



LUDWIG-  
MAXIMILIANS-  
UNIVERSITÄT  
MÜNCHEN

VOLKSWIRTSCHAFTLICHE FAKULTÄT



# Ekkehart Schlicht: Entitlements and Obligations

Munich Discussion Paper No. 2016-20

Department of Economics  
University of Munich

Volkswirtschaftliche Fakultät  
Ludwig-Maximilians-Universität München

Online at <http://epub.ub.uni-muenchen.de/30956/>

# Entitlements and Obligations\*

Ekkehart Schlicht<sup>†</sup>

## Abstract

Market interactions are brought about by the interplay of entitlements and obligations. Entitlements are rights, as perceived by the individuals. They are subjectively perceived rights that go along with a motivational disposition to defend them. Obligations are the counterparts of entitlements. They refer to claims of others that are subjectively accepted, and go along with a motivational disposition to respect these claims. Very simple transactions must rely on a system of entitlements and obligations. Simple selfishness would not be sufficient to bring them about or sustain them. This is especially true for non-enforceable contracts. The relationship of entitlements and obligations to norms is also discussed.

*Keywords:* claims, contract enforcement, contracts, entitlements, interactions, motivation, norms, obligations, rights

*Journal of Economic Literature* classifications: A12, D01, D03, D86, K11, K12, L14, P14, P48

---

\*This is an electronic reprint of the second chapter of the book *On Custom in the Economy* that has been published in 1998. I thank Oxford University Press for permitting this reprint.

<sup>†</sup>Professor emeritus of economics, Ludwig-Maximilians-Universität Munich, Germany (*schlicht@lmu.de*).

1 A Treacherous Image – 2 The Nature of Entitlements and Obligations – 3 Entitlements, Obligations, and Custom – 4 Entitlements and the Law – 5 Clarity – 6 An Everyday Transaction – 7 Compliance and Moralistic Aggression – 8 Coordination Failures – 9 Norms – 10 Contracting – 11 Non-Enforceable Contracts – 12 Entitlements and Morality – References

## 1 A Treacherous Image

A portrait of society, gathered from surface impressions, may be drawn as follows. There exists a body of legal rules that fixes the framework of social and economic interaction. The law does not determine activity fully, nor does it coordinate everything. It may mandate paying taxes according to a certain schedule, but it does not prescribe what to produce and whom to marry; it only rules out certain types of production and certain marriages.

A prevalent, but deceptive, sequel to these observations runs as follows. Economic processes are governed, within the legal confines, by custom and competition. These are, in the words of John Stuart Mill, “the two determining agencies” in market economies.<sup>1</sup> Some traditional economies may be entirely governed by custom, but in modern economies the forces of competition will erode all kinds of customary arrangements. It is held that the “economic sphere” will eventually be coordinated by competition alone. Modernization will supplant customary arrangements by market processes.

Custom, it is maintained, will not be superseded by the market in all dimensions. Many activities cannot, will not, or ought not to be mediated by the market. The “social sphere” will remain the domain of custom. It comprises diverse areas of social interaction and may be subdivided accordingly. Politics, religion, family patterns, sports, fashion, and others belong to this sphere. While the economic sphere is the domain of economics, the social sphere is the province of the other social and political sciences.

The rough division of fields suggested by this offhand description is deeply entrenched in our society. The academic disciplines dealing with social phenomena are subdivided along these lines: law, economics, and sociology. These disciplines derive their identity from presupposing the division.

---

<sup>1</sup> MILL (1909, ii.iv).

This picture is, however, grossly deceptive. Custom, competition, and the law are not of equal standing. It is misleading to depict them, with Mill, as alternative means to solve problems of economic and social coordination. Market processes build on custom and on the law. The law itself is, to a large extent, shaped by custom and works through similar channels. Custom constitutes, so to speak, the primordial soup from which economic and legal relations emerge.

The purpose of this chapter is to depict market processes as thoroughly dependent on elements of custom, and to delineate how the customary support is affected by economic processes in turn. Further, a perspective on social norms is outlined which conceives them as emerging from an intermeshing of individually perceived entitlements and obligations. This contrasts with conceptions that take norms as irreducible social facts.

## 2 The Nature of Entitlements and Obligations

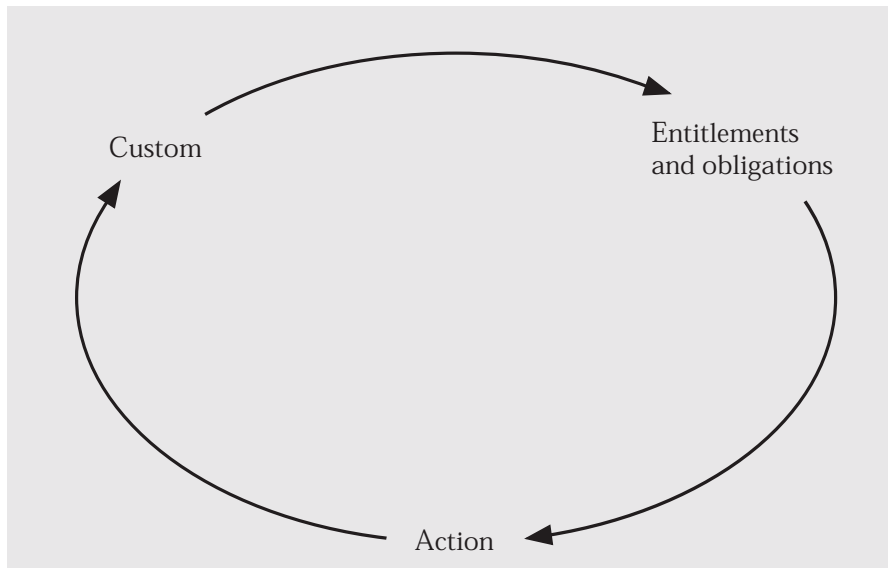
The view of social interaction proposed here is as follows. Individuals perceive “entitlements” and “obligations” which channel and direct their action. In this way, entitlements and obligations coordinate social interaction. While different societies may entertain quite different sets of entitlements and obligations, they share the feature that social interaction is organized by a system of entitlements and obligations.

