Contracts & Cartels: Reconciling Competition and

Development Policy

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Abstract

 It has become conventional wisdom that effective competition policy is a necessary ingredient to economic development. But competition policy should be secondary to the more pressing priority of securing contract rights, and sometimes competition policy is at odds with the priority of securing contract rights. This is because in undeveloped legal systems, cartels are sometimes necessary to enforce contracts.

When courts and other public instruments are unable to reliably enforce contracts, private ordering systems often arise to mobilize a group of affiliated merchants to direct coordinated punishments against parties who breach contracts. Yet such coordinated punishments is akin to a group boycott that normally invites antitrust scrutiny. This chapter focuses on this tension between the well-understood harms of group boycotts as restraints on competition and the unappreciated benefits of group boycotts as a pro-competitive solution to court failures.

The chapter pays particular attention to development needs in India, which (in addition to hosting the conference that preceded this volume) is home both to courts that historically have not achieved the degree of reliable contract enforcement and to a burgeoning diamond industry that for generations has relied on cartel-like instruments to secure transactions. Accordingly, those who seek to wipe out India’s cartels in the name of competition policy should be careful not to undermine the diamond industry, which is an important contributor to India’s economic growth.

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 It has become conventional wisdom that effective competition policy is a necessary ingredient to economic development.[[2]](#footnote-2) A volume, such as this, that dedicates itself to examining global antitrust policy and competition policy in developing nations appropriately emphasizes the damage of local monopolies and cartels to regional economies, the utility of fostering competitive pricing in international markets, and the importance prosecuting anticompetitive practices. This chapter offers a modest cautionary note against the call for greater antitrust—and specifically, anti-cartel—enforcement in the developing world. The reason is because sometimes, cartels are needed to enforce contracts.

 In the hierarchy of priorities for promoting economic development, securing contract rights is probably at the very top. No less than Nobel Laureate Douglass North has advanced the strong claim that “the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.”[[3]](#footnote-3) Yet sometimes, courts and other public instruments are unable to reliably enforce contracts. For some contractual settings, this type of “court failure” invites the emergence of private enforcement to secure transactions. Many such private ordering systems rely on mobilizing a group of affiliated merchants to direct coordinated punishments against parties who breach contracts, which in turn creates a group boycott that normally invites antitrust scrutiny. This chapter focuses on this tension between the well-understood harms of group boycotts as restraints on competition and the unappreciated benefits of group boycotts as a pro-competitive solution to court failures.

 This chapter first explores the literature on contract enforcement and economic development. It then highlights within this literature a species of merchant communities that self-enforce contracts by collectively punishing parties that breach contractual obligations. The chapter then illustrates how self-enforcement mechanisms effectively rely on cartel-like arrangements, yet even though they cause what amounts to concerted refusals to deal and coordinated group boycotts, they are procompetitive because the cartels enforce contracts that state courts cannot.

The chapter pays particular attention to development needs in India, which hosted the conference that preceded this volume. India, in addition to having courts that historically have not achieved the degree of reliable contract enforcement that businesspeople generally need, is also home to a burgeoning diamond industry that for generations has relied on cartel-like instruments to secure transactions. Accordingly, those who seek to wipe out India’s cartels in the name of competition policy should be careful not to undermine the diamond industry, which is an important contributor to India’s economic growth. Perhaps there should be a more general apprehension to eradicate other coordinated boycotts since they too might be enforcing value-creating contracts that state courts cannot reach.

Contract Enforcement and Development

 The world has by-and-large listened to North’s admonition. International agencies and external donors have invested heavily to promote the rule of law and law reform in many developing countries.[[4]](#footnote-4) Even though North cautions that no one has effectively demonstrated how to develop state institutions that effectively exert the requisite coercion to enforce contracts and property rights effectively without also risking abuse of that coercive power, development strategists have followed a formal “rule of law” recipe to promote economic development.

