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# Organization as Property: Economic Analysis of Property Law Applied to Privatization

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# The Emergence of Market Economies in Eastern Europe

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Most production in capitalist countries occurs in organizations, which come in many forms, such as corporations and partnerships. Private property and capitalism ideally provide a framework for competition among them. The most productive organizations should flourish in a capitalist environment and the least productive forms should disappear. In practice, however, fundamental differences in organization, especially in the way leaders are chosen and dismissed, result from differences in law and public policy. For example, management of public corporations faces the possibility of a hostile take-over in America, but not in Germany or Japan. The difference is a consequence of law, not competition. This observation raises questions about the limits of competition. Are private property and capitalism incomplete until law and policy favor particular forms of business organization? Or can private property and capitalism provide a neutral framework for competition among enterprises with different forms of organization? This chapter seeks to answer these questions in section 1 by explaining the concept of property as developed in the economic analysis of law and then relating property to markets and organizations concluding that imperfections in markets for corporate control preclude pure neutrality of the law.

In section 2 this conclusion is applied to the privatization process in the post-communist countries. They must develop a legal framework for corporate control by choosing among alternative models such as those offered by America, Germany, and Japan, or developing their own hybrid. This chapter suggests some guidelines for the law. Section 3 discusses the legal process to assess the prospects that privatization will yield good laws.

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## 1 A Pure Property Regime

Property is the institution that gives people discretion over scarce resources. Discretion is created by assigning rights to owners and prohibiting others from interfering with their exercise. Rights convey upon owners the legal power to act or forbear without imposing the obligation to do either. The owner is not legally bound to answer to others, whether private persons or public officials, concerning how he exercises his property rights, unless he has voluntarily assumed such obligations by contract. By surrounding the owner with discretion, property creates a zone of privacy within which he can do as he pleases.<sup>1</sup>

The phrase, "a pure property regime," refers to a body of law that creates full and complete rights of ownership and protects them from interference. A conventional list of full and complete property rights includes the right to use, consume, deplete, destroy, improve, develop, transform, sell, donate, bequeath, mortgage, or lease the resource. Full and complete protection from interference by private persons or governments includes prohibitions against trespass, invasion, theft, destruction, nuisance, pollution, flooding, unauthorized use, appropriation, expropriation, takings, and nationalization. Violation of the owner's rights might result in liability for past harm, injunction against future recurrences, or criminal punishment.

### 1.1 Principle of constrained maximum discretion

How large should the owner's zone of discretion be? An owner enjoys the most discretion justifiable purely within a framework of liberty when he can do anything with his resources that does not harm others. In economic terms, the law maximizes the owner's discretion subject to the constraint that its exercise does not cause harm to anyone. This proposition is called the principle of constrained maximum discretion. As defined in liability law, "harm" encompasses pain, fear, injury, or loss of income or wealth. Causing harm is a necessary condition for legal liability in most circumstances and it is a sufficient condition in some circumstances ("strict liability"). The attribution of causation is problematic because people and nature form a complex ecology of interdependence. In such a world, the definition of "not harming others" is not purely technical and partly normative. Social and legal norms stipulate what counts as causing harm to others.

To illustrate, charging a monopoly price harms buyers and often results in liability under antitrust law. In contrast, bidding down the price of a good harms competing suppliers without ordinarily resulting in liability. The relevant legal norms for ascertaining harm and liability are formalized in the law of property,

torts, contracts, crimes, and other bodies of law, such as antitrust and regulation. Property is thus imbedded in a larger normative framework.

### 1.2 Efficiency of a pure property regime

Property serves a variety of purposes. First, it constitutes a significant aspect of liberty. As an aspect of liberty, property is important for its own sake, independent of its effect. Second, property helps to preserve liberty by decentralizing power and resisting tyranny. One of its effects is the preservation of all the other forms of liberty. Third, property promotes efficiency. The latter is within the focus of this chapter. The law pertaining to property ideally internalizes the effects of using resources. To achieve internalization, property law assigns to the owner the immediate benefits and costs from using a resource. Sometimes the use of a resource causes spillovers such as pollution of air, reduction of light, or contamination of water. Nuisance law assigns liability for spillovers to the owner of the resource that causes them. Similarly, risks are sometimes imposed upon others by, say, driving cars, blasting rocks, serving food that can spoil, or selling potentially defective products. When these risks materialize, the law of torts may assign liability for the resulting harm to the owner of the resource that caused it.<sup>2</sup> Property law thus satisfies the principle of rectification by making people bear the cost of the harm that they do to others.

The law of nuisance and torts can be viewed as a mechanism for internalizing costs. When internalization is perfect, all the costs and benefits from using property enter the decision calculus of a self-interested owner. Assigning the net benefits of resource use to its owner gives him an incentive to maximize them. Maximizing the net benefits from resource use requires enterprise and innovation. Internalization is thus both efficient and fair.

Besides internalization, property law promotes efficiency by channelling transactions into voluntary exchange. Much of microeconomic theory since Adam Smith is built upon the insight that trade usually benefits everyone who engages in it, and competitive markets maximize the total surplus from trade. Property law promotes trade, first, by providing clear and secure definition of ownership rights. To illustrate, a public registry of deeds assures the purchasers of real estate that their title is clear. Conversely, obscure or insecure ownership rights burden exchange with high information costs and heavy risk discounting.

Similarly, contract law promotes trade by reducing coordination costs. Coordination becomes problematic when exchange of value is not simultaneous. The party who delivers value first runs the risk that the other party will not reciprocate

<sup>1</sup>The relationship between property and liberty is an old theme in political philosophy. A thorough bibliography and critical discussion is in Underkuffler (1990).