Entitlements are rights, as perceived by the individuals. They are not, however, abstract legal rights. Rather, they denote the subjectively perceived rights that go along with a motivational disposition to defend them.<sup>2</sup> Obligations are the counterparts of entitlements. They refer to claims of others that are subjectively accepted, and go along with a motivational disposition to respect these claims.

The distinguishing characteristic of entitlements and obligations is thus their motivational and behavioural component. Entitlements and obligations affect valuations and change behaviour. In this, entitlements and obligations influence social and economic interaction. It will be argued in this chapter that entitlements and obligations

---

<sup>2</sup> The usage follows the psychological interpretation by KAHNEMAN *et al.* (1986), which differs from the usage that attaches the term to legal or natural rights; see CALABRESI and MELAMED (1972, 109of.). It differs also from the view proposed by sociologists such as COLEMAN (1990, 306-10), for whom “obligations and expectations” are created and entertained by “rational” actors for selfish reasons. The account given here stresses the direct motivational force of entitlements and obligations.



**Figure 1:** Custom, Entitlements, Obligations, Action

are crucial for all kinds of everyday transactions. Exchange and contracting depend on behaviours that are elicited by entitlements and obligations.

Yet entitlements and obligations are not reducible to habit formation. They depend on justifications that conjoin customary experience with current conduct, and flow from convictions about appropriateness, as nourished by custom. An entire complex of diverse reasons and experiences spawns entitlements and obligations.

### 3 Entitlements, Obligations, and Custom

The first and most important source of entitlements and obligations is custom. Repetition over time as well as shared patterns of behaviour within a reference group generate perceptions of entitlement and obligation. Individuals will feel prompted to conform to customary patterns of behaviour; they will feel entitled to act in customary ways, and will more readily accept demands by others if these demands are affirmed in such a manner.

Repeated action will become ingrained in custom and will in turn add support to the bundle of reasserted entitlements and obligations. In this way, conservatism and conformity will link entitlements and obligations to perceived patterns. Entitlements and obligations will influence action. The working of custom is schematically depicted in Fig. 1.

## 4 Entitlements and the Law

Another important source of entitlements and obligations stems from the law. Laws contribute to the shaping of entitlements and obligations in several ways. First, the law can be imposed by sanctions. The behaviour enforced in this manner will eventually become customary, and perceived entitlements and obligations will adjust to accommodate the new state of affairs.

The law may exert a more direct influence, however. It has been observed that the mere declaration of a law, without imposing any punishment for disobedience, will induce behavioural changes.<sup>3</sup> This “direct” influence of the law is perhaps most clearly visible when “contractual presuppositions” command bargaining results. Contractual presuppositions are standard clauses that can be readily replaced by other clauses if the parties wish to do so. Standard clauses are not backed up by sanctions and are, in this sense, weaker than laws. They do not affect the set of permissible contracts, nor the threat points, nor the benefits of the feasible alternatives. Yet it turns out empirically that outcomes are strongly affected by changing contractual presuppositions.

The law by itself will not be sufficient to generate entitlements and obligations, however. Consider the right to free speech. In the former (Communist) German Democratic Republic, the right to free speech was constitutionally guaranteed. Given such a right, it may appear difficult for those in power to suppress free speech. The Communists, however, were largely able to do so by using various sanctions against dissidents. The consequence was that everybody was afraid to dissent. In this way, entitlements were suppressed irrespective of the law. Laws and regulations that play no part in normal life cease to be relevant for generating entitlements and obligations.

Thus, laws can affect entitlements and obligations only within an atmosphere of generalized law obedience. Such generalized law obedience is established by custom. In this sense, the law may be understood as a modifying link in the chain that relates custom to entitlements and obligations. The law is legitimized by custom, and custom plays a part in prescribing the content of the law.

It may be added that many laws may be seen as codifications of usages that came about for quite other reasons. It sometimes follows, rather than guides, custom. This is characteristic of labour legislation or international law, for example.

---

<sup>3</sup> KILLIAS (1985).

In another sense, the influence of the law is enigmatic, because people often do not know their own legal position in everyday life.<sup>4</sup> They largely follow customary patterns when shopping or marrying, but are ignorant of the legal aspects of what they are doing. Few know about the liability regulations that are brought into effect by a marriage contract, a lease of a flat, or the purchase of a power saw. Yet people engage in these transactions and deliberately inform themselves about the legal rights only if something goes wrong. They follow established patterns. The law affects these patterns by influencing custom.