 Michael Trebilcock and coauthors have called this prevailing strategy of pursuing legal development for economic development the “contract-formalist approach.”[[5]](#footnote-5) The international community has aimed primarily to develop state-sponsored, third party contract enforcement mechanisms, along with sophisticated financial intermediaries, public administrations, and other hallmarks of a first world government. Trebilcock observes, however, that an “alternative school of thought has emerged that downplays the need for a formal third-party mechanism for contract enforcement.” He calls this alternative school the “contract-informalist perspective” because it acknowledges that “extralegal, socially, or culturally, determined norms can and o provide the assurance of stability and predictability necessary to induce participation in private transactions.”[[6]](#footnote-6) In other words, this school recognizes that informal mechanisms can—at least at early stages of development—serve the same roles in facilitating economic growth as conventional formal legal structures. Even without diminishing the central importance of securing property and contract rights, there appear to be substitutes for formal instruments of property and contract law.

Both law and society scholars and economic historians have long recognized that formal and informal mechanisms alternatively compliment, crowd out, and with each other in securing economic transactions, so Trebilcock’s observation of alternative mechanisms is not new. In the context of economic development, however, Trebilcock remarks that some aspects of the informalist school are associated with a “radically skeptical” view of whether legal reforms promote economic development.[[7]](#footnote-7) Because informalists understand that social structures can usefully facilitate commercial exchange like well functioning courts, informalists argue that “it would be unwise for development practitioners to use the quality of a society’s legal system as a benchmark for development.” In short, the legal system often plays a marginal role in informal capitalism, so “substantial investments in legal reform are of dubious value.”[[8]](#footnote-8)

Development practitioners debating the relationship between law and development, according to Trebilcock, can thus be divided among optimists and skeptics. Optimistic formalists believe that contract rights are advanced by building new legal institutions, and skeptical informalists believe that contract rights are secured through indigenous institutions. There is no disagreement, however, is North’s identification of contract enforcement as a foundational prerequisite to growth and prosperity. And even formalists would have to concede that pockets of commerce that rely on informal contract enforcement institutions should be left to prosper. In circumstances where legal development is unnecessary to secure contracts, there likely is agreement that the introduction of laws that might disrupt fluid commerce would be counterproductive.

Contract Self-Enforcement and Cartels: Peering into the Diamond Industry

 The species of enforcement mechanisms articulated by informalists have been popularized most famously by recent Nobel laureate Elinor Olmstrom,[[9]](#footnote-9) as well as a star-studded list of institutional economists like Avinash Dixit[[10]](#footnote-10) and Avner Grief,[[11]](#footnote-11) development economists like Marcel Fafchamps,[[12]](#footnote-12) and multidisciplinary social scientists like Janet Landa.[[13]](#footnote-13) Legal scholars long ago observed that agreements are secured through both legal and nonlegal mechanisms, often thriving “in the shadow of the law,”[[14]](#footnote-14) but more recent legal scholarship has capitalized on the phenomena of informal contract enforcement, concluding both that contract rights can be secured—even in the modern state—without any reference to formal legal entitlements[[15]](#footnote-15) and that informal enforcement achieves many administrative and transaction cost efficiencies. [[16]](#footnote-16)

 The underlying mechanisms articulated by all of these scholars are essentially identical. Economic parties are expected to adhere to certain norms, specifically, to comply with the contractual obligations to which they voluntarily assent. Individuals that fulfill their obligations will be deemed to deserve the benefits of future transactions, but those that fail to comply with an obligation will be denied future opportunities. Thus, reputation mechanisms punish those who earn bad reputations, and the penalty—in the form of lost future business—that follows a breach of contract will induce parties to fulfill their obligations. Thus, the benefits of maintaining a good reputation sustain commercial exchange.

 Although the theory is both intuitive and relatively simple, there is a steep logistical challenge to develop institutions that can sustain reputation mechanisms. One industry that relies on reputation mechanisms, both in the developed and developing worlds, is the diamond industry. Although the structure and mysteriousness of the diamond industry (which I elaborate in earlier work[[17]](#footnote-17)) might suggest its unusualness along many dimensions, its reliance on informal mechanisms is explained simply by the inability of courts—even the most sophisticated in the most developed nations—to enforce the most common and essential transaction in the industry: a sale of a diamond on credit. Because of diamonds’ universal and extraordinary value, and because of the ease with which diamonds can be carried undetected across jurisdictions, courts alone cannot credibly secure a simple diamond credit sale. A merchant purportedly purchasing a diamond on credit can easily flee with the diamond to a distant and undetectable jurisdiction, leaving no secured assets for a court to reclaim. Informal mechanisms, however, are not limited by jurisdictional constraints, can rely on industry expertise to resolve difficult evidentiary questions, and most importantly can impose reputational harm that includes both monetary and nonmonetary sanctions. For these reasons, the diamond industry relies exclusively on informal enforcement, and the industry offers a concrete empirical window into the institutional foundations of a reputation mechanism.