<sup>2</sup>Causing harm is almost always necessary for liability (vicarious liability is the exception). If causing harm is sufficient for liability, the rule of law is said to be "strict liability". In contrast, liability under a negligence rule requires the injurer to cause the harm and also to be at fault.

as promised. In the event of a breach of contract, the standard legal remedy is either to make the promisor perform as promised ("specific performance"), or to make the promisor pay compensation at a level that leaves the promisee just as well off as if the promise had been kept ("expectation damages"). Contract law, thus, overcomes the reluctance of the promisee to advance value by guaranteeing that he will enjoy the expected benefit of the bargain. The preceding remarks about trade and law are succinctly summarized in the technical language of economics. Economists lump together information costs, risk discounting, and coordination costs into the general category of "transaction costs". Thus, it can be said that the law pertaining to property ideally promotes trade by minimizing the transaction costs of exchange.

### 1.3 Mixed property regimes

The pure property regime sketched above has never been realized historically. In some respects, the closest approximation was achieved in the second half of the nineteenth century in Britain and America when politics was dominated by the philosophy of liberalism. In this period, voters rejected most forms of regulation of the market, so interference was minimal. Nevertheless, law in the period fell short of the ideal of a pure property regime in two respects.

First, many social costs were externalized, including pollution, hazards from defective consumer products, and spillovers from real estate development without town planning. In America and Britain, manufacturers were shielded from consumer suits by the legal doctrine that the consumers' contract was with the retailer ("privity of contract"), not the manufacturer. Polluters and others who harmed many people a little and no one a lot ("public bads") were shielded from liability by the absence of class action suits or regulations. Town planning in the rapidly expanding cities required a regulatory framework that was absent in nineteenth century America and Britain and still seems inadequate today, especially in America. Second, the public in this period had little recourse against exploitation by private monopolies, including monopolies in financial markets. Judges did not fill the gaps in legislation by extending common law doctrines or interpreting existing statutes sufficiently to protect against monopoly. Antitrust laws were not enacted in America until the end of the nineteenth century. These defects in the nineteenth century liberal state came under increasing criticism in the late nineteenth and early twentieth centuries from progressives, populists, and socialists. The more modest reformers wanted zoning and public health ordinances, safety in the work place, job security, worker's benefits, and recognition of labor unions, while extremists wanted a social revolution ending in socialism or communism. In America, the nineteenth century liberal state was brought to a decisive end in the 1930s when Roosevelt's New Deal introduced extensive regulations and restrictions on property owners. The story of how law changed is worth re-telling because it illuminates the connection between property and constitutions.

American courts have arrogated to themselves the power to review federal and state statutes to determine whether or not they conform to the constitution. An amendment to the US Constitution states that the government cannot take property from its owner except for a public purpose and with full compensation. In addition, American courts have found in the constitution the right of citizens to contract freely with each other. These constitutional rights protect the owners of property from expropriation by majority vote of the citizens.

Whether these rights are interpreted broadly or narrowly by courts determines the extent to which legislatures can regulate property without violating the constitution. In the early years of this century, the US Supreme Court vigorously protected property rights by striking down as unconstitutional those statutes that limited freedom of contract. The symbol of this approach is the 1905 case of *Lochner v. New York* (198 US 45, 1905), where the Supreme Court struck down a New York statute prohibiting employers from requiring or permitting bakers to work for more than sixty hours a week. In a similar decision in 1923, the Supreme Court invalidated a minimum wage statute for women and children (*Adkins v. Childrens Hospital*: 261 US 525, 1923).

In the *Lochner* era, the courts "constitutionalized contracts," meaning that regulations passed by the majority in legislatures to control the terms of contracts were often judged to violate the individual's constitutional rights. The rejection of this tradition marks a turning point in American constitutional history. By 1937 the Supreme Court repudiated *Lochner* by upholding a minimum wage law for women (*West Coast Hotel v. Parrish*: 300 US 379, 1937). Subsequently the court reversed its previous rulings and upheld many new regulations of contracts favored by President Roosevelt, thus ending the *Lochner* era.

The American constitution guarantees both human rights and property rights. Before the New Deal, the courts vigorously protected property rights but neglected human rights as currently conceived. In the years after the second world war, the Supreme Court reversed itself. Human rights were aggressively protected, especially in such areas as racial discrimination, freedom of speech, freedom of religion, and "due process" (the right not to be harmed by government actions which are illegal). In this same period, the court permitted a wide interference by government with property rights in the form of zoning laws, regulation of industry and contracts, and redistributive taxation. Especially relevant to this chapter are regulations enacted in the field of finance. After Roosevelt's New Deal, commercial banks could not own industrial companies, and the ability of other financial institutions to do so was curtailed. Thus commercial banking was separated from investment banking.

Beginning in the 1930s, regulation of property in America and Britain went far beyond cost internalization or control of monopolies. Instead of a pure property regime, the capitalist democracies have a mixed regime of regulated property. Some laws imposed burdensome regulations that redistributed wealth to politically favored groups. Other laws addressed real market failures, like



environmental pollution and urban sprawl, but employed clumsy policies that raised the cost of public goods, like clean air and town planning, so that people demanded too little of them.

A general critique of the mixed economy, however, is not this chapter's aim. Instead, the focus is on industrial organization and corporate leadership. The stock market is often called capitalism's heart but is more accurately called its brains, because it directs the allocation of resources among alternative uses.

In every country this market is regulated by law. Section 2 explains why regulation of capital and corporate control is an inevitable part of contemporary capitalism. Understanding this fact is essential to guiding the process of privatization in the formerly communist countries. However, regulation of capital markets tends to go far beyond what is inevitable or necessary. Inappropriate and burdensome regulations tend to proliferate in capital markets, as in so many other markets. For example, regulations ostensibly protecting executives from hostile takeovers have proliferated in America just as much as laws ostensibly protecting workers.

