a shortage of lawyers. Nevertheless, arbitration courts have not become popular in post-Yugoslav countries either. A variant of the argument just presented might be thought of as solving the puzzle. While in purely quantitative terms post-Yugoslavia does not feature an excess demand for lawyers, in terms of quality it does. As Triva (2001, p. 30) indicates these quality deficiencies have been remarkably persistent. Post-Yugoslav countries continue to suffer from a shortage of competent lawyers in whom traders are ready to trust. If clients tend to distrust their lawyers, arbitration may be inferior to litigation. In state courts a decision can be appealed against, in arbitration it cannot. If somebody litigates at a state court and his lawyer turns out to be incompetent or unreliable, he can exchange him after his first failure and go to the appellate court, i.e. he effectively has a second chance. In arbitration the first try usually is the last. This conjecture may appear as plausible until we come to realize that in some post-Yugoslav countries, in particular in Serbia, a substantial number of entrepreneurs and top-managers do have a legal education themselves and thus may be expected to be sufficiently competent to make an informed choice of their lawyer[15].

[13] For this argument see e.g. Triva (1991, p. 20).
[14] However, notice that the historical development of merchant law did not depend on lawyers. In those times merchants were rarely represented by lawyers.
[15] See *Ekonomist magazin* 259, 5.5.2005, p. 24 which reports that Serbian top managers usually have university degrees, mostly either in economics or law.

2.3 Distrust in Arbiters

It is a well-known fact that on the Balkan penninsula arbitration tribunals often are distrusted. However, state courts are distrusted as well. Distrust is due to two reasons. Traders perceive courts as potentially biased and as incompetent. It turns out as useful to distinguish two kinds incompetence, factual incompetence and legal incompetence. Factual incompetence concerns the lack of ability of the court to recognize and appreciate the facts which are relevant for the case and resist attempts of litigants to stir confusion. Legal competence concerns the ability of the court to apply the law correctly to the facts i.e., to dispense justice.

The major reason to perceive courts as prone to favoritism is the suspicion that they might be influenced by bribes, connections or political pressure. In real life this is a major reason to avoid courts altogether, but it is less obvious that it affects the division of the dispute resolution market between arbitration courts and state courts. It may seem that distrust should reduce the market share of arbitration only if arbiters were distrusted more than state courts judges. However, there is no indication that this holds in any of the Southeastern European countries. Most of these countries have several arbitration courts, thus, litigants have a choice and may select arbiters who appear as comparatively trustworthy. If none of them is trustworthy they may opt for ad hoc arbitration i.e. the arbitration clause may specify a procedure to select a particular trustworthy person and appoint it as arbiter for the particular dispute in question. It is worth noting that arbiters are likely to be less susceptible to political pressure than judges at state courts[16]. Arbiters often are wealthy and reputable lawyers who as a result of their private wealth may be less dependent on politicians than judges. Judges at state courts are badly salaried and in many respects dependent both on the chairmen of their courts and the bureaucrats who are in charge of managing the judiciary. These bureaucrats often pursue a political agenda and entertain a broad variety of connections.

Thus, if favoritism is the concern, arbitration appears to come out ahead of state courts[17]. Nevertheless, even though the possibility to choose an arbiter has value, it fails to provide a complete solution to the problem of bias. In Balkan countries clientelistic networks are perceived as pervasive, as a result one can never be quite sure who is involved with whom.

[16] Balkan judiciaries differ substantially with regard to the independence from political pressure which they enjoy. Bulgarian and Croatian courts are rather independent, while Albania, Crno Gore and Serbia mark the opposite end of the spectrum. These differences will be neglected in this paper.
[17] This issue is reconsidered in the next section.

If the small market share of arbitration in the dispute resolution market does not seem explainable by perceived favoritism, how about perceived incompetence ? Perceived incompetence presumably is the predominant reason why all sorts of legal dispute resolution mechanisms are distrusted. Under communism the legal professions were downgraded, except prosecutors legal professionals had little prestige. They were thought of as low-grade academics, similar to economists, and much inferior to engineers, who were viewed as the elite group[18]. Such misperceptions of legal professionals and the resulting distrust are reinforced by the deficiencies of academic legal education which often has changed only to a minor extent. Moreover, perceived incompetence of courts is also nurtured by the rarity of lateral entry into the judiciary. Young legal professionals tend to have a poor understanding of business matters. When they age and mature their understanding improves, they learn by experience and they need to if they practice as commercial lawyers. If instead they enter a judicial career at young age as is so typical for the career judiciaries found in Southeastern Europe, this process of maturing may be slowed down.

Does perceived incompetence affect the market share of arbitration ? Arbiters usually are reputable and experienced lawyers, viewing them as incompetent is a bit farfetched. To be sure, if arbitration courts would become busy they would need to delegate much of their workload to young unexperienced lawyers for the plain reason that experienced lawyers are in short supply, but so far this has not occured yet. Moreover, in arbitration traders are able to select the arbiter and are thus in a position to make sure that he is a competent person. In state courts litigants cannot influence the allocation of cases to judges, at least not by legal means. In summary, it seems that concerns about competence should drive up the market share of arbitration rather than reduce it.

[18] This perception also was held in Yugoslavia. On this see e.g. Triva (1991, p. 23). Really it always was inadequate, from his personal East German experience the author of this paper is under the impression that most of the legal professionals educated under the communist regime were by far not as stupid as engineers believe, the superiority of engineers was more a matter of arrogance than a reality. However, the perception was there and it still exerts quite an impact.

2.4 The Missing Appeals Process

One potential reason why the missing appeals process may hamper the development of arbitration has already been noted in section 1.2.. In arbitration usually there is no right to appeal except if certain major failures like violating basic principles of due process or *ordre publique* have occured. If this happens the arbitral award may be appealed at a state court. Of course, as a matter of principle, traders willing to choose arbitration can decide differently. If they wish to have an appeals option statute law often[19] does not hinder them from providing for it. All they need to do is specifying the arbitration clause accordingly.

