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Introduction

Most production in modern economies 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 less productive forms should disappear. The legal ideal of capitalism is neutrality of law towards forms of organization.

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 in 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. There are many capitalisms, not just one.

This observation raises questions about the limits of the law's neutrality in the competition among organizational forms. 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 paper seeks to answer these questions by applying the concept of property as developed in the economic analysis of law to markets for organizations. I conclude that imperfections in markets for corporate control preclude pure neutrality of the law. This conclusion has an important implication for privatization in Eastern Europe. The post communist countries must choose among the several capitalisms when developing a legal framework for corporate control. Alternative models are offered by America, Germany, and Japan, although the post-communist countries will probably develop their own hybrids.

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.

I use the phrase "a pure property regime" to refer 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.

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. I call this proposition the principle of constrained maximum discretion.

Causing harm is a necessary condition for legal liability in most circumstances. However, people and nature form such a complex ecology of interdependence that determining who harmed whom is problematic. 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 in a competitive market harms other suppliers, but does not ordinarily result 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, which I cannot canvas in this essay.

Efficiency of A Pure Property Regime

Property serves a variety of purposes. First, it constitutes a significant aspect of liberty, which is important for its own sake, independent of its effects. Second, it helps to preserve liberty by decentralizing power and resisting tyranny. Third, property promotes efficiency, which is the focus of this essay.

The law pertaining to property ideally internalizes the effects of using resources. "Internalization" means that all the benefits and costs of the owner's actions accrue to him, not to others. To achieve internalization, property law assigns to the owner the immediate benefits and costs from using a resource, but sometimes resource use causes spill-overs, such as pollution of air, reduction of light, or contamination of water. Nuisance law assigns liability for spill-overs 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.[1] The law of nuisance and torts can thus be viewed as a mechanism for internalizing costs.

Fairness requires that people who cause harm must compensate their victims, or so it seems to many lawyers. When internalization is perfect, so is compensation. What is more important for efficiency, however, is that perfect compensation causes all the costs and benefits from using property to 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, which makes the economy production. So internalization is both fair and efficient.

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.

These 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 we can say that the law pertaining to property ideally promotes trade by minimizing the transaction costs of exchange.

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 19th 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 spill-overs from real estate development without town planning. In America and Britain, manufacturers were shielded from consumer suits by the legal doctrine that the manufacturer could not be sued by the consumer because his contract was with the retailer ("privity of contract"). 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 19th 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 19th century.

These defects in the 19th century liberal state came under increasing criticism in the late 19th and 20th 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, whereas extremists wanted a social revolution ending in socialism or communism. In America, the 19th 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 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, whereas the regulation of property went far beyond cost internalization or control of monopolies. Instead of a pure property regime, America and other capitalist democracies now have a mixed regime of regulated property. A general critique of the mixed economy, however, is not this essay's aim. Instead, I focus upon 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. Law and policy favors some forms of organization over others, rather than providing a neutral framework of competition. I will next explain why

regulation of markets for corporate control is an inevitable part of contemporary capitalism, and why regulation of capital markets tends to go far beyond what is inevitable or necessary. To do so, I must first explain why owning an organization is so much more problematic than, say, owning an oil well or a toothbrush.

Organization as Property

Any organization can own property, as when a corporation owns real estate. In addition, some organizations can be property, as when Henry Ford owned the Ford Motor 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.

Organizations that cannot be property can own it. Thus a cooperative or government can own property such as real estate, machinery, patents, and trademarks. 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 must be explained. I will offer a definition and explain its terms. 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 towards 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,

whereas 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 oil wells, usually creates a surplus. Empirical research on the stock market indicates a substantial surplus from buying companies.[2] 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, whereas 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 may

generate consent and create effective norms better than a system of ownership. So property and non-property forms of organization each have their advantages and disadvantages.

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 towards 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.

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.

Policy makers often face a tradeoff 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 in order 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.

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 problematic when the property is an organization staffed by people. People in an organization, unlike a toothbrush or oil well, have legal and moral rights, and their interests and welfare are matters of public concern.

Restructuring an organization and re-targeting its goals directly affects 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. I cannot survey the variety of executive protections from one country to another, but I can mention a few examples. A vivid American example is the so-called "golden parachute." This phrase refers to

generous severance pay guaranteed to executives in the event that they lose their jobs in a hostile take-over 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%" rule, which stipulates that no single stockholder can have more than 5% of the votes, even if he owns more than 5% 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% of the votes in the companies.[3] 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.[4]

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% 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 thus 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 I now explain.

Separation of Profits and Power

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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% 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, whereas 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.[5] 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. A perfect solution typically requires the principal's information about the agent's behavior to be perfect. In reality, the principal's information is highly imperfect, so the agent usually has incentives to do some acts that benefit him at the principal's expense. Thus the principal-agent problem raised by the modern corporation does not have a perfect solution.

In this imperfect world, 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.[6]

A familiar fact of business life is that people are more inclined towards 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.[7] 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? Law makers 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. I offer no general solution for this problem because it has none. 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 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 of thumb, 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.

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 <u>less</u> than four companies remain in the market for corporate control after one company adopts restrictive practices to preclude a hostile takeover. The "four firm" 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. My guess is 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, whereas companies that are flourishing and expanding need access to public funds. So my guess is 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.[8]

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, which I outline briefly. 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.[9] 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.[10] 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.[11] 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.[12] His findings remind me of a saying I heard 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 property, rather than to produce it. In general, game theory 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 under-developed, so that promises are difficult to enforce, long-run relationships will replace contracts as a device for coordinating behavior.[13] 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 thus 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, whereas cooperation collapses when the game approaches its end (the "endgame

problem").

Which Capitalism?

Leaders in the post communist countries perceive privatization as the only way out of their current dilemma. I cannot discuss all the aspects of privatization here, so I will focus on organizational property. Many people in the post communist countries observed that social ownership caused irresponsible management. They concluded that a stock market will automatically cure the problem, which is a mistake. The mistake arises from the failure to distinguish between buying stock and buying a company. As explained, the management 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 U.S. 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 U.S., most financial institutions like commercial banks are not allowed to own a controlling share of stocks. Instead, the U.S. has developed hostile takeover, 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.

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. Uncertainty about property rights multiples the opportunities for political redistributions of wealth and undermines the confidence of investors.

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 mean time, 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. Space does not permit me to develop an economic analysis of legislation here, but such an anlysis provokes pessimism concerning the likelihood that privatization will lead to anything resembling a pure property regime.

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, whereas 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 U.S. provide alternative models.

Economic analysis of the legislative process provokes skepticism that privatization will lead to anything like a pure property regime. Legislation is directed towards efficiency in fits and starts, as government responds to shifting political currents. Protection of property from political redistributions, which undermine the confidence of investors, requires a strong, independent judiciary.

Constitutional historians of the United States have identified certain moments in history when politicians and the public has been able to rise above immediate self-interest and respond to a larger vision.[14] 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. The brightest hope for privatization in Eastern Europe is that these countries will enjoy such a moment in their history right now.