 *The Institutional Foundations.* The diamond industry’s central nervous system—the mechanisms that enable the industry’s use of reputations and support exchange—lies in its network of diamond bourses scattered throughout the world’s diamond centers. In New York City, for example, the New York Diamond Dealers’ Club (“DDC”), located in Manhattan’s diamond district on 47th Street, is organized like the others as a voluntary association with by-laws and mandatory rules for its diamond merchant members. The DDC’s approximately 1,800 members organize the vast majority of America’s commercial traffic in diamonds, with most members acting as middlemen between the diamond producers who mine the stones (most of which are organized by the DeBeers syndicate) and the diamond retailers who convert them into jewelry. Nearly half of the world’s sixty-billion-dollar sales in diamond jewelry are in the United States, and DDC members handle over ninety-five percent of the diamonds imported into the country. Since most diamonds are bought and sold several times before they are ultimately purchased by a jewelry manufacturer, DDC merchants are active traders and transact with each other frequently.

As a voluntary association, the DDC has extensive rules and by-laws to which each member must agree upon admission to the DDC, and failure to comply with DDC rules would lead to a member’s dismissal. The most important of the DDC by-Laws compels members to resolve all disputes before an arbitration panel. Arbitrators are fellow DDC members who have earned the respect of their peers and have abundant industry expertise. The panel abides by its own set of procedures that limit testimony (and thus a trial’s length) and enable arbitrators to ask questions and probe into fact-finding, thus empowering arbitration panels to arrive at prompt and informed rulings. Far more important is the mandatory nature of arbitration. Members are prohibited from bypassing DDC arbitration and bringing suit instead in New York state courts or any other system of dispute resolution.

The key to, and genius of, the arbitration panel is not its role as an alternative enforcement mechanism. To the contrary, the arbitration panel—like public courts—cannot by itself return a diamond to a jilted seller or impose fees or penalties on a breaching party. The true value of industry arbitration is its role at the fountainhead of the industry’s reputation mechanism. Once a panel has reached a conclusion, it announces nothing more than its judgment, which amounts to identifying the merchant against whom the panel issued a judgment, the date the judgment was decided, and the amount owed. The individual found to be liable has an opportunity to pay his debt to the merchant who brought the suit, and if he does so he remains a DDC member in good standing. However, if that individual fails to make payment immediately following the arbitration panel’s decision, he is dismissed as a member of the DDC. In addition, a picture of the individual in default is placed on the wall of the DDC’s central trading hall with a caption that details his failure to comply with the arbitration panel’s ruling, which immediately makes the default known to all DDC members. News of the individual’s default spreads rapidly throughout the global marketplace, as similar pictures and captions are placed in the world’s twenty-two other diamond bourses as well. This formal dissemination of information supplements the transmission of news through the many informal information networks in the DDC and other bourses worldwide. Each bourse, which houses restaurants, prayer halls, and other areas where members congregate regularly, is designed to gather merchants together, thereby collecting and disseminating valuable market and reputation information.

Thus, the DDC’s procedures—and the similar procedures of the world’s other diamond bourses—ensure that news of an individual’s default spreads quickly to future potential trade partners, and this news substantially affects commercial opportunities. Merchants in default have tremendous difficulty obtaining further business, and maintaining a DDC membership in good standing becomes a signal to other merchants of a spotless past. Moreover, current DDC members will not transact with merchants who were dismissed from the DDC because their own reputations would be discredited by dealing with members who have failed to live up to previous commitments. Accordingly, although members who receive an adverse arbitration ruling can compensate an opposing party without suffering additional sanctions, the penalty that is collectively imposed by the merchant community (following the lead of the arbitration panel) is designed to punish wrongdoing by denying future business, not by forcing compensation to victims of breach. This enforcement system is thus vulnerable to parties who leave the industry—a major concern to the industry—but is less vulnerable to gaps in enforcement that plague the state-sponsored civil and criminal justice systems, such as the failure to detect wrongdoing or the high litigation costs to initiate punishment. The information network at the foundation of the reputation mechanism responds quickly to reports of wrongdoing, imposes few costs to members who bring wrongdoing to the arbitrators’ attention, and is available to the parties who are most familiar with and highly incentivized to report misconduct.