While custom is affected by the law, therefore, this effect is not direct and simple. An appreciation of the law requires a grasp of the way in which the law moulds entitlements and contributes to the shaping of custom. Hence any view of custom must offer a perspective for integrating the influence of law on custom. A later chapter will suggest such a perspective.<sup>5</sup>

## 5 Clarity

It is obvious that all cognition, emotion, and behaviour must be rooted in the human mind. This holds true for entitlements and obligations as well as for all other kinds of customary behaviour. However, it is not feasible to trace all behaviours explicitly to specific psychological processes. Even if such a reductionist approach were manageable, it would not yield an appropriate understanding of very general phenomena such as custom. Yet the opposite approach of side-stepping all psychological issues by appropriately demarcating the field of inquiry is not helpful either. Economic and sociological approaches proceed in this manner when assuming given “preferences” or “social values.” These approaches must remain powerless with regard to all issues relating to the formation of preferences and norms. Such questions are, however, central concerns for any theory of custom.

The theory of custom is thus obliged to build on psychology, but this does not imply any extreme reductionism. It will suffice to invoke some broad psychological regularities. Just as economics can deal with price formation in a market while leaving the nature and the precise attributes of the commodities unspecified, the theory of custom can build on fairly general and abstract ideas about human motivation and cognition while remaining tacit about particulars.

---

<sup>4</sup> See ELLICKSON (1991, 140) for references to these and other cases.

<sup>5</sup> SCHLICHT (1998, Chapter 12)

The following argument, therefore, will build on a cluster of some general psychological tendencies in learning and motivation relating to psychological “clarity.” This notion will attain central importance as the argument is developed. A preliminary characterization of clarity in its relation to custom is as follows.

Any custom refers to regularities that must be perceived, learnt, memorized, and passed on. Unclear and complicated rules cannot be handled in this way, and cannot, therefore, be coded by custom. This constrains possible customary patterns. Clarity eases encoding, while unclarity smothers it.

It has been stressed earlier that custom comprises both cognitive and motivational aspects; it is confined neither to the cognitive nor to the emotional sphere alone.<sup>6</sup> Similarly, the notion of “clarity” is not restricted to mere perceptual or mnemonic simplicity, but comprises multifarious psychological phenomena. It is devised as a portmanteau term referring to psychological consistency between conviction, motivation, and action.

Justifications in terms of custom illustrate some aspects of such consistency. A certain action may be justified by pointing out that it conforms to custom; clarity refers here to the fit of action to custom. Customary behaviour may be justified in terms of its usefulness or appropriateness; clarity refers here to the fit of the practice to the purpose. The everyday desire for justification instances further pertinent clarification processes.

Clarity requirements affect entitlements and obligations in many other ways which will be discussed later. Before doing so, however, it seems appropriate to consider the workings of entitlements and obligations, and how they control social interaction.

## 6 An Everyday Transaction

The effect of entitlements and obligations is most easily understood by looking at commonplace transactions. Consider, as an example, a taxi ride in an unfamiliar town.<sup>7</sup> A person enters a taxi cab and tells the driver where to go. Upon arrival the taxi driver points to the taximeter and indicates the fare. The customer pays, possibly including a tip. The customer leaves, the taxi disappears. Neither party expects to meet the other again, and no-one thinks about the episode any further;

---

<sup>6</sup> SCHLICHT (1998, Section 1.6)

<sup>7</sup> The following example for anonymous and non-repeated exchange elaborates on BASU (1984, 5-7) and SCHLICHT (1993, 79f.).



this is the usual pattern of behaviour. Yet it is not easy to understand the incident in terms of self-seeking behaviour.

Surely there was an initial contract. The taxi driver promised to take the person to the place mentioned, and the passenger promised to pay the fare. This initial contract created entitlements: the passenger obtained an entitlement to the ride, and in exchange for that the driver obtained an entitlement to the fare. Congruous obligations were generated simultaneously.

But why do both parties honour the contract? Why do they care for those entitlements? The passenger, for his part, may consider leaving the taxi without paying, as he has been brought to the place where he wanted to go. He may fear, however, that this would infuriate the taxi driver. As the driver appears to be a strong and determined person, this appears too high a risk, and the passenger decides to pay.

However, after having handed over the money, nothing has changed in the mutual bargaining position: the taximeter reading is still the same, the physique of the taxi driver appears as threatening as before, and the passenger still has some cash in his pocket. So why does the taxi driver not insist that the passenger pay again, and why shouldn't the passenger comply if he did before?

The taxi driver may think that such a demand would infuriate the passenger. The passenger could resist, and could consider legal action. So he is content with what he has obtained and drives away.

But if the passenger can threaten the taxi driver by taking legal action, he could do so at the outset and could save the fare. He could falsely pretend that he had already paid, and that the taxi driver was trying to extort him. There is no clear solution to the bargaining problem: if one party has the means to render the other party compliant, this threat could be used right at the beginning, and also repeatedly. It is not at all clear from the mutual options available to the parties why the initial contract is in fact honoured.