## 2 Organization as Property

Property law promotes economic efficiency in two ways, specifically by internalizing net benefits of resource use and minimizing the transaction costs of trade. These two efficiency mechanisms apply, not just to natural resources, but also to the organization of enterprises. The relationship of property law to organization is subtle and confusing, so detailed explanation is needed. Any organization can own property, as when a corporation owns real estate. In addition, some organizations can be property, as when J. Paul Getty owns the Getty Oil Company. Sole proprietorships, partnerships, and closely-held corporations are pure property. Property in this sense is a form of organization. To be property, an organization must have a form that gives someone discretion over it. Discretion is conveyed by a full and complete set of rights as listed above including the right to use, improve, develop, transform, reorganize, deplete, destroy, sell, donate, bequeath, mortgage, or lease the organization. Owning an organization as pure property is much the same as owning a toothbrush, a farm, a song, a patent, or an oil well, because a pure property regime allows owners full discretion to do what they want with their property.

Organizations that cannot be property can own it. Thus a cooperative or government can own property such as real estate and machinery, which form the material base of production, or it can own patents, trademarks, and copyrights, which form the information base for production and marketing. Furthermore, a cooperative or government can make contracts with sellers, buyers, and employees. The property of a cooperative or government can be sold and the contractual

rights can be assigned. But an organization is not its assets, just as a person is not the property that he owns. Cooperatives and governments cannot be sold because they are not themselves property.

To understand why some organizations can be property and others cannot, the general idea of an organization — its definition and terms — must be explained. From a sociological viewpoint, an organization is a structure of offices and roles capable of corporate action. An office is a job with legal powers and obligations explicitly attached to it. The fundamental offices in a business organization are usually defined and powers are allocated to them in a constitutional document such as a corporate charter. The organization's constitution also stipulates how to make operating rules.

Much of the activity of the organization follows informal practices, not formal rules laid down in its constitution or operating rules. The informal practices are organized around roles formed by shared expectations about the division of labor. To illustrate, the accountant's role includes keeping the books, and the secretary's role includes transcribing reports. The people who perform roles often have employment contracts, but the contracts do not explicitly state in detail what the employees' powers and duties are.

Offices and roles can be structured to direct peoples' efforts toward common goals, whose pursuit constitutes corporate action. To facilitate corporate action in a business organization, offices and roles are usually arranged hierarchically. Information flows up the hierarchy, and orders flow down it. Hierarchical structure gives the organization the capacity to act quickly and decisively. Some businesses have departed from the traditional hierarchical model and formed decentralized networks. Such a network remains a single organization so long as it retains the capacity for corporate action. If this capacity is lost, the network is best described as a relationship among different organizations.

Inside an organization, people have offices and roles that coordinate their behavior. Outside the organization, goods are exchanged in markets, and behavior is coordinated by prices. Thus, the boundary of an organization is formed by the markets in which it operates. To illustrate, the Ford Motor Company needs tires for its automobiles. Ford could go outside its organization and buy tires on the market from another manufacturer. Alternatively, Ford could establish a subsidiary to manufacture tires. Production in a subsidiary keeps the activity within the same organization.

When an organization is pure property, the owner has the legal right to choose its goals. In addition, the owner can restructure its offices and roles to suit his own ends. Thus the owner can transform, dissolve, merge, or sell the organization in whole or part. In a corporation or partnership, these ownership rights are conveyed by the organization's constitutional document and by applicable law. In a cooperative or government, which is not property, ownership rights are suppressed by the organization's constitution and applicable laws, which limit any individual's discretionary power over the organization.

As explained, property conveys discretion on the owner to do as he pleases with it. An alternative is to vest power in a group of people acting collectively. To illustrate, the members of a cooperative usually determine how to use its assets by majority vote. When several parties must participate in a decision, a problem of governance exists. Thus, the alternative to property in organizations is politics. Property is a form of individual choice, while non-property control of resources is usually a form of collective choice.

The economic advantage of an organization having an owner is the same as for any other resource. Specifically, ownership aligns incentives for effort and risk-taking by internalizing benefits and costs of resource use. The same person — the owner — determines the organization's structure and also enjoys the resulting profits or suffers the resulting losses. In addition, only organizations that are property can be bought and sold. Trade in organizations, like trade in toothbrushes or coal mines, usually creates a surplus. Empirical research on the stock market indicates a substantial surplus from buying companies.<sup>3</sup> The surplus often arises from replacing inferior management, cutting unprofitable product lines, and re-arranging industrial structure to take advantage of complementarities and synergies. The sale of an organization redeploys its resources very quickly enabling rapid adjustment to changes in technology and demand.

There are also disadvantages of organizational property. Concentrating benefits and costs in an individual focuses risk, while risk spreading may be more efficient. In addition, the owner's discretion over the organization may undermine the loyalty of its members, as will be explained later. An advantage of governance over property concerns norms. An old tradition in Western thought, called contractarianism, holds that law's authority comes from the consent of the people to whom it applies. Consent is more likely to result in voluntary or enthusiastic compliance rather than evasion or grudging compliance. A system of governance in an organization generates consent and creates effective norms better than a system of ownership. So property and non-property forms of organization each have their advantages and disadvantages.

## 2.1 Property as framework for competition

Organizations compete for money and members. Ideally, organizations should flourish that are judged best by the people who decide where to invest and what to join. The law should be neutral in this competition. To achieve neutrality, the law declares that organizations are "legal persons" and formulates property law in terms of the rights and obligations of people. An owner ideally has the same property rights over material resources whether it is an individual, family,

clan, tribe, partner, stockholder, cooperative, corporation, collective, foundation, pension fund, bank, or government. Thus, a pure property regime takes no interest in the identity of owners.