A first reason offered in the literature[20] why arbitration clauses rarely provide for an appeals process is that arbiters are usually selected for their expertise. This renders error less likely than in state courts and, consequently, reduces the value of the appeals process. This value largely depends on the need to correct for errors made at the first instance and on the ability of the appellate court to identify and correct them. For more on the latter see *infra*.

Second, it is argued that arbiters have strong incentives to avoid error because error may damage their reputation and thus their ability to attract future business. As a result, the likelihood of error at the arbitration court is further reduced. Once more the argument applies that the lower the likelihood of error at the first instance the less the need for and the utility of an appeals process. However, notice that this reputation mechanism depends on prerequisites which cannot be taken for granted in postcommunism. In particular, it presumes that disputants resp. their lawyers are capable of recognizing error. If it is not properly recognized commiting an error is less likely to impair the arbiter's reputation and he has less of a reason to avoid it. In postcommunism, legal (as opposed to factual) error often is difficult to recognize because the law is not sufficiently clear. As Shavell (1995, p. 413) put it the concept of legal error is "clear when the law is well articulated ... otherwise error is not a well-defined concept." Postcommunist law often is obscure, this obscurity is, to quite some extent, due to the fact that much of it is new law. Hamilton (1788 as quoted in Voigt 2003 p. 33) put it succinctly: "All new laws, though penned with the greatest technical skill and passed on the fullest and most mature deliberation, are considered as more or less obscure and equivocal, until their meaning be liquidated and ascertained by a series of particular discussions and abjudications." To make matters worse, postcommunist law often fails to be "penned with the greatest technical skill". As Landes and Posner (1979) observed, arbitration

[19] E.g. the Croatian arbitration statute offers this opportunity.
[20] See e.g. Shavell (1995a).

occurs mostly in fields in which legal error is largely irrelevant, because the law is clear[21]. A reason for this presumably is that in the absence of a well-articulated law the reputation mechanism is less efficient in disciplining arbiters and it may even fail to work altogether[22].

Third, an appeals process is less useful in arbitration because it is more difficult and costly to recognize and correct error. This is because in many countries arbitration courts do not issue opinions and because their procedure often is rather informal and relies heavily on the expertise of the arbiter. As a result a reviewer, in particular a reviewer who does not share the particular expertise of the arbiter, may find it difficult to spot an error when reading the records of the tribunals' proceedings and he may have to engage in an extensive reconsideration and additional fact finding. This renders the appeals process more costly and makes error at the appellate court more likely, reducing the value of the appeals process. Of course, arbiters often write down some reasons for their decisions but the purpose of this document is making their decision more acceptable to the disputants[23]. The disputants usually are not concerned about the substantive legal questions which their dispute raises, and as a consequence arbiters do not see a need to discuss them. In accordance with this conjecture Bernstein's (1992 p. 127, 150) study of arbitration in the diamond industry finds that "in complex cases ... it is difficult to determine what substantive rules of decisions are applied" and that, as a result, "in complex cases ... diamond industry arbitration suffers from the same weakness as most commercial arbitration: unpredictability."[24] As Landes and Posner (1979) point out issuing an opinion proper which exposes the substantive rules underlying the decision and presents a well articulated legal argument is like producing a public good. If published, this opinion renders utility to various nonparticipants and even to the public at large. They can learn from it about the legal problems which the dispute raised, and how these problems may be resolved, it thus contributes to development of law. Unless they are required to, for-profits such as arbitration courts are unready to produce public goods except if they

[21] This claim may be somewhat overstated. As the historical *lex mercatoria* demonstrates arbitration has not always been unfit for lawmaking. Sometimes contemporary arbitration courts engage in precedence production as well, as it seems this is relevant mostly for courts established by trade associations of certain industries. E.g. in the Netherlands most disputes relating to construction works are decided by an arbitration court established by the trade association of the construction industry. This court produces precedents on a substantial scale, many of its opinions are published. The same happens in quite a number of other Dutch industries. The presumable reason for this behaviour is that the relevant trade associations chose to require it. For more on this see Blankenburg (1995).

[22] Evidence for this proposition may be found in Western arbitration systems as well. Bernstein (1992, p. 127) reports about the arbitrators of the diamond trade association, that „many traders feel that the arbitrators have redistributive instincts; they cite the unpredictability of the decisions as well as the arbitrations' tendency 'to split the difference' as an important motivation to settle their disputes on their own." This is because the rules of decision applied are less than clear, in particular „there are no general rules of damages."

[23] In some countries like e.g. Germany arbiters are required to issue sort of an opinion, but the standards applied to its quality are much less exacting than at state courts. See e.g. Lachmann (2002, p. 347).

[24] Bernstein is not alone in making such claims, see e.g. Lachmann (2002, p. 52).

happen to be joint products of their core activities, whose production does not cause substantial additional costs. However, it does. Writing a high-quality opinion is a time-consuming task which most jurists tend to dislike[25]. In addition, postcommunist judges and arbiters are not used to writing sensible opinions, it tends to be a difficult job for them, their writings frequently are of very mediocre quality and more often than not fail to spell out a perceptable legal argument[26]. In most post-communist countries law schools do not prepare their students for this aspect of their future jobs[27]. Thus, jurists usually write opinions only if they are required as they are in state courts. There are a few exceptions to this rule, e.g. some Bulgarian arbiters write and publish opinions, presumably in order to advertise their outstanding level of competence[28]. While this marketing strategy may be effective, it is also very costly, cheaper alternatives are often available. Thus, opinion-writing it is not likely to become popular among arbiters[29]. As Bernstein (1992, p. 150) points out, another reason why arbiters often do not issue (high-quality) opinions is the disputant's desire for rapid dispute resolution. Informality and reliance on the arbiter's intuitive understanding render the procedure less time-consuming.

