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Published in:
Legal Validity and Soft Law

DOI:
10.1007/978-3-319-77522-7_9

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Abstract We argue in this note that the principles of validity need fresh understanding to explain the elements of private ordering exhibited in the vast swathes of informal markets around the world. Informal markets, by definition, lie outside formal legal systems and yet display a tenacious stability in their norms. We show that these norms are valid because they are driven by reputation rather than any higher order of law. In doing so, reputation drives efficacy into validity. By remolding Kelsen's ideas on validity into Hart's internal point of view, we show how reputation drives efficacy into validity. We illustrate this idea through a case study on a centuries-old footwear cluster in Agra (India).

1 Introduction

Legal philosophy is usually concerned with a formal legal order, which owes its origins to the sovereign state. The study of the norms that regulate social groups or foreign nonstate cultures is left to sociology or anthropology. This has had the result that many informal normative arrangements, usually assembled under the broad and uninformative—if not puzzling—heading of "customary law" have largely remained unexplored terrain as far as legal philosophy is concerned.[1] It is at best conceived as the poor relation of "real" law, vestiges of which remain to be seen in rural regions or in the underdeveloped countries of the world.

The emergence of soft law practices in Western Europe and the United States, however, testifies to the fact that nowadays in the developed world, too, the state is less than ever the sole source of law. On the contrary, in order to cope with the

[1] A notable exception is of course Lon Fuller. See Klink & Lembcke in this volume.

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P. Westerman et al. (eds.), *Legal Validity and Soft Law*, Law and Philosophy Library 122, https://doi.org/10.1007/978-3-319-77522-7_9

complexities of the regulatory state, modern legislatures of the Western world often invoke the help of social fields and private partners. By relying on extant customary and informal arrangements, they try to find more effective ways of realizing domestic policies. But in doing so, they rely on forms of "law" that cannot be seen as valid in the usual and strict sense of the word, that is, as in conformity with some higher legal norm that regulates the creation and application of legal rules. Does this mean that these informal forms of soft law have to be denied any validity at all and that we should allow for the emergence of "invalid law"? Or should we revise the concept of validity?

In order to shed some new light on this question, it may be instructive to take a look at informal economies. The economies of more than half of the world are unregulated by formal law. They are guided by all kinds of rules. But there is no formal banking system, there is no access to the formal judiciary, and the norms that guide the way these markets function are not in any sense linked to the formal legal system. In India, more than 90% of the total workforce is engaged in the informal economy.[2]

Examining informal markets also helps us understand the concept of validity across time. As von der Pfordten in this volume reminds us, the history of this concept in philosophy is rather recent, the nineteenth century. This is also the time when formal legal structures were emerging in market-based frameworks around the Western world. To understand the concept from the point of view of formal arrangements alone ignores how human societies have dealt with "validity" across time, and informal markets provide a unique window for us to view it through.

In this article, we will describe the case of the informal arrangements by which the shoe trade and manufacture are regulated in Agra, India. The survey for this research was conducted by Goyal during December 2012–January 2013 and April–June 2013. Since the market is concentrated in a small geographical space and traders are present in their shops every day (except Sunday when the market is closed), this was an ideal locale to collect cross-sectional data. Goyal employed unstructured interviews to understand the market, the credit structure, and risk-sharing institutions. The description of the case will prompt us to raise a couple of questions and observations that may be helpful in developing a concept of validity that may apply to informal and nonstate normative systems.

[2] According to recent ILO estimates, the informal economy provides employment to 71% of nonagricultural workers in sub-Saharan Africa, 71% in Asia, 51% in Latin America and 47% in the Middle East and North Africa.

2 The Case

Agra, the poster city of India's tourism (home of the Taj Mahal), is also famous for its centuries-old leather footwear cluster. It produces more than 40% of the domestic and 20% of the export footwear of India. It has both highly formal manufacturers (in the form of huge export-oriented enterprises and smaller factories), as well as unorganized shoemakers in the form of household artisans or small-scale factories. More than two-thirds of the manufacturing units are located in household artisan-dominated communities. The unorganized trade exists "outside" the legal net since most shoemakers are not registered legally, and even traders, many of whom are indeed registered, conduct businesses without disclosing their incomes to save taxes (shadow or black economy).