Indifference of law over owners' identity helps create a neutral legal framework. To understand why, contrast property that is actively traded, such as toothbrushes and trucks, with property that seldom changes owners, such as Rembrandt's paintings. If the market for organizations is active, they change owners from time to time becoming the subsidiary first of one company and then another. In inactive markets, organizations persist for long periods of time as the property of the same legal person, such as a large holding company.

Active markets are needed for competition. An important question of public policy toward any market concerns the legal framework needed to sustain competition. In the most favorable circumstances, law sustains competition merely by defining and enforcing property rights. An industry is naturally competitive when the efficient scale of production is small relative to demand for the industry's product. In the absence of collusion, a naturally competitive industry is very active, and it has too many buyers and sellers for any one of them to influence prices. Alternatively, a natural monopoly exists when competition extinguishes itself, because economies of scale are large relative to demand, so that the largest producer always has the lowest costs.<sup>4</sup>

Unfortunately, a market for large organizations inevitably has at least two elements of natural monopoly. First, potential buyers may hesitate to purchase an organization unless they possess the technical knowledge required to manage it. To illustrate, primary candidates to acquire a failing airline are other airlines, and there are few airlines in many markets. Second, potential buyers of large organizations are limited to those who can assemble sufficient capital, and capital markets are notoriously imperfect. Lending necessarily involves asymmetrical information and moral hazard, which are inconsistent with perfect competition.

Policy makers often face a trade-off between monopoly power in markets for products and organizations. To illustrate, if the antitrust authorities allow one airline to acquire another, competition decreases in the market for airline travel. If the antitrust authorities forbid one airline from acquiring another, competition decreases in the market for airline companies. Similarly, if the antitrust authorities allow small banks to merge or collaborate to finance the purchase of large companies, competition may decrease in the market for financial services. Conversely, if the banking industry is fragmented by law as in the United States, few buyers exist for large organizations.

<sup>3</sup>The acquiring firm usually pays a premium, and the higher stock price persists after the acquisition while the acquiring firm's stock price remains largely unchanged. See Jensen and Ruback (1989).

<sup>4</sup>Borrowers usually know more about their credit-worthiness than lenders (asymmetrical information), and borrowers may take excessive risk with the creditor's money (moral hazard).

## 2.2 Biased frameworks

The element of natural monopoly partly accounts for inactivity in markets for organizations, but contract and law are also important. To see why, recall that a pure property regime allows the owner to do anything with the resource that does not harm others. The constraint of not harming others becomes problematical when the property is an organization staffed by people. People in an organization, unlike a toothbrush or coal mine, have legal and moral rights, and their interests and welfare are matters of public concern.

Restructuring an organization and re-targeting its goals directly affect the welfare of its members. People care about the offices and roles assigned to them. They want good, secure jobs. To achieve job security, the current holders of jobs seek to limit the rights of the owners to restructure the organization. Ownership rights over organizations are typically circumscribed and regulated rather than full and complete.

The limits most familiar to the public concern the protection of workers. Less familiar, but no less important to productivity, are the protections for directors and managers. While the variety of executive protections from one country to another is vast, a few examples merit mention. A vivid American example is the so-called "golden parachute". This phrase refers to generous severance pay guaranteed to executives if they lose their jobs in a hostile takeover of the company. The severance pay can be large enough to deter corporate raiders.

In Germany, corporate charters of large firms often contain a "5 percent" rule, which stipulates that no single stockholder can have more than 5 percent of the votes, even if he owns more than 5 percent of the stock. As a consequence of this rule, German banks enjoy secure control over many German companies. Control is secured by virtue of the fact that owners leave stocks on deposit at the banks, and the banks have the right to vote them. Thus, the banks, unlike other large investors, have more than 5 percent of the votes in the companies (Baums 1990). German banks almost never relinquish control over their client-corporations.

In Japan, job security is more a matter of role than contract. The corporate culture favors employment for life including managers. The main bank and the network of suppliers, who together own a controlling share of the corporation's stock, may shunt unsuccessful management aside in the corporate hierarchy but will not fire them. Selling an organization is perceived as disloyal to its members (Sheshido 1991).

In these three examples, limits on dismissing executives are imposed by contract or custom. These private agreements reduce the level of activity and competition in the market for organizations by increasing the cost and difficulty of restructuring and selling them. In addition to private agreements, limits on the market for organizations are usually imposed by law. To illustrate by an American example, the Williams Act requires someone who purchases 5 percent of the

stock of a company to announce that fact publicly and to delay further purchases for a specified period of time.

Adam Smith observed that, monopoly being more profitable than competition, businessmen can seldom talk together without conspiring against the public. Are the agreements and laws protecting executives conspiracies against the public? This question has no simple answer. To illustrate, a "golden parachute" can be legitimate severance pay that enables a company to hire the most able managers, or it can be an insidious device for protecting inferior managers from competition. In spite of this complexity, a simple fact provides some guidance to law and policy. Executives are not a class of people who need the state's paternalistic protection. They have the knowledge and power to negotiate protection for themselves by private agreement. A strong argument, therefore, exists against any laws or regulations ostensibly protecting executives or otherwise impeding the market for organizations on behalf of executives. Executive protection should arise from private agreement, never from law.

A more difficult question concerns whether law should refuse to enforce, or actively suppress, private agreements to protect executives. Should such agreements be suppressed by antitrust law on the grounds that they are conspiracies to restrain trade? The question is complicated because private constraints in markets for organizations can promote efficiency. Efficiency is promoted when security induces loyalty and effort as the next section suggests.