## 7 Compliance and Moralistic Aggression

The answer suggested in the above episode is that “moralistic aggression” may serve as an effective enforcement mechanism. The parties may be prepared to defend whatever they perceive as their entitlement, even if they cannot expect any

immediate benefit, and even if it involves some cost to them.<sup>8</sup> Under such an assumption, the taxi driver would act aggressively if the passenger tried to walk away without paying, and the passenger would act aggressively if the taxi driver asked him to pay twice. Both expect this. After calculating costs and benefits, both conclude that demanding and paying one fare is the preferred action for both of them. The strategic considerations may even be skipped, as everybody has gone through similar episodes before and has acquired the appropriate strategy as a matter of routine.

Many everyday transactions rely in this way on entitlements that generate a threat of moralistic aggression. This stabilizes the transaction. Such moralistic aggression is irrational in the sense that it would require each of the parties to engage in actions that worsen their position, but it is precisely this psychological disposition to act aggressively in non-normal cases that sustains smooth transactions in the normal case.<sup>9</sup>

Obligations influence action in a parallel way. If a person accepts that somebody is entitled to obtain something from him, this will increase his inclination to actually concede. Obligations spawn compliance.

It is to be noted here that the entitlements and obligations are mental phenomena lacking any “real” foundation. The taxi driver knows that the passenger has demanded a ride; if the driver had offered a free ride because he was going in that direction anyway, he would not have been entitled to demand a fare. Similarly, the passenger *knows* that he has asked for a ride; if the taxi had not been properly marked, and the passenger were hitch-hiking, he might not feel an obligation to pay the normal fare. Entitlements and obligations reside in the minds of the individuals concerned and in their understanding of a certain situation.

---

<sup>8</sup> See KLEIN *et al.* (1978, 305). They built on the work of the biologist R. L. TRIVERS (1971). See also KUBON-GILKE (1997, Section 4.3.2).

<sup>9</sup> This type of behaviour may lead to a more desirable outcome in the long run and thus may be considered rational in a wider sense FRANK (1988, 1989, 13). However, FRANK (1989, 6) notes a problem with this: “If there are genuine advantages of being vengeful or trustworthy and being perceived as such, there are even greater advantages in appearing to have, but not actually having, these qualities.” The maxim “never tell a lie” seems to be individually less efficient than the maxim “never tell a lie if it can be found out; otherwise tell lies if it is to your own advantage.” Frank terms this the “problem of mimicry.” But if mimicry is better than truthfulness, truthfulness can be sustained only by forgoing immediate gains.

## 8 Coordination Failures

Most, if not all, transactions build on perceived entitlements and obligations that influence behaviour and settle the outcome. Without entitlements and their impact on behaviour, many transactions would not be feasible. The taxi driver would, for instance, anticipate that any passenger would leave the taxi without paying and would ask for advance payment. Any passenger would reject such a demand because he would anticipate that the taxi driver would take the money and refuse to make the trip unless paid again, etc. As a result, such transactions would be blocked by strategic considerations. There would be no taxi service available, since it would not be feasible. Taxis would not exist.<sup>10</sup>

In the presence of entitlements, economic and social coordination runs smoothly in the normal case. This is highlighted when things go wrong and incompatible entitlements clash. Consider again the example of the taxi ride. Assume that the taxi driver has erroneously made a detour. He may feel that he is entitled to the full fare as indicated by the taximeter, as he has driven the passenger that distance. The customer may feel obliged to pay somewhat less, since the optimal distance was shorter than that shown on the taximeter, and the detour was caused by the driver's incompetence: the passenger has not asked for it. The passenger may refuse to pay the demanded fare. In an incident of this sort, a female passenger in Munich injured a taxi driver to such an extent that he had to be hospitalized.<sup>11</sup>

Such conflicts are well known. They relate to warranty, delivery, performance, modes of payment, parking, the noise and smell coming from the neighbours' flat, and so forth. On a larger scale, neighbouring groups or nations may perceive entitlements differently—they may for instance interpret history and historical contracts in a different way. This may lead to war even in cases where no party can expect to win. Inaction, or maybe joint military action against some others, would appear a preferable strategy for both parties in such cases, yet the parties choose to engage in a war. On an intermediate scale, industrial disputes that are particularly severe can be observed if “matters of principle” are at stake.

---

<sup>10</sup> The above is just one example of the “hold up” problem that arises if one party can withhold performance after the other party has performed. Often these problems can be solved by means of hostages (O.E. WILLIAMSON 1985, 167-205). In the taxi driver example, the contracting problem might be solved in that manner, but it should be noted that this is not done in practice. It seems more efficient if there is no necessity for pawning. It is also to be doubted if such pawning would not induce other problems elsewhere.

<sup>11</sup> TOCHTERMANN (1992).

## 9 Norms

Entitlements and obligations are closely related to social norms. While the importance of social norms is often recognized, it is less common to view those norms as arising from entitlements and obligations on the individual level.