In view of these obstacles against a meaningful review of arbitral awards an alternative technology to reduce the likelihood of error is superior, this is decision by a panel of arbiters rather than by a single arbiter. This argument has been made rigorous by Shavell (1995a) who compares the appeals process with decision by panel, he conceptualizes them as alternative technologies of error avoidance. He demonstrates that the appeals process is superior to a no-appeal decision by panel only if the decision of the first instance lends itself to a meaningful review[30].

In summary an appeals process for arbitral awards makes less sense than an appeals process for state court decisions. However, forgoing the option of an appeals process may seem like a reason to avoid arbitration if litigants, although maybe mistakenly, tend to

[25] As is evidenced by the observation that when American judges became busy writing opinions was one of the first tasks which they delegated to their law clerks. German judges and arbiters are no different. While in German state courts judges are effectively required to write their opinions themselves, in arbitration opinion-writing is often delegated to employees of the arbiter. See Lachmann (2002, p. 693).

[26] For illuminating insights on this see Schröder (2003).

[27] Exams tend to be taken orally, law students are rarely required to solve a case in a written exam. Law students do not discuss actual cases in class, legal education still boils down to memorizing statutes.

[28] The Bulgarian law journal Tŭrgovsko pravo regularly features a column Arbitražna praktika which contains excerpts of opinions written at one of the two major Bulgarian arbitration courts.

[29] It might be thought that this problem can be circumvented by a contractual requirement on arbiters to imitate the procedure of state courts including opinion writing. This drives up the costs of arbitration, are traders really ready to pay for that ? Moreover, who is going to decide whether the arbiter has really fulfilled this requirement and how will nonfulfillment be sanctioned ?

[30] Intuitively, his argument may be represented as follows: If appeals courts frequently reverse correct decisions which is the likely outcome if a meaningful review is difficult, correct decions often go to appeal. As a result the appeals process is costly and wasteful.

perceive this option as valuable. The available data on appeal rates may lead one to believe that they indeed do. It is well-known that in most Balkan countries, and similarly in East Central Europe, an amazing number of court decisions goes to appeal, appeal rates are enormous by any standards[31]. An option which is very widely used presumably has value. However, at closer inspection this inference turns out as dubious. A straightforward counterargument is, that appeal may be attractive only for the losing party because it delays matters. The higher the appeals rate the longer the court queue at appellate courts, appeals may amount to mere foot dragging. This abuse of the appeals process for dilatory tactics is no doubt common, and unfortunately it is often facilitated by procedural law which in some Balkan countries allows litigants to reveal evidence only at the appellate court, even though they could have presented it just as well at the trial court. Foot-dragging may be particularly attractive if the defendant can engage in fraudulent conveyance or expects to be judgement proof by the time when the plaintiff has got a final judgement and can initiate enforcement. This is not all a rare occurence. Uzelac (1999, p. 67) proposes that dilatory tactics are employed even if they are not rational and characterizes the prevailing behaviour of Croatian litigants as follows: "... a litigation practice between domestic subjects, in which the process is dragged out as long as possible and the enforcement is delayed by exhausting each and every legal means regardless of chances for success." This implies, that the abuse of the appeals process for dilatory tactics should render arbitration more attractive for honest traders. Signing an arbitration clause means forgoing an option to employ such tactics. As a consequence, refusal to sign an arbitration clause may be perceived as a valuable signal disclosing information about the true intentions of a potential business partner. If the potential partner does not have the serious intention to discharge his contractual duties faithfully he will be hesitant to sign an arbitration clause which deprives him of some opportunities to muster dilatory tactics to protect himself from being held responsible. Thus, the abuse of the appeals process should make arbitration more popular among honest and rational traders. This is however not what we really observe. So, the issue remains: is there a countervailing force which dominates this proarbitration effect ?

As Shavell (1995a) stresses, a crucial function of appellate courts is error correction. Another one, of course, is lawmaking, clarifying and amplifying the law[32]. Arguably this legislative function is their key contribution to social welfare. Since this is about producing a

[31] While in the Balkans we have to rely on estimates, in East Central Europe real statistical data are available. E.g. in the Czech republic some 40 per cent of all judgements go to appeal. See Návrhy (2004). For some estimates on the share of appeals in Bulgaria see Judicial (2003).

[32] The very high appeal rates found in postcommunist nations are actually a hindrance to a proper discharge of these legislative tasks because it creates an excessive workload which tends to debase the quality of the output.

public good, most litigants care little about this sideproduct of their activities. Instead a litigant cares about judicial errors but only if they are to his disfavor. In Shavell‘s model error is conceptualized as an event whose likelihood depends on the amount of time which a judge devotes to deciding a dispute. Devoting more time reduces the error rate. Note that this conception of error is inappropriate for modelling the impact of favoritism. The analysis of favoritism involves a crucial element of strategic interaction. The appeals process may dampen the influence of favoritism on judicial outcome because trial court judges whose decisions indicate blatant favoritism run the risk that this is recognized by the appellate court and that this may e.g. reduce their promotion possibilities. The error-likelihood function proposed by Shavell is not relevant for the „errors“ of a biased judge because he is not really in error, he knows quite well what he is doing and spending more time on the case is unlikely to change his decision.

Since favoritism is so important in the Balkan, our analysis will distinguish between the sort of error which Shavell models and errors caused by favoritism. Shavell-type errors are considered first. As will be shown these errors cannot explain the preference for dispute resolution mechanisms offering an appeals option which we observe in the Balkan penninsula.