## 2.3 Separation of profits and power

When an organization is pure property, someone ideally possesses full discretion over it and also internalizes the net benefits of its use. To illustrate, power and responsibility are joined in a family business where the sole proprietor makes the decisions and absorbs the profits or losses. In modern capitalism, however, it is uneconomic for the owners of flourishing businesses to finance expansion internally. Funds must shift rapidly from one large organization to another in response to the market's creative destruction. To acquire funds quickly, corporations must sell bonds or stocks. A corporation that sells stock to the public is not wholly the property of the people who run it. In public corporations, sale of stock to the general public fragments and distributes the bundle of rights constituting ownership.

To understand fragmentation, consider the public corporation's governance. The stockholders are usually entitled to one vote per stock on matters of central importance to the corporation including the choice of its directors. The directors, in turn, appoint management and approve policies. In closely held companies, a single person or small group of associates owns enough stock to control the election of directors. Secure control of small companies requires owning 51 percent of the shares. Control may be achieved in large companies by owning a much smaller percent.



Collective choice theorists sometimes define the "power" of a vote as the probability that it will be decisive. To illustrate, each vote is powerful in a close election between two candidates, and each vote has little power in a landslide victory by one candidate. The power of a vote belonging to the controlling block of a company is high while the power of a vote by a minority shareholder is nil. Controlling shareholders hold power and enjoy part of the profits. Minority shareholders enjoy part of the profits and hold no power.

In reality, the managers of a corporation often control it even though they own a small percent of its stock. Thus, power and responsibility are imperfectly conjoined in a public corporation. The resulting separation of profits and power, which is called the "separation of ownership from control," has been studied intensively, most recently by game theorists (see Holmstrom and Tirole 1989, or Tirole 1988). In the standard formulation, the stockholders are described as the "principal" and management is described as an "agent". The principal-agent problem is to design an incentive scheme so that the agent's best interest is served by doing what benefits the principal the most. A perfect solution to the principal-agent problem is an incentive scheme such that the agent maximizes his own utility or income when his actions maximize the principal's utility or income.

Solutions to the principal-agent problem depend upon the constraints built into the model. Typically, a perfect solution requires the principal's information about the agent's behavior to be perfect. If the principal's information is imperfect, the agent usually has incentives to do some acts that benefit him at the principal's expense. In practice, the monitoring of managers by stockholders is costly, so information is asymmetrical. Thus, the principal-agent problem raised by the modern corporation does not have a perfect solution. Instead of perfection, the aim must be a constrained optimum.

To achieve a constrained optimum, a variety of means are employed by contract and law to elicit effort and appropriate risk-taking from managers. Contractual solutions include stock options to increase management's share of ownership, and bonuses or performance pay to reward effort and results. Legal solutions include civil and criminal liability, especially for breach of fiduciary duty. Fiduciary law is noteworthy for its clean solution to the problem of asymmetrical information. Stockholders seldom obtain sufficient evidence of manager's wrongdoing to satisfy the standards of proof ordinarily demanded by courts. Consequently, fiduciary law replaces the usual standards of proof and presumes wrongdoing from its appearance. For example, a manager who appropriates a corporate opportunity is presumed by law to have damaged the stockholders, and he must disgorge the profits to the corporation even if damage to the stockholders cannot be proved (Cooter and Freedman, forthcoming).

A familiar fact of business life is that people are more inclined toward sharp practices or cheating in short run relationships than in long run relationships. The corresponding technical proposition is that many inefficiencies in one-shot

games disappear in repeated games.<sup>5</sup> Consequently, lengthening the time horizon helps solve the principal-agent problem. The time horizon is lengthened by contracts and practices that create job security and loyalty among executives. The optimal solutions to the principal-agent problem often rely upon contracts and practices that sustain long run relationships.

Creating monopoly power for members of an organization builds loyalty to it. Who would quit a job that pays monopoly wages to take a job that pays competitive wages? Lawmakers and regulators, thus, face a difficult problem of trying to sort out optimal solutions to the principal-agent problem and private agreements to create monopoly profits for executives. No general solution for this problem is readily apparent. It has no general solution, because the relevant markets are naturally too thin to be perfectly competitive.

Scholars sometimes say that only four numbers should matter to antitrust policy: one, two, three, and four-or-more. These cryptic remarks mean that a market with four or more suppliers behaves much like a perfectly competitive market, whereas each reduction in suppliers below four increases the likelihood of monopolistic practices. Although not strictly true, this rule of thumb provides a focal point for discussing markets for organizations.

For purposes of discussion, ignore complexities like import competition, contestable markets, and barriers to entry. Assume that when the market for organizations has, say, four or more active participants, it is naturally large enough for effective competition. To illustrate, assume that more than four airlines compete against each other. Furthermore, assume that they actively search for airline companies to acquire and that no airlines companies have created obstacles to hostile takeovers. By assumption, the market for airline organizations is naturally competitive. Now suppose that a contract between an airline and its executives creates obstacles to a takeover, such as "golden parachutes". By assumption, the "golden parachutes" remove this company from the market for hostile takeovers.

The antitrust authorities must decide whether to allow its removal. The preceding rule of thumb suggests an answer. If at least four companies remain in the market, then the rule of thumb suggests that the market will remain competitive. Consequently, the antitrust authorities should allow the restrictive contract.

As a rule, private restrictions that inhibit competition for owning organizations are not troublesome if they effectively remove one company from a market with more than four competitors. Under such conditions of workable competition, the law can provide a neutral framework for competition among organizations and, thus, realize the ideal of a pure property regime. Competition will subsequently determine whether the restrictive contract is inferior or superior to unrestricted contracts.

<sup>5</sup>In general, see Fudenberg and Maskin (1986). For application to the law of contracts, see Hadfield (1990).