The economic importance of social norms may be illustrated by looking at fairness. Perceptions of fairness influence economic behaviour. In many settings people prefer fair over unfair actions even if these are to their own disadvantage. They are also prone to punish unfairness, even if this involves some costs to them.<sup>12</sup> Fairness judgements arise from judging a given transaction in the light of a “reference transaction,” which serves as a standard for comparison. If the given transaction deviates from the reference transaction, this is considered unfair. Empirical observations have prompted the surprising conclusion that the reference transaction “provides a basis for fairness judgements because it is normal, not necessarily because it is just.”<sup>13</sup> Fairness standards are, thus, related to normality and custom. As fairness perceptions influence behaviour significantly, the fairness standards, established by custom, shape behaviour.<sup>14</sup>

Fairness standards play an important role in social and economic life. One important function is that they serve to fill the gaps in insufficiently specified contracts. Most transactions and interactions proceed on the assumption that the usual meaning is invoked, and the usual interpretations are applied, whenever something is left open. But even if the singular case obtains that everything is specified in a contract, the interpretation of the terms of the contract is governed by considerations of common usage. In this way, many transactions are carried out smoothly.

It should be clear, however, that standards of fairness are not invariably beneficial. They may ease many transactions, but they may also block beneficial transactions. Customary wage differentials may, for example, be maintained for reasons of fairness, but the wrong wage structure may hinder an improvement in the allocation of resources.

---

<sup>12</sup> KAHNEMAN *et al.* (1986, 736). SCHMITT and MARWELL (1972) summarize their findings, for instance, by asserting that “a substantial proportion of subjects will forgo rewards to avoid inequitable conditions.” See GÜTH *et al.* (1982), and KAHNEMAN *et al.* (1987).

<sup>13</sup> KAHNEMAN *et al.* (1986, 730). See also OPP (1982, 144-47) for a theory about the sequence recurrent behaviour–preference formation–norm formation from the point of view of modern social psychology.

<sup>14</sup> Fairness and justice refer here to standards factually entertained by the individuals, not to some absolute philosophical standards.

The same may be said with regard to other social norms. They set standards and bias behaviour and thinking in the direction of these standards. The standards themselves refer to normality. It may be argued, as with fairness, that various norm-guided behaviours have some good and some bad consequences, but this is not the concern here. The point is rather that these norms exist and that they strongly influence social and economic interaction. This must be taken into account, and allowance must be made for the fact that these norms are not fixed, but are shaped by social and economic processes.

In all these examples, the term “norms” can be used interchangeably with “entitlements and obligations.” Speaking about entitlements seems, however, preferable in most cases. Such a parlance stresses the subjective element and makes it easier to envisage conflict. The coordination failures such as the conflict between the taxi driver and his passenger discussed above can be rephrased in terms of conflicting social norms held by the parties.<sup>15</sup> This appears vexatious since social norms are typically related to shared understandings. “Conflicting norms” must refer to “conflicting shared understandings.” Such a parlance requires further refinements to make sense. Therefore, it seems more appropriate to conceive of these cases as arising from conflicting entitlements, and to conceive of social norms as arising from intermeshing perceptions of entitlements and obligations.<sup>16</sup>

The entitlement view permits an analysis of norm formation in terms of psychological processes that shape entitlements and obligations. By treating norms as results of psychological processes that generate entitlements and obligations, issues of norm formation and, more broadly, of custom formation can be addressed. The other position of taking norms as irreducible social facts would block all understanding of norm formation and the dynamics of custom from the outset.

## 10 Contracting

Economic interaction is intimately related to contracting. The possibility of contracting is tied up with the way in which contracting gives rise to entitlements and obligations. The exchange of one good for another involves mutual agreement on the transaction. Such an agreement—an “implied contract”—is often implied by

---

<sup>15</sup> See Section 8.

<sup>16</sup> The “dual entitlement” theory of fairness proposed by KAHNEMAN *et al.* (1986) derives fairness judgements in a similar—but somewhat more detailed and elaborate—way from entitlements.

acting conclusively. If so, an “implied” or “implicit” contract is concluded. In other cases, an explicit contract may govern the transaction.

Market exchange, certainly one of the core themes in economics, is just one form of implicit or explicit contracting. The taxi driver example can be seen in this way.<sup>17</sup> Institutional economics as well as political economics, labour economics, and various branches of microeconomics have stressed that economic activity involves contracting from the outset. Some authors view institutions in general as clusters of contracts between individuals.<sup>18</sup>

Contracting refers to an exchange of promises: one party promises to act under certain conditions in a certain way, and the other party makes a similar promise. Both promises are contingent on one another: if one party does not perform, the other party is not bound to perform either. Further, both promises will restrict behaviour away from what the parties may otherwise prefer to do. A promise to behave strictly selfishly under all circumstances will not fetch a price.<sup>19</sup>

Contracting is possible because the promises affect behaviour. They are binding. They may be not binding in any absolute sense, but the probability of behaving as promised is increased by the making of the promise. This may come about in several ways.

First, there may be institutions that are responsible for contract enforcement, such as the courts. This “external enforcement” is certainly of great importance, especially for large-scale explicit contracts.

The second possibility is that contracts are “self-enforcing.” It may be in the mutual interest of the parties to carry them out.<sup>20</sup> The parties may want to do business with one another and promise to meet at a certain place at a certain time. Both

---

<sup>17</sup> See Section 6.