The appeals process creates value both for society and for litigants if it reduces the rate of judicial error and if the benefit of this reduction outweighs the additional costs generated by the appeals process. This requires that a mistaken judgement is considerably more likely to be reversed at the appellate court than a correct judgement. If an appeals process is available it however may also be used if this condition is not met. The social usefulness of the appeals process is enhanced if litigants are frequently able to recognize trial court error. In contrast if litigants are mostly unable to distinguish correct and erronous trial court decisions they often will appeal even against correct trial court decisions. The inability of litigants to distinguish correct and erronous decisions results in a flood of appeals which generate costs, but no social value. Moreover, if the probability that a correct decision is reversed on appeal is relatively high, the loser in the trial court may go to appeal even he realizes that the decision of the trial court was correct. These appeals are undesirable as well.

At this point the distinction between the two types of errors introduced in the last section comes in handy. Appellate courts have only limited abilities to correct factual errors. In particular, they do not have the resources nor the time to engage in lengthy factfinding. Consequently, factfinding at the appellate court often is unlikely to generate value for society. For obvious reasons the party who lost at the first instance nevertheless often wants to engage in additional fact-finding. Except under rather special circumstances this should be curbed.

Matters are different with legal errors. Trial courts surely commit large numbers of legal errors. Appellate courts typically have superior legal competence, and are thus likely to correct legal errors. This tends to create social value. The likelihood of legal error is high because, as was noted above, much postcommunist law is new law and thus obscure. However, for the very same reason litigants often find it difficult to distinguish erronous and correct decisions. This drives up the (expected) costs and hence reduces the value of the appeals process for society and similarly for traders who are in the process of negotiating a contract and consider including an arbitration clause and have thus not yet entered a dispute, a situation which will be referred to as ex ante. Judicial overload at the appellate courts also drives up the error rate at the appellate courts, this similarly reduces the ex ante value of the appeals option.

These drawbacks are significant, but presumably not sufficient for definite conclusions about the ex ante value of the appeals process. Two additional considerations however allow for more definite results. This is: Going to appeal may eliminate a legal error, but this is ex ante desirable for traders only if correct is tantamount to efficiency-enhancing. And second, the ability of arbiters to come to a correct decision resembles that of trial courts rather than that of appellate courts. Neither of these two conditions is actually satisfied.

Ex ante, before the dispute arises, rational traders care about efficiency in the Kaldor-Hicks-sense posited in the law and economics literature. I.e., ex ante traders prefer that potential disputes are resolved in a way which maximizes the expected value of their business relationship. Ex post, after the dispute has arisen, they often do not care about this, but the ex ante view is relevant for the decision to sign an arbitration clause. Posner (2003) argues at great length that the key doctrines of common law are roughly in line with this efficiency requirement and seems inclined to extend this claim to Roman law as well. To the extent that the basics of Southeast European substantive civil and commercial law rest in Roman law it may be in accordance with efficiency, but the actual interpretation of this law by appellate courts often is not[33]. Consequently, it is conceivable that the judgements of arbitration courts outcompete state courts by being more in line with the efficiency requirement than the rulings of appellate courts. This would be greatly facilitated if Southern European arbitration statutes were to provide traders with a choice of substantive law. Then they could choose a law which is more in line with the efficiency requirement. Unfortunately, even the most liberal arbitration statute of the region, the Croatian one, bars such a choice of law except if

[33] An obvious example of deviation from the efficiency requirement is the tendency of postcommunist courts to underestimate damages.

foreigners are among the disputants[34]. In this regard Southeastern European arbitration statutes are notably less liberal than e.g. German arbitration law or the resp. laws of Anglosaxon countries. The Croatian statute, however, allows traders to opt for a decision *ex aequo et bono*. The precise meaning of this phrase has never been clarified, according to a prominent Croatian arbiter serving at the Zagreb arbitration court it simply means that the arbiter has to respect the basics of Croatian law but may disregard the details[35]. As a matter of principle, this provides arbiters with some leeway to make efficiency-enhancing decisions and thus an opportunity to outcompete state courts. Even in countries which as a matter of principle do not allow decision *ex aequo et bono* arbiters in actual fact have such opportunities as well because the case law of appellate courts often lacks coherence and because arbiters are not required to reveal the substantive rules underlying their decision. Triva (1991, p. 19, translation by B.S.) put it like this: "Even in countries whose statute law disallows rulings ex aequo et bono arbiters can nevertheless do it, this is in particular ... because they are not required to rationalize their decisions which effectively renders a judicial review ... impossible."[36]

Concerning the second consideration, arbitration courts similarly may achieve superiority. As was argued already in section 1.3., it is not difficult to find an arbiter who is less likely to commit a legal error than the run-of-the-mill state court judge for the simple reason that the latter often are underspecialized and required to handle a broad variety of cases.

To sum up, the unpopularity of arbitration is not explainable by the ability of appellate courts to correct for legal error. Thus, if the missing appeals process is a major obstacle to the development of arbitration this must be due to another reason. The only remaining candidate is the ability of appellate courts to curb favoritism at the trial court. Above it was argued that in postcommunism the reputation mechanism fails to discipline arbiters to a sufficient extent, and thus offers no adequate substitute for supervision. Consequently, the ability of appellate courts to curb favoritism may be an advantage of state courts. Presumably, this holds in particular, if the following four conditions are met: First, favoritism is perceived as widespread. This clearly holds in the Balkan penninsula. Second, favoritism is at least among jurists considered as sort of an evil, although maybe a necessary evil. If this condition is not

[34] The same holds for Bulgarian law which otherwise is fairly liberal as well. See Stalev (2001, p. 673).
[35] See Sikirić (1995, p. 130).
[36] At least Germany, text books on arbitration law typically warn against authorizing arbiters to rule *ex aequo et bono* arguing that such decisions are nearly totally unpredictable. See e. g. Schütze (1998, p. 95). To be sure, invoking a well articulated and efficiency enhancing law is a superior choice. However, since Southeastern European traders are not allowed to do that the uncertainty involved in ex aequo et bono may be a minor evil compared to the inefficiencies caused by the case law of state courts.

fulfilled appellate court judges are unlikely to sanction trial court favoritism. However, it seems to be fulfilled by and large. Third, a trial court judge whose behaviour reveals blunt favoritism can be punished for that in some way. It is not necessary that the punishment is immediate or sure, already a nonnegligible likelihood of some disadvantage imposed on him sometimes in the future should suffice to curb favoritism somewhat.