*How It Works.* The identification of a wrongdoer and the announcement of his transgression trigger the sanctions, which rely on informal mechanisms. The diamond industry’s system of rewards and punishments, which is responsible for securing credible contract enforcement, rests on a remarkable network of family and community institutions. Since diamond dealers will only deal with other dealers who maintain a strong reputation, a merchant found by the DDC arbitrators to have defaulted on a contractual obligation will no longer be able to do business with other industry actors. Moreover, merchants almost exclusively come from family businesses, where profitability is dependent on the quality of a family’s reputation and where family reputations are both inherited and bequeathed. Because a good reputation is essentially a prerequisite to enjoying profitable dealings, entry is largely limited to merchants who enjoy some reputational sponsorship and tacit insurance from existing industry players. Thus, family connections create a valuable and otherwise hard-to-obtain entryway into the industry. Conversely, fulfilling contractual obligations and maintaining a good reputation secures not only a lifetime of business but also enables one to confer a good reputation, and the opportunity to secure future business, on one’s heirs. Merchants are thus induced to fulfill their contractual obligations throughout their lifetimes, and the industry overcomes what game theorists typically describe as an end-game problem.

Since the reputational information has such a dramatic impact on the livelihood of individual merchants, the reliability of reputation information, not just its dissemination, is also crucial to ensure proper incentives to cooperate. Several forces work to ensure the veracity of industry information sources. The composition of the DDC’s arbitration board provides one guarantee of accuracy. The industry’s arbitrators are experienced insiders who are extremely familiar with the nature of the industry and the difficulties involved in entering diamond contracts. Their expertise helps arbitrators understand the context within which disputes arise, distinguish meritorious from non-meritorious claims, assess the reliability of proffered evidence, and, when appropriate, impose the proper damages. Additionally, the board may respond to misinformation and punish any party responsible for spreading inaccurate information about another’s reputation. In a world where good reputations are so critical to commercial success, and where gossip can be so damaging, these filters are important in discouraging the aimless spread of information of questionable veracity.

This reliance on reputations, and on the associated sanctions, means that the reach of the DDC arbitration board is limited to cooperating parties. Merchants comply with the DDC arbitration board not to avoid the brunt of the DDC penalties, which exiting merchants can simply ignore, but instead to reap the benefits of having good industry and community reputations. Thus, the DDC’s actions will only compel compliance from those who have strong preferences to remain active in the industry and respected in their community. Accordingly, the role of the DDC’s arbitration board is purely informational, and the power of its dispute resolution system rests solely on the degree to which it can disseminate information about merchant reputations and past dealings. In this sense, the DDC is a modern, though more effective, version of the private judges in the 16th Century in the Champagne Fairs, whose power lay solely in their ability to publicize the individuals who shirked contractual obligations. Perhaps the continued use of reputations in the diamond industry into the modern era also illustrates important differences between the Champagne Fairs and the diamond trade. Reputation enforcement in commercial settings such as the Champagne Fairs were displaced when more effective state-sponsored enforcement became available, but the diamond industry’s very unusual structure and reward system remains necessary because there remains a lack of effective state-sponsored alternatives.

In sum, the DDC’s arbitrators identify merchants who have engaged in wrongdoing, and both formal and informal industry mechanisms disseminate the identities of those deserving of bad reputations. Industry and community norms then inflict coordinated punishment on wrongdoers by foreclosing future business to those who have failed to uphold their commitments in the past. This collection of industry and community institutions has sustained the reliability of a sixty-billion-dollar industry that has avoided, has not required, and could not be supported by state court enforcement. Could the institutional foundations for the industry’s procompetitive reputation-based enforcement nevertheless amount to a violation of competition law? Ought developing nations crafting their own competition laws aggressively prosecute industry-wide group boycotts when those arrangements may simply compensate for ineffective contract enforcement?