<sup>18</sup> The view that institutions are just contracts has been elaborated, e.g. by JENSEN and MECKLING (1976) and ALCHIAN (1984) with respect to the firm, and may be extended to other institutions. See SCHLICHT (1998, Ch. 13) on the theory of the firm.

<sup>19</sup> Contracts are taken thus as dealing with—possibly limited—conflicts, where it is in everybody’s interest to default provided the other party observes the contract, and where the other party’s obedience is brought about by the other party’s promise not to defect. In contrast, pure coordination problems may be solved by simple agreements. Note also that the above discussion is simplified in that third parties are not invoked in the argument. The main conclusion is, however, not affected by that: symbolic action must trigger the behaviour of the parties. This can work only through motivational channels, since no real incentives are changed by uttering the words “I agree.” The problem that symbolic action must trigger behaviour relates to the problem that “strategic” speech may destroy communication altogether (BASU, 1984, 2).

<sup>20</sup> See TELSER (1980, 27) and KLEIN (1985) on self-enforcing contracts.

would benefit from keeping the promise, and both know this: the “contract” is “self-enforcing.” Such “contracts” ought be termed “agreements,” since they do not restrict future action away from what would be preferable otherwise. They do not pose any particular theoretical problem.

Sometimes this self-enforcement comes about through reputation effects in long-term relationships: in order to continue doing business with the customer, the firm performs as expected—otherwise, the custom may be lost. The danger of spoiling the firm’s reputation may provide a sufficient incentive to perform. There are some theoretical problems associated with such reputation mechanisms, but these problems will not be discussed here.

## 11 Non-Enforceable Contracts

Many contracts rely neither on self-enforcement nor on external enforcement. Such non-enforceable contracts are typical for many everyday transactions, both for business contracts and for contracts between nations. The importance of non-enforceable contracts has been widely recognized in the literature, and it seems unnecessary to stress their importance again.<sup>21</sup> The following remarks are intended to illustrate the nature of these of non-enforceable contracts.

Every-day interaction is often guided by customary patterns which trail the law in many cases. For instance, German labour and commercial law states that common practice is binding in cases of dispute. In the dozen reported Anglo-American cases in which ownership of a whale’s carcass was contested, judges regarded themselves as bound to honour whalers’ usages which had been proved in a trial. The usages and property rights evolved among whalers without any outside interference. When whaling switched from right (*Balaenidae*) whales to sperm whales, these practices and customs adapted to the new circumstances. This happened spontaneously and without any external intervention.<sup>22</sup> Sometimes custom simply overrides the law. In Shasta County, California, people settle their disputes by customary rules that are quite unrelated, and sometimes even contrary, to prevailing legal arrangements:

---

<sup>21</sup> The literature refers to non-enforceable contracts as “relational contracts,” “private ordering,” or contracts governed by social norms. Classical papers include LLEWELLYN (1931) and MACAULAY (1963). O. E. WILLIAMSON (1985, 20-22, 163-68) has stressed the importance of private ordering for business relationships. ELLICKSON (1991) has investigated in detail how everyday life in a California county (Shasta County) is governed by social norms that are unrelated to the pertinent legal norms.

<sup>22</sup> ELLICKSON (1991, 192,197).

When adjoining landowners there decide to split the costs of boundary fences, they typically reach their solutions in total ignorance of their substantive legal rights. When resolving cattle-trespass disputes, virtually all rural residents apply a norm that an animal owner is responsible for the behaviour of his livestock—even in situations where they know that a cattleman would not be legally liable for trespass damages.<sup>23</sup>

Business contracts are often rather vague in their contents. They articulate aims and intentions, rather than tight quality descriptions and formulas linking quantity with price. However, they often contain provisions for arbitration in cases of dispute, presumably to keep the disputes out of court.<sup>24</sup>

Such contracts rely on informal, customary ways of enforcement, for several reasons. Small-scale contracts cannot count on external enforcement, because it simply would not be worthwhile to go to court, and it would be difficult to supply adequate evidence. Fraudulent taxi drivers exploit this.

Large-scale business contracts require a flexibility that can be obtained only by keeping the terms vague. Such contracts require specialized knowledge for interpreting them in an appropriate manner. The courts with their schematized reasoning, bound by abstract general rules, and with their ignorance of the many specifics surrounding a dispute, are poorly equipped to enforce such contracts sensibly. In consequence, courts are avoided.

International relations are dominated by non-enforceable contracts for obvious reasons. Although international courts do exist, they have no means of enforcing their rulings other than by resorting to the help of other nations. There is no supreme agency for enforcing international contracts, and many contracts are not self-enforcing. The spontaneous emergence of whaling rights and the change of these rights in response to changing conditions illustrates this.

“Non-enforceable” contracts are thus central for our understanding of economic processes. They govern everyday exchanges and are *a conditio sine qua non* for a proper functioning of any market system; they are absolutely necessary for the maintenance and workability of all social structures. Yet they have been often disregarded.<sup>25</sup> Such non-enforceable contracts are concluded because they affect behaviour, in spite of lacking a supporting enforcement mechanism. They work, because they

---

<sup>23</sup> ELLICKSON (1991, 141).

<sup>24</sup> KUBON-GILKE (1997, Section 5.3.6).