Fourth, favoritism is not due to political pressure which equally hits trial courts and appellate courts. Obviously if the appellate court is exposed to the same political pressure and equally likely to yield to it, the appeals process is useless. If favoritism is however due to reasons other than such political pressure, the appeals process may provide for a curb on favoritism at the trial courts even if appellate judges are similarly prone to favoritism. This holds if appellate court bias is uncorrelated or only weakly correlated with trial court bias.
Appellate court bias may be expected to be largely uncorrelated with trial court bias if relevant connections typically are not connections to formal institutions but connections with individuals and extended families. This means that a plaintiff who manages to instrumentalize a connection to the trial court judge and influence him has to start from scratch and engage in a new connection building effort if it comes to influencing the appellate court judge except in the unlikely case that the latter and the former are members of the same extended family or have roots in the same village. According to the accounts given by anthropolists[37] this condition appears to be met, anthropologists usually describe connections as resulting from networks between individuals, and thus unrelated to formal institutions except the extended family. It is worth noting that anthropologists have gathered much material which suggests that e.g. in Bulgaria favoritism is viewed as pervasive and a necessary evil which nobody can avoid. As a colourful example consider the rather common practice to approach jurists with the request to serve as godparents when a newborn child is to be baptized. This is an effort to extend the extended family into a desirable direction.

Since all of the four conditions seem to be met in quite a number of Balkan countries, it may be inferred that favoritism at lower instance state courts is likely to be more effectively curbed than at arbitration courts. This presumably is an advantage of state courts. However, a possible counterargument resembling an argument presented above needs to be considered. Couldn't favoritism be curbed just as effectively by a panel system ? Arbiters can be required to sit in panels. According to a common argument panels make corruption more difficult. However, in the Balkans this often does not seem to work. Doubts about the ability of panels to curb favoritism may be inferred from observing appellate judges who sit in panels

[37] see e.g. Benovska-Săbkova (2001).

everywhere. It seems that more often than not they endorse a policy of „mind your own business“ and “live and let live”, they effectively delegate the decision to one member of the panel and do not intervene if he displays favoritism[38]. Presumably, this may occur among arbiters as well. In most Balkan countries there is every reason to harbor such suspicions, Croatia is an exception to this rule. The personalities of quite a number of arbiters working at the Zagreb arbitration court strongly suggests that selecting a panel which is uninclined to this “minding your own business”-attitude is perfectly feasible. Consequently, in Croatia the favoritism-curbing ability of the appeals process is unable to explain the unpopularity of arbitration, elsewhere it may.

2.5 Preference for Secrecy

Not only judicial dispute resolution but also arbitration, although to a lesser extent, has the disadvantage that it may result in disclosure of facts which disputants prefer to keep secret. Often they have a lot to hide because the shadow economy continues to be of crucial relevance for their success and much business is partly conducted in the shadow. Because judicial dispute resolution is more likely to result in unwelcome disclosures than arbitration, the desire for secrecy is likely to increase the market share of arbitration in the dispute market. Moreover, within the market for arbitration services the desire for secrecy may be expected to favor ad hoc arbitration over institutional arbitration[39]. In ad hoc arbitration it is easier to keep secrecy. Nevertheless, secrecy is not perfect in ad hoc arbitration either, thus the desire for secrecy implies that the overall dispute resolution market is smaller than it were in an environment of transparent and openly conducted business. This is because the loser in the arbitration court may file a complaint at a state court. Irrespective of whether he has reason to complain or not, the state court will then get access to and look at the files of arbitration, and this may imply that the prosecutor gets access to the files as well. So if traders want to keep secrecy there is some reason to beware of arbitration as well, the competitive advantage created by the more discreet style of arbitration is of limited relevance except if traders trust each other that neither will complain to a state court. The fact that we do not observe a large

[38] See e. g. Schönfelder (2005, p. 77).

[39] Ad hoc arbitration refers to a tribunal created for the purpose of resolving a specific dispute, institutional arbitration refers to the dispute resolution services dispensed by an arbitration court which offers its services to a variety of individuals.

market share of ad hoc arbitration thus does not necessarily imply that the considerations of this section are misguided, it may rather be due to low levels of trust among traders.