Like many trading businesses, trade in the Agra footwear cluster takes place on credit. Artisan shoemakers arrive with their shoes in the market every day in the evening to sell the shoes to the traders. Market norms mandate that they sell the shoes on credit (usually for 3 months). For trade credit to work in any informal market, two conditions are necessary: first, there needs to be a credible commitment from the trader's side to pay the debt, and second, the cost of liquidity to suppliers must be low. In other words, promises to repay the outstanding amount must be kept, and the credit supplier must have sufficient capital that he can withstand the restricted cash flow until the debt is paid. Since the market operates outside the law, it is difficult to make credible commitments. If the trader reneges on his promise, the shoemaker cannot really go to court since there is no explicit contract fulfilling legal obligations. Further, the shoemakers are extremely poor, which makes the cost of liquidity very high for them. They need cash every day to buy raw materials from the market and cannot quite sell on credit unlike the rich suppliers.

The market solves the two problems simultaneously through the institution of a credit note, commonly known as parchi. Whenever the shoemaker sells shoes to a trader, the latter issues a credit note (parchi) to him, noting the details of the outstanding amount, the trader's name, and the due date. When the parchi is returned to the trader on the due date, he is obliged to clear the debt.

2.1 Solving the Credible Commitment Problem

Commitments come from the prevalent high degree of information symmetry in the market as regards reputation. Almost everyone knows everyone else: should a trader renege on his payment, this is quickly known to the entire industry through the many informal channels of information dissemination, that is, discussion, gossip, chats, rumors, and informal gatherings. The market is very cohesive and closely knit, which also explains the relational- and trust-based mechanisms invoked in transactions daily. If one looks at the traders' dwelling patterns, they reside in certain expensive areas in Agra and meet often at social gatherings, make conjugal alliances, and are members of the same town clubs.

Most traders are Punjabis by caste, and the shoemakers belong to the lower castes. The caste networks bring them closer. Laborers live in ghettos, and after work they get together for local drinks and food, sharing stories and rumors, constructing and disseminating information. Opportunities for arbitrage are low. Almost everyone knows everyone else, and impersonation is not easy. Hence, if news of a trader reneging on his dues or canceling a contract is revealed to one, almost every shoemaker will hear of it. The market allows everyone to keep a keen eye on the capital and net worth of the traders.

2.2 Solving the Liquidity Problem

Over the decades, the market has evolved an indigenous way of solving the problem of liquidity. The parchis have assumed the role of a promissory note. This means that the shoemaker can sell the parchi to a third person at a discount. Informal intermediaries have emerged in the market, called *aadhatiyas*, who buy the parchis at interest (which is the discount offered by the parchi seller, the shoemaker). Thus, the shoemaker obtains the liquidity owed, minus interest, perhaps on the same day as the shoes are traded. The trader gets credit. Upon maturity, the *aadhatiya* collects the cash noted on the parchi from the trader who issued it and pockets the interest. In this way, the parchi system institutionally creates liquidity in the market. The system resembles the historical emergence of commercial paper. Parchis are the pivot over which a parallel banking system for the enormous footwear industry in Agra rotates.

The question remains: how is the *aadhatiya* able to monitor and manage the risk in securing his money outside the law? Interest rates play a crucial role in this. The interest rates on the parchi depend solely on the reputation and creditworthiness of the trader who issued the parchi. This means that if A is considered trustworthy and the market values his promise, the interest rate on A's parchi will be lower than C's, who has a lower reputation for fulfilling his promises in the market. This will discourage the shoemaker from approaching C to sell his shoes in the first place: the higher interest rates on C are costly for the shoemaker. To attract shoemakers, therefore, traders have to be trustworthy. Hence, C has an incentive to keep his promises and create a good reputation. The parchi institution therefore creates a self-enforcing mechanism.

Inevitably, there are also cases of unavoidable bankruptcies. Again, they are dealt with by an informal dispute settlement, organized by the local associations of traders and the like. These bodies are headed by veterans of the trade who mediate and order how much the creditors need to be paid, assessing the leftover worth of the bankrupt trader. Settlements are not made with documentary evidence and lawyer-driven arguments. People know the story, and lying is impossible. The judgments of the association members are usually adhered to, and the judicial system of the local courts is seldom invoked.