<sup>25</sup> Modern treatments, such as LEWIS (1969), SCHOTTER (1981), or SUGDEN (1986), have often been inspired by game theory and rule this out by assumption.



create entitlements and obligations and set the standards that trigger compliance and moralistic aggression. The contracting parties rely on this mechanism.<sup>26</sup> In the words of David Hume, “there must be some act of mind attending these words, I promise; and on this act of mind must the obligation depend.”<sup>27</sup> However, many promises are not kept, and many assertions do not create entitlements. If somebody says: “I will do my best,” this will not necessarily mean anything more than “I want to be polite, and I will do the usual.” The entitlements that can be evoked by concluding a contract rely on customary standards of performance.

## 12 Entitlements and Morality

The above account of entitlements as the backbone to market transactions covers many of the topics that are usually associated with discussions about social norms and business morality. More specifically, it is held that societies have developed “implicit agreements of certain kinds of regard for others, agreements which are essential to the survival of the society or at least contribute greatly to the efficiency of its working.”<sup>28</sup>

In the example of the taxi driver, however, it seems a little farfetched to talk about morality and a mutual regard for others. The ethical connotations may even be unwarranted. They may be quite irrelevant for conducting the transaction. Transactions may even occur under relatively wicked circumstances. Contracting among gangsters or drug traffickers and addicts is remote from current notions of morality but may be covered from an entitlement perspective. It seems confusing rather than enlightening to invoke moral behaviour in these cases.<sup>29</sup> The entitlement term is morally neutral, and seems also more appropriate in the context of exchange.

---

<sup>26</sup> It may be noted that even very refined notions of self-enforcement, e.g. BULL (1983), implicitly make such an assumption. In Bull, the assumption is that a contract is of relevance because renegotiation is not possible. Any slight deviation from the behaviour specified in the original contract is considered a breach rather than a modification of the original contract and triggers a non-cooperative response.

<sup>27</sup> HUME (1978, 516).

<sup>28</sup> ARROW (1974, 26). CASSON (1991) has used the terms “morality” and “trust” in the same sense, as referring to mutually advantageous individual dispositions that enhance economic performance by lowering transaction costs.

<sup>29</sup> David HUME (1978, 532) put this as follows: “Here are two persons that dispute an estate; of whom one is rich, a fool, and a bachelor; the other poor, a man of sense, and has a numerous family: The first is my enemy, the second my friend. Whether I be actuated in this affair by a view of public interest, by friendship or enmity, I must do the utmost to procure the estate to the latter.” Still, the first may be entitled to obtain the property!

Another reason for avoiding reference to morality is as follows. “Morality” refers not only to conventions and moral values that vary across cultures, but also to ethical core ideas of truth, justice, and human rights that are shared across cultures in spite of different interpretations. Speaking about entitlements and obligations invokes stronger conventional and weaker ethical connotations. If conventional aspects of morality are concerned, the entitlement terminology is preferable, while morality terms are more appropriate when referring to absolute ethical aspects.

## References

- ALCHIAN, A. A. 1984, “Specificity, Specialization, and Coalitions,” *Zeitschrift für die gesamte Staatswissenschaft / Journal of Institutional and Theoretical Economics*, 140, 34–49, URL <http://www.jstor.org/stable/40750671>.
- ARROW, K. J. 1974, *The Limits of Organization (Fels Lectures on Public Policy Analysis)*, first ed., W. W. Norton & Company, URL <http://amazon.com/o/ASIN/0393093239/>.
- BASU, K. 1984, *The Less Developed Economy: A Critique of Contemporary Theory*, Blackwell, URL <http://amazon.com/o/ASIN/0631131116/>.
- BULL, C. 1983, “Implicit Contracts in the Absence of Enforcement and Risk Aversion,” *The American Economic Review*, 73, 658–671, URL <http://www.jstor.org/stable/1816565>.
- CALABRESI, G. and A. D. MELAMED 1972, “Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,” *Harvard Law Review*, 85, 1089–1128, URL <http://www.jstor.org/stable/1340059>.
- CASSON, M. 1991, *The Economics of Business Culture: Game Theory, Transaction Costs, and Economic Performance*, Oxford University Press, URL <http://amazon.com/o/ASIN/019828375X/>.
- COLEMAN, J. 1990, *Foundations of Social Theory*, Belnap Press, Cambridge, URL <https://books.google.de/books?id=XgC2AAAIAAJ>.
- ELLICKSON, R. 1991, *Order without Law: How Neighbors Settle Disputes*, Harvard University Press, URL <http://amazon.com/o/ASIN/0674641698/>.