The Antitrust of Reputation Mechanisms: Carving Out Permissive Treatment for Development

 Competition laws outlaw cartels and place limits on the degree to which competitors can cooperate. Informal enforcement mechanisms, however, rely on cooperation among competitors. Thus, a formal application of current antitrust law presents a number of arguments that might lead a court to conclude that diamond merchants and their coordinating trade associations are in violation of the Sherman Act.

 In other work, I have detailed the assorted legal possibilities in which the collaboration that enables reputation mechanisms in New York’s diamond industry might run afoul of the Sherman Act.[[18]](#footnote-18) Diamond merchants might be found, for example, to have orchestrated a group boycott with a competitive target,[[19]](#footnote-19) created a joint venture with positive externalities that prohibit excluding competitors,[[20]](#footnote-20) or engineered information sharing mechanisms that trigger anticompetitive restraints.[[21]](#footnote-21) A meaningful antitrust analysis can only proceed if there is recognition that the industry’s collaborative restraints are necessary consequences of the transactional difficulties of contract enforcement. Or, put more starkly, just as competition law permits procompetitive collaborations that improve upon particular market failures,[[22]](#footnote-22) competition law also ought to permit collaborations that compensate for a court failure.

 Note that these concerted enforcement mechanisms—wherein industry arbitrators disseminate information and merchants and community leaders that coordinate punishment—is not merely a species of private third-party arbitration. Typical arbitration is a simple product of contract, wherein parties contractually agree on arbitration to reduce the collective costs of dispute resolution. But following an arbitration ruling, the victorious party then seeks enforcement in public courts and associated state-sanctioned coercion, such as asset seizure and property liens, remain available to enforce the arbitration judgment. Reputation-based sanctions, therefore, are not merely a response to costly rules of litigation, and they would not evaporate if legal procedural rules became more efficient or less costly. In short, whereas most commercial parties choose arbitration to reduce the costs of litigating in public courts, the diamond industry abandons public courts because they offer ineffective enforcement. And whereas the effectiveness of most commercial arbitration depends on ultimate state court enforcement, the diamond industry designs its own arbitration rules to harness its reputation mechanisms and coordinated punishments.

Competition law, therefore, ought to be sympathetic for the need for certain concerted actions to compensate for the failure—or inherent limits—of public institutions. This is true even if the concerted actions closely resemble group boycotts that traditionally have been deemed illegal *per se*. This should be all the more true for developing nations that are aiming to improve upon both competition law and, critically, securing contract and property rights. And even truer for developing nations, like India, that hope to foster a thriving diamond industry.

The Diamond Industry in India’s Past and Future

Indian merchants have traded in diamonds for nearly two and one-half millennia. From the world’s first discovery of diamonds in 800 B.C. until diamond finds in Brazil in 1844, the Indian subcontinent was the world’s only source of diamonds. But despite this long history, Indian diamond merchants did not have a major impact on the global market until the mid-1970s. Only then did Indian diamond merchants translate their diamond expertise into major cutting operations that, one decade later, developed into lucrative global trading networks. (In recounting the early growth of India’s diamond industry and the establishment of large cutting operations specializing in small stones, Bharat Shah, founder and multi-billionaire chairman of India’s largest private empire, boasted “We went to the bottom end of the market, buying and cutting diamonds which the Jews had rejected.”[[23]](#footnote-23)

The diamond industry is now part of India’s economic resurgence. Over 700,000 Indians work as diamond cutters, and thousands of family-owned cutting factories are spread throughout Gujarat province, just five hours north of Mumbai. Nineteen out of every twenty stones in the world are polished in India, constituting 80% of the world’s diamond cartage and 55% of the total value. Diamond exporters are among India’s leading foreign exchange earners, providing the nation with an influx of cash from developed nations, and are responsible for substantial export growth.

Significantly, Mumbai is home to a thriving and chaotic epicenter of diamond merchants, who police each other with extralegal reputation mechanisms. Although Mumbai’s center does not rely on trade rules as strictly as New York’s DDC, and although there is not as formal an arbitration system as there is in New York’s diamond center, reputational information spreads rapidly and contract breaches trigger a foreclosure of economic opportunities. This burgeoning industry, which has meaningfully contributed to India’s economic awakening and will meaningfully contribute to its economic future, is built atop the same species of cartels that deserve, and have received, antitrust scrutiny in the United States. They also are built atop the very cartels that might be targeted by India’s new anti-cartel laws and competition law enforcers.

