[The Impact of Contract Enforcement Costs on Outsourcing and Aggregate Productivity](#)

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Economists have argued for a long time that the quality of legal institutions is an important determinant of the level of development, yet the precise mechanisms and their relative importance are not well understood. This paper focuses on a particular dimension of the quality of legal institutions: the speed and, more generally, the cost of enforcing a contract in a court. If enforcement of contracts is slow and costly, firms may prefer to do more of the production process itself, instead of outsourcing it to a potentially more productive supplier. That, in turn, leads to lower productivity.

To give a concrete example, let's take the case of India. India has extremely slow courts; in some districts it takes many years (or even decades) to enforce a contract in a court. This leads manufacturing firms to avoid dealing with suppliers for inputs that are tailored to them, such as services inputs. The result is that many manufacturing firms do the services themselves: a shoe producer will ask one of its own workers to do the accounting, or to help with research and development, even though it would be better to contract with a firm that is specialized in that task.

This paper studies the pattern of intermediate input use across countries, and how it is related to the cost of enforcing contracts. Firms do not always rely on courts to enforce contracts: some intermediate inputs are traded on spot markets, where exchange is possible without formal enforceability; sometimes firms find a way to make their relationships with suppliers work through long-standing interaction. But when firms actually take their trading partners to court, then they are subject to the quality of the legal system, and this is when the cost of enforcement should matter. This is a pattern that I observe in the data: in countries where contract enforcement costs are high (think: developing countries), there are less intermediate input flows between two sectors when there is a lot of litigation between these two sectors in the United States. Hence, these firms will prefer to do these production steps in-house, instead of outsourcing it to a supplier.

To study how important this mechanism is for overall development, we need to go back to the macro level, and ask: how much of the variation in input use across countries is explained by bad contract enforcement institutions? It turns out, quite a lot. By estimating the parameters of a structural macroeconomic model, I find that countries' real per-capita income would rise by (on average) 7.5% if they all had the quality of legal institutions of the United States (or on average 15.3% if you only look at low-income countries). Hence, the potential gains from legal reform are large, and should not be missed by policymakers.