- FRANK, R. H. 1988, *Passions Within Reason: The Strategic Role of the Emotions*, W. W. Norton & Company, URL <http://amazon.com/o/ASIN/B01JXTSFoA/>.
- 1989, “Beyond Self-Interest,” *Challenge*, 32, 4–13, URL <http://dx.doi.org/10.1080/05775132.1989.11471314>, <http://dx.doi.org/10.1080/05775132.1989.11471314>.
- GÜTH, W., R. SCHMITTBERGER, and B. SCHWARZE 1982, “An experimental analysis of ultimatum bargaining,” *Journal of Economic Behavior & Organization*, 3, 367–388, URL <http://EconPapers.repec.org/RePEc:eee:jeborg:v:3:y:1982:i:4:p:367-388>.
- HUME, D. 1978, *A Treatise of Human Nature*, second ed., Oxford University Press, URL <http://amazon.com/o/ASIN/0198245882/>, the first edition is electronically available at <http://oll.libertyfund.org/titles/hume-a-treatise-of-human-nature>.
- JENSEN, M. and W. H. MECKLING 1976, “Theory of the firm: Managerial behavior, agency costs and ownership structure,” *Journal of Financial Economics*, 3, 305–360, URL <http://EconPapers.repec.org/RePEc:eee:jfinc:v:3:y:1976:i:4:p:305-360>.
- KAHNEMAN, D., J. KNETSCH, and R. THALER 1986, “Fairness as a Constraint on Profit Seeking: Entitlements in the Market,” *American Economic Review*, 76, 728–41, URL <http://EconPapers.repec.org/RePEc:aea:aecrev:v:76:y:1986:i:4:p:728-41>.
- KAHNEMAN, D., J. L. KNETSCH, and R. H. THALER 1987, “Fairness and the Assumptions of Economics,” in: R. M. HOGART and M. W. REDER (eds.), *The Contrast Between Economics and Psychology*, Chicago University Press, URL <http://amazon.com/o/ASIN/0226348598>.
- KILLIAS, M. 1985, *Zur Bedeutung von Rechtsgefühl und Sanktionen für die Konformität des Verhaltens gegenüber neuen Normen*, pp. 257–275, VS Verlag für Sozialwissenschaften, Wiesbaden, URL [http://dx.doi.org/10.1007/978-3-663-14478-6\\_15](http://dx.doi.org/10.1007/978-3-663-14478-6_15).
- KLEIN, B. 1985, “Self-Enforcing Contracts,” *Zeitschrift für die gesamte Staatswissenschaft / Journal of Institutional and Theoretical Economics*, 141, 594–600, URL <http://www.jstor.org/stable/40750808>.
- KLEIN, B., R. G. CRAWFORD, and A. A. ALCHIAN 1978, “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,” *The Journal of Law & Economics*, 21, 297–326, URL <http://www.jstor.org/stable/725234>.

- KUBON-GILKE, G. 1997, *Verhaltensbindung und die Evolution ökonomischer Institutionen (Institutionelle und evolutorische Ökonomik)*, Metropolis, URL <http://amazon.de/o/ASIN/3895181366/>.
- LEWIS, D. K. 1969, *Convention: A Philosophical Study*, first ed., Harvard University Press, URL <http://amazon.com/o/ASIN/0196265991/>.
- LLEWELLYN, K. N. 1931, "What Price Contract?. An Essay in Perspective," *The Yale Law Journal*, 40, 704–751, URL <http://www.jstor.org/stable/790659>.
- MACAULAY, S. 1963, "Non-Contractual Relations in Business: A Preliminary Study," *American Sociological Review*, 28, 55–67, URL <http://www.jstor.org/stable/2090458>.
- MILL, J. S. 1909, *Principles of Political Economy with some of their Applications to Social Philosophy*, 7th ed., Longmans, Green and Co., London, URL <http://www.econlib.org/library/Mill/mlP.html>.
- OPP, K.-D. 1982, "The evolutionary emergence of norms," *British Journal of Social Psychology*, 21, 139–149, URL <http://dx.doi.org/10.1111/j.2044-8309.1982.tb00522.x>.
- SCHLICHT, E. 1993, "On Custom," *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift für die gesamte Staatswissenschaft*, 149, 178–203, URL <https://epub.ub.uni-muenchen.de/3163/>.
- 1998, *On Custom in the Economy*, Clarendon Press, Oxford, URL <http://amazon.com/o/ASIN/0198292244/>, also available at <http://www.oxfordscholarship.com/view/10.1093/0198292244.001.0001/acprof-9780198292241>.
- SCHMITT, D. R. and G. MARWELL 1972, "Withdrawal and reward reallocation as responses to inequity," *Journal of Experimental Social Psychology*, 8, 207–221, URL <http://www.sciencedirect.com/science/article/pii/S0022103172800027>.
- SCHOTTER, A. 1981, *The Economic Theory of Social Institutions*, Cambridge University Press, URL <http://amazon.com/o/ASIN/0521230446/>.
- SUGDEN, R. 1986, *The Economics of Rights, Co-Operation, and Welfare*, Blackwell, URL <http://amazon.com/o/ASIN/0631144498/>.
- TELSEER, L. G. 1980, "A Theory of Self-Enforcing Agreements," *The Journal of Business*, 53, 27–44, URL <http://www.jstor.org/stable/2352355>.

TOCHTERMANN, E. 1992, "Handfester Streit um Taxi-Rechnung," *Süddeutsche Zeitung*, Munich, Germany, August 4, URL <http://www.sz-archiv.de/sz-archiv/sz-librarynet>, article ID A94171.

TRIVERS, R. L. 1971, "The Evolution of Reciprocal Altruism," *The Quarterly Review of Biology*, 46, 35–57, URL <http://www.jstor.org/stable/2822435>.

WILLIAMSON, O. E. 1985, *The Economic Institutions of Capitalism*, Free Press, URL <http://amazon.com/o/ASIN/B00JYHGSQA/>.