2.6 Inadequate Execution

Obviously, the value of judgements both of arbitration and state courts is seriously debased by weak enforcement. Different from the historical law merchant reputational concerns frequently have failed to incentivize Southeastern European traders to comply with judgements which are not credibly supported by the coercive powers of government. This seems to be due to two reason. The first is the short time horizon of many businesses. The highly unstable political, legal and economic environment makes longterm considerations less relevant, it drives up discount rates. Reputational damages are mostly a long term consideration. Moreover, in a highly unstable environment it is very difficult to decide whether failure to fulfill a contract is due to forces which are beyond the control of the business partner or not. Thus a business partner can mask opportunism by invoking force majeure and it may be difficult to disprove this claim. As a result the damage which failure to deliver promises causes to his reputation is less severe. Fortunately, many Balkan countries have witnessed a gradual stabilization which has already made reputational concerns more relevant. Consequently, many observers have noted an improvement of business morals in most of postcommunist Europe. Business morals had reached an all-time low in the early nineties. The betterment observed since then certainly has not yet gone far enough that the capitalist ethos of honesty, industry and thrift has come to the fore, nevertheless, this improvement has been much more pronounced than what can be possibly explained by the typically very moderate upgrading of judicial systems. This has surprised many observers. This surprise in itself has revealed a shortcoming of much research in postcommunist affairs, namely it reveals that these observers have grossly underestimated the potential power of reputation-based self-enforcement mechanisms. What is relevant for the topic of this paper is that the increasing role of reputation-based self-enforcement mechanisms should render arbitration increasingly attractive as well. Failure to comply with an arbitral award may cause damage to the reputation of the loser. Because the future is discounted, the shorter the time until this damage occurs the more powerful the threat of reputational damage, and here arbitration has two advantages over state courts: it tends to be considerably faster and there is no appeals process which drags matters out. This suggests, that the market share of arbitration should be on the rise because traders are no longer as short-sighted as they used to be in the

early nineties. This conjecture is in accordance with the data, but the rise has been very very slow.[40]

3. Some Empirical Evidence

The dearth of reliable empirical information on arbitration is often deplored in the theoretical literature[41]. The analysis of private justice thus amounts to a fairly speculative venture virtually anywhere, but data about postcommunist arbitration are even poorer. To mitigate this problem at least somewhat, a survey was conducted among a selected group of lawyers practising in two major Bulgarian cities, Plovdiv and Varna. Lawyers were thought of as the best available source of information because it is known that on the Balkan penninsula arbiters usually are lawyers by profession. Moreover, in arbitration courts litigants are nearly always represented by lawyers[42]. Lawyers are the primary and often the only source through which businessmen learn about arbitration. Thus, lawyers presumably are more knowledgeable about the obstacles hampering arbitration than any other discernible group.

Among the reasons to select Plovdiv and Varna was that both cities are major centers of commerce, they have witnessed considerable economic growth in recent years, and are among the most prosperous places in Bulgaria and on the Balkan penninsula. In both cities there is a local provider of arbitration services. Local availability of an arbitration court may be expected to stimulate the demand for arbitration. This is because lawyers are hesitant to recommend out-of- town arbiters. It is believed (and not without reason) that lawyers practising in the city in which the court which decides the case is located are in a better position to take influence on its arbiters resp. judges. Bribes and other activities undertaken to influence courts often are intermediated by lawyers who entertain connections to arbiters resp. judges. For this reason, recommending an out-of-town arbitration court may amount to losing clients. If a dispute arises the client is likely to prefer a lawyer practising in the town where the court resides because the latter is likely to have better connections.

As was noted above, Bulgarian arbitration is well-developed by Balkan and even by East Central European standards. Thus, it was conjectured that among the Plovdiv and Varna

[40] To a large extent it has occurred not via growing business at traditional institutions but by setting up new courts which attract some new business. This makes the expansion harder to measure. E.g. in Bulgaria throughout most of the nineties there existed only one arbitration court. Since the late nineties at least three more courts have been set up.

[41] See e.g. Uzelac (1999, p. 56).

[42] This may seem evident to the reader. However, at least historically this often has not been the case in Western Europe.

lawyers there should be more expertise for arbitration than in most other regions of the Balkan. However, even in Plovdiv and Varna a considerable majority of the local lawyer population rarely handles commercial cases and has little first-hand experience with arbitration. An attempt to interview all of the 1012 lawyers registered with the Plovdiv bar association[43] and the 967 lawyers registered with the Varna bar association thus was unlikely to deliver meaningful results. To solve this problem the two interviewers, who were graduated law students[44], took an effort to identify lawyers specialized in commercial cases and ensure their participation. They got hold of 90 such lawyers in Plovdiv and 70 in Varna. To ensure adequate participation of lawyers specializing in commercial cases the interviewers took an effort to visit all of them in person[45]. When they were successful, they conducted a short interview in the course of which a questionaire of only nine questions was filled. As a result a high participation of these expert lawyers was assured[46].

The most clearcut result of the survey is that according to a considerable majority of respondents at most ten per cent and most likely even less of all commercial contracts contain an arbitration clause. Informally, some lawyers voiced the opinion that even in those cases in which an arbitration clause is included in the contract this often is not due to a conscious decision of participants but rather to their using a standard contract form loaded down from the internet or supplied by some consultant. By now, such standard forms more often than not contain an arbitration clause. An overwhelming majority of respondents view ignorance as the primary reason why businessmen fail to consider this issue, most businessmen are not aware of this alternative to state courts. In addition they typically fail to seek legal advice before a dispute arises and thus stay behind a veil of ignorance until it is too late. This indicates that legal illiteracy continues to be the primary reason for the slow development of arbitration.

Compared to legal illiteracy distrust in arbiters is a much less relevant factor. It is well known that all courts are distrusted but only eighteen Plovdiv respondents thought that state courts are more objective and less susceptible than arbitration courts. Most of the Plovdiv respondents thought that in this regard there is little difference between state courts and arbitration courts. Some of the respondents – apparently those who had most first-hand experience with arbiters - were aware of arbiters' superiority in terms of competence but this was not common knowledge among the surveyed lawyer population. Among the more

[43] Not all of them practise in the city of Plovdiv, some instead practice in various smaller towns in the surroundings.
[44] I am grateful to Rositsa Tsvetkova and Temenuga Blagova for doing this work.
[45] Out of the 90 experts identified in Plovdiv only 15 preferred to answer the questions by mail, the others agreed to a personal interview.
[46] It would have been considerably more costly and difficult to implement this procedure in Sofija. This was a reason to prefer Plovdiv and Varna.