3 The Attribution of Validity

The parchi system is clearly an institution that functions outside the law. Violations of its rules will not be dealt with by formal courts: the rules are enforced by other market players. The story of the parchi system paints a natural landscape for most transactions in the developing world. These transactions are not backed up by any formal law but work on the basis of reputation mechanisms.

It is clear that the reputation of the trader plays an important role in ascertaining the value of a particular parchi. The better is the reputation, the more it is worth. In fact, we might say that whereas in a formal system the validity of any document is decided by reference to some other—higher—*law*, in an informal system that question is decided by referring to the reputation of the *person* by whom the document is created or forwarded. Personal reputation is therefore a type of what Hage in this volume calls source validity. The worth or validity of the document is determined by reference to its source, and in this case the source is the object of gossip, rumors, and all that idiosyncratic knowledge[3] that builds up a personal reputation. On the basis of this form of knowledge, not only is it decided whether a certain piece of paper is a genuine (valid!) parchi or not (in an all-or-nothing fashion), but its value (in a gradual way) is also determined. In the parchi system, validity and value hang closely together.

Yet we must distinguish here between the validity of a particular parchi and the validity of the parchi system as a whole. At first sight, the notion of the validity of an entire system is somewhat strange and elusive. But we should not understand "validity" as an objectively attributable quality of systems. We think that it is more appropriate to understand validity on the basis of what Hart (1994) called the internal point of view. Validity is then *perceived* validity: the degree to which norms are regarded as standards, deviation from which calls for criticism and justification. In informal systems, validity is perceived not only by officials but by all the participants in that normative order. We might therefore say that the rules of the shoe market are valid if people regard them as standards. They are quite different from, for instance, traffic rules as regarded by Indian drivers in India, for whom they are merely legally valid. Despite their legal validity, people do not choose to follow the traffic rules, even when all these rules are bound by a higher valid norm, leading all the way up to the Constitution of India. They are simply not seen as standards for

[3]Idiosyncratic knowledge is similar to Polanyi's tacit knowledge (Polanyi 1966). It denotes specific knowledge that cannot be easily transferred from one individual to another nor can be aggregated for generalization (See also, Williamson 1975, 1979). If idiosyncratic knowledge is in play, the underlying governance structures and contractual arrangements become highly transaction-specific and are unique. The low degree of formalization of these arrangements means that third parties (for example courts) cannot assess them and hence cannot enforce them. As a consequence the trust relation between the parties involved becomes central to running the transaction successfully. Thereby the routines and practices for maintaining the trust relation also become part of the shared idiosyncratic knowledge.

action. On the contrary, traffic *violation* is an all-pervasive norm, existing, interestingly, as one of the few uniting features in a country as diverse as India.

As Hart rightly points out, the internal point of view is not just a feeling. The acceptance of norms as standards should be expressed in action. The horror that Western visitors go through when being driven in a car in Delhi's streets is in stark contrast to the peaceful demeanor of the Indian driver of that same car. The driver knows the norms and does not flinch one bit when he sees a law violation since for him it does not constitute a norm violation. It is important to stress actual practice: only then can people know other people's internal points of view.

4 Trust and Reputation

What conditions should be fulfilled by rules in order to be accepted as standards? Jellinek's (1905) answer would be simply because these rules exist. In a certain minimal sense, we may concede with Jellinek that, indeed, the bare existence of the system is enough to give it a certain validity. Jellinek argues that it is an observable human psychological fact that people attach normative power to that which exists and repeats itself, a phenomenon already to be witnessed in the child who asks every evening for the same story to be read to him and who considers the slightest deviation from regular practice as abnormal, as a violation of the norm. Jellinek called this *die normative Kraft des Faktischen.* We can concede that there is a grain of truth in this observation at the collective level as well, which is observable in the phenomenon of path dependence. Path dependence also plays a role in our example.[4] The very fact that a certain practice has evolved along particular lines makes it more acceptable to people who consider such a practice not only as that which *is* normal but also as that which *should* be normal. Apart from this, path dependence also turns any change in direction into a costly affair. Change entails both psychological and financial effort.