Conclusion: In Defense of Cartels

 The utility of informal contract enforcement in context of development economics is rather straightforward: when public institutions are unable to credibly secure economic exchange, informal institutions have unquestionable value. The persistence of informal private ordering in the modern state, where ostensibly efficacious public contract enforcement is available, reveals a far more powerful lesson: cartel-like arrangements that engineer reputation mechanisms achieve efficiencies that extend even when public courts are available. They therefore deserve favorable treatment from competition law and ought to be considered in the context of development objectives, not just in the short run but perhaps in the longer run as well.

 The most immediate implication for the spread of competition law in developing nations law is that they should not prohibit concerted group boycotts that are the foundation to meaningful economic growth. But it also suggests that those advocating the spread of competition law to developing nations should recognize, first, that meaningfully securing rights is a far greater priority than combating cartels, and second, sometimes securing contract rights are best achieved by cartels. While a detailed antitrust analysis of an idiosyncratic industry with an odd structure and unusual features offers a relatively small insight into competition law, it also meaningfully reveals the proper role of the rule of law in bringing prosperity to the world’s poorest nations.

1. \* Professor of Law and Business Administration, Duke University [↑](#footnote-ref-1)
2. See, e.g., William E. Kovacic, “Getting Started: Creating New Competition Policy Institutions in Transition Economies,” 23 Brook. J. Int’l L. 403 (1997); Clive S. Gray & Anthony A. Davis, “Competition Policy in Developing Counties Undergoing Structural Adjustment, 38 Antitrust Bull. 425 (1993). International agencies have similarly encouraged the development of competition laws in transition economies, see, e.g., United Nations Conference on Trade an Development, Report by the UNCTAD Secretariat, Empirical Evidence on the Benefits from Applying Competition Law and Policy Principles to Economic Development in Order to Attain Greater Efficiency in International Trade and Development (May 25, 1998). [↑](#footnote-ref-2)
3. Douglass C. North, Institutions, Institutional Change and Economic Performance, 54 (1990). [↑](#footnote-ref-3)
4. *See, e.g.,* Thomas Carothers, “The Rule of Law Revival,” *Foreign Affairs*, Mar.-Apr. 1998, at 95. [↑](#footnote-ref-4)
5. Michael Trebilcock & Jing Leng, “The Role of Formal Contract Law and Enforcement in Economic Development,” 92 Virginia Law Rev. 1517 (2006). [↑](#footnote-ref-5)
6. Id. at 1523-24. [↑](#footnote-ref-6)
7. Kevin E. Davis & Michael Trebilcock, “The Relationship Between Law and Development: Optimists Versus Skeptics,” 61 Amer. J. Comparative L. 895 (2008). [↑](#footnote-ref-7)
8. Id at 933-34. [↑](#footnote-ref-8)
9. CITE [↑](#footnote-ref-9)
10. Avinash Dixit, Law and Lawlessness (2004). [↑](#footnote-ref-10)
11. Grief (1997XX) [↑](#footnote-ref-11)
12. Fafchamps (2004) [↑](#footnote-ref-12)
13. Landa (1981, 1994) [↑](#footnote-ref-13)
14. Galanter (1981/1976) [↑](#footnote-ref-14)
15. Robert Ellickson, Order Without Law (1990); Barak Richman (2006). [↑](#footnote-ref-15)
16. Lisa Bernstein (1992, 1996); Barak Richman (2004). [↑](#footnote-ref-16)
17. Richman (2006, 2009). [↑](#footnote-ref-17)
18. Richman, The Antitrust of Reputation Mechanisms, Va. Law. Rev. [↑](#footnote-ref-18)
19. See, e.g., Fashion Originators Guild, (applying the per se rule to horizontal refusals to deal even if the restraints enjoy procompetitive justifications or are designed to vindicate legal rights). [↑](#footnote-ref-19)
20. See, e.g., Associated Press [↑](#footnote-ref-20)
21. See, e.g., Container Corp. [↑](#footnote-ref-21)
22. See, e.g., Broadcast Music Industry, California Dental, Eurocheques, Synthetic Fibres. [↑](#footnote-ref-22)
23. Gita Piramal, Business Maharajas (1996). [↑](#footnote-ref-23)