sursprising results of the survey was that at Varna distrust in arbitration was much more prevalent than at Plovdiv. The interviewer also learnt about the reason. As was mentioned above laywers recommend local arbiters. When asked about their trust in arbiters respondents tend to have the local arbitration court in mind. In 2002 and 2003 the Varna arbitration court had been attacked by the prosecutor, and as a result it was defunct during the time of the interviews. A defendant who had lost his case at the local arbitration court and was subjected to execution had complained to the prosecutor arguing that the procedure had been conducted in a grossly unfair way. He did not file for setting aside the arbitration award[47] even though Bulgarian law similar to most other countries offers this venue for disputants claiming that arbiters failed to grant due process. The prosecutor initiated several criminal and civil procedures against the arbitration court and its arbiters arguing that they routinely (!) violated basic principles of due process and that the court itself was illegitimate because it had not been set up by "statute". The second reason is clearly spurious because Bulgarian arbitration law requires no more than a civil law contract to set up an arbitration court. The prosecutor ordered a search of the arbitration court, this police action was widely publicized and thus noticed by the local legal community and others. Later the prosecutor took measures to suspend the arbitration court's work. While his actions appeared as strange and of dubious legitimacy to the better informed observers, they did not fail to put a shadow on the arbitration court[48]. 33 of the Varna respondents thought of arbitration courts as less reliable than state courts. The observation that trust in this arbitration court plummeted is suggestive of the shakiness of the foundations on which trust in such institutions rests.

When asked whether they would advise their clients towards arbitration 49 of the 90 Plovdiv respondents said yes and 40 no, in Varna only nineteen of the 70 respondents were ready to advise for arbitration, the other 51 would advise against it, reflecting the local crisis of confidence. Since among all Bulgarian arbitration courts only the Varna court has been involved in a "scandal" the Plovdiv results are presumably more relevant. When asked about the reasons to advise against the arbitration a considerable majority of Varna respondents

[47] Instead he challenged the enforcement decision which the local state court had issued at the request of the judgement creditor because the judgement debtor refused to serve the award. This complaint against the enforcement decision however was turned down by the appellate court.

[48] It is worth noting that the criminal procedures never reached the court room, they were suspended resp. interrupted. The reader may wonder about the role played by the prosecutor. This behaviour is possible only because Bulgaria has not yet broken away from the Soviet tradition of conceiving the prosecutor as a watchdog over „legality" endowed with broad authority and a range of duties extending far beyond investigating and prosecuting criminal violations. This concept puts the prosecutor into competition with courts. Courts and prosecutors effectively have overlapping jurisdiction.

denied that execution of arbitration awards may be more difficult than execution of state court decisions, while 31 of the Plovdiv respondents thought that execution of an arbitration award may be more difficult than execution of a state court decisions. This suggests that concern about execution sometimes may be a reason to stay away from arbitration but it is not the key obstacle. Among both Varna and Plovdiv respondents who would advise against arbitration the key concern rather was that arbitration is a no appeal procedure. 42 Varna respondents and 34 Plovdiv respondents pointed to this. Nearly two thirds of those respondents who tended to advise against arbitration viewed this as the key disadvantage. The questionnaire did not contain a question inquiring into the reasons why the lack of an appeals process is considered a disadvantage. This is actually quite in line with the theoretic analysis suggested above because among Bulgarian legal professionals it is well known that state courts in which judges sit in panels are no less venal than single judges sitting alone. Bulgarian experience thus leads one to believe that panels should not be regarded as an effective brake against favoritism.

Information communicated informally suggests that the appellate courts are viewed not only as institutions of superior legal competence and thus capable of correcting legal error, but also as less susceptible to favoritism except in cases involving fairly high stakes. Appellate judges may be venal but they are not cheap. Local courts and some arbiters are thought of as susceptible to petty bribary. Even trifling presents such as bottle of whisky apparently may exert quite some impact. This seems to be much less common at appellate and supreme courts, there the issue is large-scale corruption. In view of common perceptions of corruption it is worth noting that by far not all judges are venal and that this is widely recognized as well[49].

The conjecture that legal illiteracy among traders remains the key obstacle against the growth of arbitration is supported by some other evidence as well. As noted above traders may prefer ad hoc arbitration over institutional arbitration because they want discretion. Thus, legalizing ad hoc arbitration may be expected to stimulate the development of arbitration. In Croatia ad hoc arbitration between domestic traders was legalized in 2001, much later than in Bulgaria. However, this does not seem to have exerted much of an effect, opportunities for ad hoc arbitration have not been widely used. This is easy to understand if legal illiteracy happens to be wide-spread.

Another factor which has not been mentioned in the above analysis but is believed to have an impact on the use of the arbitration is whether state courts respect arbitration clauses.

[49] For evidence that this is common knowledge see e.g. *Kapital* 30 April 2005 p. 111.

If state courts in particular appellate courts sometimes void arbitration clauses without giving a convincing reason this is said to create doubts about arbitrability and discourage traders from using arbitration. Moreover, it is believed to keep foreign investors away because foreign investors typically do not want to rely on state courts. Neither Bulgaria nor Croatia have been fully reliable in this regard, but the Croatian record has been better[50]. To be sure it has not been impeccable either, state courts have sometimes failed to honour arbitration clauses. In Bulgaria, the judiciary behaved worse and furthered doubts about arbitrability in 1992 and 1997 when it voided arbitration clauses for reasons considered as spurious by authoritative observers[51]. Thus, if doubts about arbitrability are a major factor influencing the development of arbitration, Croatia has performed better than Bulgaria. However, there is no indication that this helped Croatian arbitration to pick up with Bulgaria, it continues to lag behind.