To illustrate, suppose the law permitted organizations to make contracts with executives that interfere with takeovers or restructuring. Some manufacturers might form tight links with banks, as in Germany. Other manufacturers might form networks with a main bank and suppliers, as in Japan. Other manufacturers might maintain distance from banks and networks, as in America. If enough companies of different types exist, competition among them would decide in time which form of organization is more efficient.

This scenario assumes a large market for corporate control, so that diverse types of organizations can co-exist. To consider the opposite possibility, return to the example of the airline company that wants to preclude hostile takeovers. However, change the assumptions and assume that less than four companies remain in the market for corporate control after one company adopts restrictive practices to preclude a hostile takeover. The rule of thumb for antitrust law suggests that the market will become uncompetitive. Here the authorities face a much tougher decision. Allowing the contract will undermine competition. Prohibiting the contract may undermine loyalty to firms that is needed to solve the principal-agent problem. This dilemma has no general policy solution. When the market for organizations is thin, a neutral framework is impossible. Instead, the law must adopt a policy of enforcing or suppressing the relevant contracts and practices.

Unfortunately, neither theory nor empirical research provides clear guidance to lawmakers. The differences between the American, German, and Japanese systems have been inadequately analyzed and researched in spite of intensive policy debate. At this point, scholars can only guess about the best policy. One can argue cogently that companies should be private or public depending upon their stage in the industry's history. Failing companies that must be restructured need the decisiveness and agility of private owners in contrast to companies that are flourishing and expanding which need access to public funds. So one can conclude that the best legal framework would permit transitions from public to private organization and back again. However, these remarks only hint at the issues involved in a complex subject.<sup>6</sup>

### 3 Property Theory Applied to the Post-Communist Countries

The communist revolutions in Europe went beyond regulating private property and attempted to abolish it. Not all forms of private property were abolished, but private property as a form of organization in large enterprises was eliminated in all communist countries. Property theory offers an interpretation of the

consequences. The aim of state socialism under Stalin was for the dictator to have complete discretion over economic life including organizational structure, offices, roles, personnel, and material resources. If ownership is equated with discretion over resources, then Stalin owned everything. His control was exercised through centralized planning, which proceeds by issuing commands backed by threats. The economic theory of deterrence offers an insight into the rationality of central planning under Stalin. A perfectly rational, self-interested person will disobey a command when the benefit of disobedience exceeds the expected sanction.<sup>7</sup> The expected sanction equals the magnitude of punishment times its probability. Raising the probability of punishing wrongdoing requires more police, courts, prosecutors, and so forth, which is costly. The cost is especially high for economic crimes where catching offenders is difficult. In contrast, a bullet in the head is cheap. Similarly, the state can actually make a profit by enslaving the wrongdoer. Thus the efficient deterrence of many economic crimes calls for extremely harsh punishments, like shooting or enslaving people, applied with low probability and little discernment (Becker 1968). Deterrence theory implies that terror minimizes the costs of enforcing central planning. Stalin apparently enforced the central plan at moderate cost to government and appalling human costs.

The Stalinist model of central planning enforced by terror was implemented in varying degrees by sector and country. His death created room for contending factions and more humane policies. Property theory explains how the growth of factions and the decline of terror may have contributed to falling economic growth rates in eastern Europe in the 1970s, which turned to stagnation in the 1980s.

As explained, terror is the rational way to enforce central planning. Once terror was abandoned, central planning became too costly to enforce, and the central plan lost its effectiveness. When the single dictator gave way to contending factions, no one had discretion over the entire economy. It was not owned by anyone; instead, property rights were diffuse. In socially owned enterprises, no one person or small group of people joined power and profit. Politics replaced discretion, collective choice replaced individual choice, and governance replaced commands.

Socially owned enterprises had various types of governance that varied by time and place according to political currents (Olson, Ch. 4). A Hungarian scholar has argued that political ends were served by keeping ownership rights vague and uncertain in Hungarian enterprises. They were, in his view, owned by no one (Sajo 1990). His findings are reminiscent of a saying in Croatia: "We know what social ownership isn't, but not what it is."

When property rights are diffuse and uncertain, people devote their energies to trying to secure wealth, rather than to produce it. In general, game theory

<sup>6</sup>For example, leveraged buy-outs by which management takes a failing company private are commended, yet these transactions have been called the "ultimate insider trading".

<sup>7</sup>This statement assumes that the agent is risk neutral.

shows that uncertainty over entitlements diverts energies from production to redistribution. This result can be explained by analogy. When oil wells were first drilled in America, the party who pumped oil to the surface was entitled to keep it by law. In other words, oil in the ground was unowned, and oil raised to the surface was owned by the party who possessed it. As a consequence, oil companies raced each other to extract as much oil from the ground as quickly as possible. Oil in the ground is analogous to social property in the sense that no one clearly owns it. Consequently, people in post-communist countries are engaged in a wasteful race to remove property from social ownership and obtain private possession of it.

The race to appropriate social property is one cause of the spontaneous disintegration of socialist enterprises. After 1989, however, disintegration accelerated into a collapse in many countries. Game theory suggests why. When the legal framework for contract law is underdeveloped, so that promises are difficult to enforce, long run relationships will replace contracts as a device for coordinating behavior (Cooter and Landa 1984; Cooter 1989). Exchange in long run relationships takes the form of reciprocal favors that follow the principle of "tit-for-tat" or "I'll scratch your back if you scratch mine". To illustrate, a mechanic repairs a truck for the driver as a "favor," but the mechanic later receives a crate of oranges off the truck as a "gift". Economic agents engage in barter and keep implicit accounts to make sure that they receive as much as they get.