Yet matters should not be exaggerated: people do not comply out of sheer resignation with the status quo and its well-established patterns of behavior. If they did, we would be able to say that they adopt what Hart would call an *external* point of view toward these rules and standards. They would view these rules mainly

[4]Until independence, the business was dominated by Muslims and Jatavs (a lower caste). But most of the affluent Muslims left for Pakistan during the partition-induced migration, and Agra's shoe industry began deteriorating with poor Jatavs in their unorganized cottage units. When the Punjabis arrived in Agra, they noticed the skills of the Jatavs and poor Muslim shoemakers. They also noticed that: (a) there was a lack of market connectivity, and shoemakers had a tough time finding customers since they could not travel far; (b) the shoemakers themselves were shoe sellers, and selling came at the opportunity cost of making; and (c) shoemaking was done in a very informal and unorganized manner. Further, working with leather was not a taboo within the Punjabi community as it was within traditional Hindu upper castes. In addition, the migrant community was badly in need of a sustainable income, and the potential of footwear trading in Agra caught their attention.

as predictions of what will happen and how others will behave. But compliance to the rules of the parchi system is not at all like that. As we noted above, people's attitude towards these rules is more like Hart's internal point of view, according to which they really see these norms as binding standards and express their acceptance of these norms in outward behavior.

That being said, we should immediately add that people's internal point of view should be corroborated, so to speak, by the outward behavior of the other participants that reveal the same internal point of view. It is only on the basis of a shared understanding of one another's internal point of view that the reputation mechanism can work. One knows then how to adapt one's behavior to the gaze of others so that one's reputation will be improved.

In the shoe market, we see this mechanism clearly at work. Again, reputation plays a pivotal role. The reputation of the trader does not only determine the value and validity of a particular parchi. It is also a sanctioning mechanism. Violation of the norms, such as reneging on one's promises, immediately damages one's reputation. Violation of the norms is therefore punished not by a specialized class of people, such as judges or arbitrators, but by all the other members of the system. Norm conformity is directly translated into an improved position in the social network, whereas norm violation is directly translated into a damaged reputation. Sanctions are not inflicted from "without" but consist in an altered composition of the social network.

In the parchi system, indeed there are two economies at work simultaneously and in parallel: an economy of money and of reputation.[5] If the mechanisms of information and reputation work, these two economies reinforce each other, and there is therefore no need for an additional normative system with sanctions of its own. Nonconformity with the norms can even result in social suicide.

So we see that reputation fulfills four functions simultaneously[6]:

1. It indicates someone's past performance (= among other things compliance with the norms).
2. It determines the value and validity of particular documents.
3. It is the key component in decision making (do I trade with trader X or Y?).
4. It sanctions nonconformity.

5 Conditions for Efficacy

In order to carry out all these functions successfully, two conditions should be fulfilled. In the first place, the stability of the system depends on the possibility of *access* to that reputation. How do we *know* someone's reputation? This is the question that haunts many emigrants who leave their rural surroundings and go to

[5] See Homans (1950, p. 295).

[6] See also, Westerman's chapter in this volume for a larger exposition on validity as reputation.

the big cities, where access to someone's reputation is difficult. So in order for the parchi system as a whole to flourish, it should function in a closely knit community in which perfect information symmetry and coordination are possible. Only then can the mechanisms of the market survive and interest rates be thought to reflect the dynamic information about traders' (non)fulfillment of their promises. The crucial factor allowing the system work seamlessly is therefore the information flow. This information flow concerning someone's reputation creates knowledge of how much to trust: a feeling of certainty in the minds of those who participate in the parchi system. In turn, this stability turns it into a viable and efficacious system. It works in practice. Mackor in this volume engages with this intersection of trust and conduct.

The second prerequisite for the system to work is the belief that others share the same internal point of view. This belief is of course crucial because one does not want to run the risk of being deceived by noncompliant others. But more important is that only on the basis of such a shared point of view can we expect reputation to perform its sanctioning task. In a context in which noncompliance is even considered a virtue (as in the traffic example), violation will not damage but may even fortify one's reputation.

Once the system is perceived to be workable and stable, the very functionality, agility, and utility of the system will be (additional) reasons for people to follow its rules. So in a sense, such an informal system is a self-reinforcing system.

Reputation → workable order → perception of effectiveness → willingness to comply → enhanced reputation.

In an informal normative order, unregulated by explicit laws, it is reputation, or—more precisely—information concerning reputation, that is the most important condition for effectiveness. Only then do we know the value of particular items, and only then will norm violation actually and effectively result in a loss of reputation. If violation of the rules has no effect on one's reputation, that order is ineffective and will also damage the internal attitude toward such rules.