4. Epilogue

The observation of widespread distrust in judges and arbiters suggests an opportunity to conduct a socially useful experiment which may reveal to what extent the market for arbitration services is depressed by perceived favouritism. There exists a straightforward way to solve the problem: Allow traders to use foreign arbitration courts or appoint foreigners as arbiters. E.g. if they contract some business allow them to insert an arbitration clause in the contract which refers to a specified foreign arbitration court. If perceived favouritism is the primary reason to avoid arbitration, legalizing such clauses should result in enough of a superiority of arbitration over state courts that court congestion would be considerably reduced and a major part of contractual disputes transferred to arbitration. Since court congestion is a common complaint in all of Southeastern Europe this should be welcome relief. Moreover, if court congestion declines, court corruption is likely to decline as well, since quite often bribes are primarily speed-money.

Why do arbitration statutes of most Southeastern European countries prohibit or limit market access of foreign arbiters ? A plausible conjecture is that the business interests of

[50] This holds in particular for appellate courts, less so for trial courts. In a widely noticed and fairly scandalous decision the Rijeka commercial court in 2002 voided an arbitration clause agreed upon between an Austrian investor and an influential Croatian businessman, but in 2004 its decision was reversed at the appellate court. For an attempt at a complete overview of earlier Croatian state court decisions concerning motions to set aside arbitration awards see Uzelac (1999).

[51] See Uzelac (1999) and Janevski (1998). The courts' reasoning as reported by Janevski is simply hilarious and strongly suggests favoritism.

domestic lawyers are at stake who want to keep potential competitors out of the market, they want to be the exclusive providers of arbitration services. This conjecture receives some support from the hesitance of most Southeastern European countries to admit foreigners to the domestic bar. This hesistance clearly is motivated by domestic lawyers' business interests. So, if these interests prevail on the bar, it is not surprising that they prevail in arbitration statutes as well. The prevalence of lawyers interests' seems even more plausible if one considers that arbitration statutes are a highly technical legislation on which politicians are not likely to have strong opinions or much knowledge. They will rather leave the drafting of the statute to the experts i.e. to domestic lawyers. Moreover, shutting out foreign arbitration courts also may seem in line with a widely held desire to limit foreign influence.

In contrast to most other Southeastern European countries Croatia conducted the suggested experiment and reformed its arbitration statute in 2001 to the effect that foreigners may now be appointed as arbiters even for domestic disputes. There is no indication that this has significantly increased the demand for arbitration services. That it was possible to break up the monopoly of domestic lawyers' seems explainable by the fact that in Croatia academic jurisprudence has been comparatively developed and influential. Academic scholars are less inclined to protectionism than the average lawyer, they have little reason to fear foreign competition. The advise offered by academic jurists shaped the Croatian reform.

The observation that even this did not cause much change is another dissapointment for our endeavour to rationalize the underuse of arbitration. We have rehearsed all conceivable rational reasons for and against arbitration, but the attempt to corroborate the resulting conjectures by empirical observation has largely failed. The only hypothesis which received a good deal of empirical support was that of plain ignorance. Unfortunately, the observation of continuous ignorance is difficult to reconcile with the rational choice approach towards information gathering favoured by economists. If businessmen fail to learn about such important matters for such a long time this suggests that they do not care to know about them in spite of their importance and that they prefer to avoid lawyers. Thus we are back to the Triva-conjecture. It seems plausible that a traders class inclined to see "buyers and sellers .... as rivals pitted in a contest of wits"[52] is not predisposed to legal thinking. This is not to say that traders are all crooks, they are not and there is indication that virtues like honesty and reliability are increasingly valued by Balkan traders. However, traders do not tend to think about law as an instrument which may help them to control contract opportunism. If the word law comes their mind they do not tend to think of civil law, they think of tax law, building

ordinances, regulations of the employment relationship etc.. They often share the deep-rooted cynicism towards law which is wide-spread in the Balkans, such cynicism is not an attitude conducive to overcoming legal illiteracy. This cynicism is continously reinforced by governments tinkering with public law. Traders might be less distrustful of arbitration if they were to perceive arbitration courts as their courts and thus different from state courts. Such a positive perception might be forthcoming if traders would join trade association and if arbitration courts would be set up by these associations. However, Balkan traders have been slow in organizing. Associations of businessmen of whatever sort typically have few members and do not enjoy much support. Those which exist often represent only a small minority of the business community and are distrusted by the others. The slow growth of arbitration may be related to the delayed development of employers' associations of all sorts which also is the reason for the political weakness of entrepreneurs in the Balkan penninsula. Historically, the development of arbitration often has been promoted by the growth of trade associations. Benson (1990, p. 218) notes e.g. on the reemergence of commercial arbitration in the USA at the end of the nineteenth century: "The main area of rapid redevelopment of commercial arbitration was in the trade associations." This observation suggests that investigating into the reasons why Balkan traders have been slow to organize[53] might be more helpful for understanding the obstacles against the growth of arbitration than the rational choice of forum approach rehearsed in this paper.

These conjectures have at least two further implications. First, they imply that in postcommunism the relation between state courts and arbitration may be different from how it is presented in much of the economic literature on arbitration[54]. This literature tends to view them mostly as substitutes resp. alternatives. However, if many traders are inclined to lawless conduct, state courts and arbitration are more in the nature of complements. Only if state courts succeed in strengthening the respect for law arbitration is likely to prosper.

Second, if ignorance is the key problem more effective advertising may help to increase the demand for arbitration services to quite some extent. Since lawyers are not allowed to engage in agressive advertising this job would be up to the minister of justice. He should welcome the potential relief for a grossly overburdened judiciary. However, so far little has been done to advertise arbitration.

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[52] Pipes (1990, p. 205). For some evidence for the continued prevalence of such attitudes see Želeva (2003, p. 153).
[53] for some observations on that see Želeva op cit. p. 154.
[54] see e.g. Benson (2000).

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