State socialism, in this way, replaced market exchange with less efficient long term reciprocal and political relationships. A problem arises with a system of reciprocity when the parties see it coming to an end. As the end draws near, economic agents begin to doubt that they will ever be paid back for the favors that they do. Consequently, they are no longer willing to do favors. A loss of faith in the future of social ownership, thus, undermines the reciprocal relationships that made it work. In technical terms, games have cooperative solutions when they are repeated indefinitely while cooperation collapses when the game approaches its end (the "endgame problem").

### 3.1 Property law and the problems of privatization

Leaders in the post-communist countries perceive privatization as the only way out of their current dilemma. The theory of organizational property offers a framework for a few observations about privatization, based on the US experience. The last few years have seen a massive failure of American banks that specialize in real estate investments. (Technically, they are called "savings and loan institutions," not "banks," but they are banks.) When these banks fail, the money is lost that is needed to repay depositors, and the US government is legally obligated to reimburse them. The US government often becomes the temporary owner of a failed bank that it must subsequently reorganize and sell. Thus, the US banking authorities are effectively engaged in nationalizing, reorganizing, and privatizing banks.

Ideally, government agencies in the US and post-communist countries would privatize each enterprise quickly and thoroughly. In reality, the agencies do not have enough personnel or resources for this task. The US banking authorities respond by dealing quickly with small banks that are easy to dispose of and then focusing their energies on those banks that are losing the most money. The philosophy is "stop the hemorrhaging". Perhaps, the post-communist countries will react similarly.

Privatizing assets involves the difficult problem of valuing them. The value of an enterprise is the market price of a controlling interest in it, which is established by entrepreneurs, not accountants. Economists recommend various auctions and similar devices to dispose of companies. Auctions are ideal, but in reality auctions for failed banks do not usually succeed in the US because there are not enough bidders. If the US banking authorities cannot organize an effective auction for, say, a small bank in Arizona, how likely is it for Czechoslovakia to organize an effective auction for a large steel mill?

Instead of auctions, the US authorities typically negotiate with several possible buyers. These practices suggest some strategies that might be useful in post-communist countries. Valuation is relatively easy for standardized assets that are regularly bought and sold in markets, such as a truck, a desk, or a piece of real estate. Valuation is relatively difficult for unique assets that are seldom bought and sold, such as an art work or an historic villa. Another unique asset is the enterprise as an organization. Entrepreneurs are sure to disagree over the value of the enterprise as a going concern especially when markets for organizations tend to be thin in the sense of not having enough participants for effective competition. In the post-communist countries, uncertainty will make these markets even thinner.

Given the magnitude of the problem, it is probably best to let small privatizing enterprises have the organization's value for free in post-communist countries. However, the government might appropriately recoup a share of the value of the material assets of small enterprises. Thus, the valuation problem for small enterprises concerns material assets not organizations.

As explained, the valuation of small, privatizing enterprises focuses upon their wealth, not their income. With respect to large enterprises, the opposite should be the case. One can argue that the primary concern of the government should not be the valuation of the current assets of large enterprises, but their future economic performance. How many new workers will be employed? How much will production increase? How much will be exported? How soon can subsidies, artificial prices, and tariff protection end?

The valuation of large enterprises must take place as an aspect of the negotiating process by which the government's privatization agencies bargain with investors including foreigners, who seek to acquire the enterprises. The "best deal" is the transfer of the assets to private owners who provide the best terms as measured in future employment and production.

### 3.2 Which capitalism?

Many people in the post-communist countries observed that social ownership caused irresponsible management. They mistakenly concluded that a stock market will automatically cure the problem. The mistake arises from the failure to distinguish between buying stock and buying a company. As explained, the managers of capitalist corporations have devices for insulating themselves from outside pressures so that they can pursue ineffective or irresponsible policies. When a company has an owner with a controlling interest, that person or organization can force managers to be responsible, whereas dispersed stockholders cannot. Germany, Japan, and the US offer different models for overseeing managers. As explained, the controlling stockholders in Germany are banks; in Japan, the controlling stockholders are the company's main bank and suppliers; in the US, most financial institutions like commercial banks are not allowed to own a controlling share of stocks. Instead, the US has developed hostile takeovers, so the market oversees the managers. The post-communist countries thus face the question, "which capitalism"?

There can be no neutral framework for competition to decide this question. Instead, it must be answered by law and policy. A neutral framework is impossible because the potential market for corporate control is not large enough for the full range of alternative forms of finance and control to compete with each other. When privatizing, the roles must be delineated for commercial banks, investment banks, mutual funds, insurance companies, and pension funds. Institutional investors are unlikely to relinquish any control that they exercise over the boards of directors during the privatization process. So the path taken in the transition to capitalism will probably have a decisive influence upon the final result.

### 3.3 Where does good law come from?

The current economic crisis in the post-communist countries demands a political solution. The privatization agencies will inevitably respond to politics. For example, in Croatia the privatization fund's director is appointed by the President of the Republic, and the fund will have access to tax revenues supplied by the state. The intimate connection between politics and finance creates many possibilities for political favoritism and corruption in the allocation of investment funds.

In the long run, the government privatization funds must be liquidated or transformed into investment banks that are insulated from politics and operate on commercial principles. In the meantime, the course of privatization will be evolutionary in part and planned in part. The emphasis and direction of privatization will shift as political currents reverse themselves, voters gain more experience with capitalism, new issues become salient, and public priorities change.

Privatization requires much law making, so the process of making law must itself be analyzed and its workings anticipated. The economic analysis of legal process is a substantial body of theory. A few of its insights, beginning by

distinguishing between legislation and judge-made laws merit attention. Property, torts, and contract law in the English-language countries find their origins in the common law. Common law is created by judges as they build upon precedent and pronounce legal rules in deciding particular cases. According to the original understanding of the common law, judges were supposed to identify social norms and enforce those that satisfy certain legal criteria (Eisenberg 1988). For example, communities develop standards of reasonable care with respect to potentially dangerous activities like driving cars.