For a viable normative order, every actor presupposes (as Hart 1994 would say) the "truth of the external statement of the fact that the system is generally efficacious," and that is how the concerned actor makes an internal statement concerning the validity of the rules. This means that the degree to which the actor perceives rules to be valid is informed by their efficacy, and at the same time, the degree to which a system is perceived to be efficacious is dependent on the degree to which the actor thinks that people generally adopt an internal point of view of its rules.

In societies where legal enforcement or empowerment is not necessarily strong, this knowledge will be the sole distinguishing factor between what is valid and what is invalid. Even though not in binary or discrete terms, validity may be a very real product of efficacy.

Hart is silent on highly efficacious systems that do not conform to the law (or are invalid through a legal lens), and Kelsen (1970) argued that valid systems must be efficacious but not necessarily the other way round. The parchi system reveals a third possibility in which a system that lacks legal validity nevertheless gains efficacy, as well as a binding force from an internal point of view. Most systems in developing countries are of this nature. Indeed, when states are no longer the sole sources of the law, one must not disregard the possibility of locating meanings of validity outside the traditional source of law, something elaborated upon by Carpentier in this volume.

6 Conclusion

What can a legal philosopher learn from this modest excursion into an informal market? In the first place, that it is not necessary to assume, in a Kelsenian (1970) way, a higher—valid—*legal* rule in order to determine whether a specific document or rule is valid. The validity—and value—of parchis is determined by personal reputation and not by law.

But reputation may also decide the validity of systems as a whole. The degree to which this reputation is or can be known and valued determines the degree to which the system is effective; in turn, the degree of efficacy determines—among other considerations—the degree to which these rules are believed to guide other people's actions, whereby such a shared internal view further reinforces effectiveness.

We have seen that the role of reputation is, however, not only limited to being an indication of validity. If there exists a shared internal point of view, reputation is also the major sanctioning mechanism of such a system. Cheating automatically damages one's reputation. The degree to which this sanctioning mechanism is effective might further strengthen the shared internal point of view concerning the validity of the system as a whole. Efficacy and validity are therefore transmitted and mutually reinforced by means of one and the same mechanism: reputation.

It is not easy to ascertain the position of reputation in the dichotomous Kelsenian world in which *is* and *ought* are separated. On the one hand, what the reputation of a certain person *is* depends on considerations of fact: it really matters whether a certain trader is indeed fulfilling his promises. But on the other hand, the ways in which reputations are evaluated is clearly dependent on norms, such as the norm that he should fulfill his promises, so we might say that in the last resort, validity is determined by (non-legal) norms.

Kelsen also seems right in saying that it is not necessary to assume the efficacy of an entire system in order to determine the value and validity of a particular parchi. Although a valid or invalid parchi presupposes a workable parchi system, its value (i.e., the numerical value of the interest rate) is determined not by that efficacy but by the reputation of the trader. In this sense, indeed efficacy is a *conditio sine qua non* and not a *conditio per quam*.

But in order to understand the validity of a legal order as a *whole*, efficacy does play a role. People should feel secure about its workings in order to participate in such a system. This security is not necessarily attached to the perceived moral qualities of the system—many workable informal markets (often dramatically) fall short of noble moral standards—but thrives mainly on the public accessibility of information that sets the wheels of the system in motion. If the system is hampered by information deficits, it cannot sustain itself in the sense we describe above. So in order to determine the validity of the system as a whole, efficacy is of supreme importance and indeed turns into a *conditio per quam.* Not only should we say that valid law should be efficacious. Efficacious laws must be valid too.

Reputation proves to be a powerful mechanism that performs many essential functions in a normative system. There is only one major shortcoming: it is limited in scope. It is dependent on personal information and idiosyncratic knowledge, which is only available in closely knit social networks. The expansion of trade beyond the confines of such localized contexts naturally called for a substitute for reputation. One such substitute is legal rules. However, times are changing. The kind of information that is required to determine one's reputation is now freely available and accessible on the Internet and can be shared with almost anyone, regardless of distance in time and space. This fact might have contributed to the emergence of soft law, which in large part relies on reputation as well. Rather than analyzing soft law arrangements by wondering to what degree they derive their validity from legal rules, it seems more advisable to inquire into the mechanisms of reputation that are at work in such arrangements. The shoe market of Agra shows how such an analysis could be carried out.

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