Social norms arise from repeated interactions among people. Economic theory has offered various proofs that repeated games often have efficient solutions under specified conditions. Efficiency in repeated games requires low discount rates for futurity, an indefinite number of repetitions, and information concerning the past history of the moves made by other players. Consequently, the social norms that judges enforce tend to be efficient. The pressure in common law toward efficiency increases when judges adopt efficiency not just fairness as a goal (Cooter 1990). Economic analysis has made remarkable progress in demonstrating the efficiency of the common law. However, the pressures toward efficiency have not always prevailed against counter-pressures that also exist in the common law.<sup>8</sup>

The victories of Napoleon resulted in the abolition of common law in most of Europe and its replacement by codes and other statutes. To become law in democratic countries, codes must usually be enacted by the legislature. Judges subsequently have some scope to make new laws by interpreting codes. The interpretation of codes has similarities to the common law. A lively debate continues concerning how large the difference really is between common law and the interpretation of codes, both of which can be called "judge-made law".<sup>9</sup>

The discretion of the court to interpret and make law is determined in part by history, such as the existence of common law or a tradition of courts reviewing statutes to determine their constitutionality. In addition, the court's power is determined by the constitution, especially by distributing power among the other branches of government. It is not hard to show that courts have more interpretative power when the constitution gives veto power over legislation to several other independent bodies (see Ferejohn and Weingast, forthcoming, and Gely and Spiller 1989).

To illustrate, under Britain's unwritten constitution, the Prime Minister gets the legislation that she wants. If Britain's highest court interprets law differently from the Prime Minister, she can easily change the law. No one else has an

<sup>8</sup>To illustrate, the enthusiasm of American judges to extend tort liability is widely perceived as having created inefficiencies and caused a crisis in the law of torts. See Priest (1985).

<sup>9</sup>This point is discussed in the context of country reports from all over Europe in a symposium. See Cooter and Gordley (forthcoming).



independent veto. In contrast, in America three independent vetoes exist for proposed legislation: the House, the Senate, and the President. The Supreme Court can depart widely from the interpretation of legislation preferred by any one of them without provoking revision of the law provided that one of the bodies with independent veto power prefers the Supreme Court's interpretation to the revision proposed by the other two bodies. Hence, the courts make a lot more law by interpretation in America than in Britain.

Judge-made law develops gradually by accretion. The principle pronounced in one case is extended to another by analogy. If cases are too dissimilar, the analogy fails, and the attempted extension of law loses legitimacy. Unlike judges, the legislature, which enjoys the sanction of a majority of voters, is not bound to proceed incrementally. Instead, legislation can strike out abruptly in new directions. Legislation is autonomous, and judge-made law is historical.

Another difference concerns incentives. Ideally, judges are insulated from political and economic life so that their decisions are disinterested. "Disinterested" means that the interests of a judge or his family, especially their wealth and power, are not affected in any discernable way by how he decides particular cases. This ideal is realized in many European countries and in U.S. federal courts. In contrast, the wealth and power of legislators is directly affected by how they vote on particular bills. Statutes and codes are enacted by interested politicians. Politicians tend to redistribute wealth toward favored groups. In many instances, regulation has been the device by which politically favored industries obtain monopoly profits that competition would dissipate in an unregulated market. The economic analysis of legislation has produced the skeptical belief that statutes pertaining to property usually redistribute wealth in favor of politically influential groups. In contrast, judge-made law is largely disinterested. That is why judge-made law remains important to preserving property rights. Protecting property against politics requires an independent judiciary with the power to make law by interpreting statutes.

Privatization in the post-communist countries is an abrupt change that must proceed largely through legislation rather than judge-made law. The economic analysis of legislation provokes pessimism concerning the likelihood that it will lead to anything resembling a pure property regime. Uncertainty about property rights multiplies the opportunities for political redistributions to politically favored groups. The hope for secure property rights in law must rest upon widespread, popular disgust with their abolition under communism.

## 4 Summary and Conclusion

Private property is a bundle of rights that gives owners discretion over the use of resources. Discretion implies that the owners are not answerable to other people or the state. This zone of privacy is an aspect of freedom and a bulwark against

tyranny. In addition, private property creates incentives for efficiency and innovation. A pure property regime promotes efficiency by internalizing the costs and benefits of resource use, lubricating trade, and promoting efficient organization.

Some organizations can be an individual's property, and others preclude individual ownership by their nature. Discretion and individual choice are aspects of organizational property while politics and collective choice are aspects of most non-property organizations. Private property and capitalism are not sufficient conditions to determine the form of corporate organization. Rather than prescribing a particular form, private property and capitalism ideally provide a framework for competition among alternative forms.

In practice, this framework cannot be perfectly neutral, because markets for organizations are thin rather than being naturally competitive. Privatization in the post-communist countries must adopt financial institutions through laws that favor particular ways of choosing business leaders. Germany, Japan, and the US provide alternative models.

Economic analysis suggests that disinterested judges might direct law toward efficiency, but legislation is less likely to take this course. Rather, legislation is directed toward efficiency in fits and starts as government responds to shifting political currents. Privatization needs a strong, independent judiciary, but it can only proceed through legislation, which counsels skepticism about the likely results.

Constitutional historians of the United States have identified certain moments in history when politicians and the public have been able to rise above immediate self-interest and respond to a larger vision (Ackerman 1977). In effect, these theories postulate behavior outside the economic model of self-interest, which leads to the creation of a constitutional framework for capitalism and democracy. Perhaps some of the post-communist countries will enjoy such a moment in their history right now. The challenge to the newly democratic governments is to develop a privatization strategy that will generate political support among voters as they experience its effects.