

## **Emergent versus Directed Property Rights: Evidence from Transition Economies**

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*While property rights are important to the market order, the transformation of common pool resources into private property through privatization has achieved mixed results. We argue that the so-called “Washington Consensus” failed not because of intentions or intelligence, but because most economists have failed to appreciate that property rights are emergent institutions. Instead, much of the work in development treats property rights like an exportable good. In this paper, we use evidence from the post-communist transition to provide preliminary evidence that countries that used direct auctioning to allocate property rights following transition outperformed other methods of privatization.*

### **INTRODUCTION**

For more than 20 years, privatization has been in vogue and the topic of much academic debate and disagreement.<sup>1</sup> With the collapse of communism, tremendous amounts of resources were shifted from the public sector to private ownership. In Czechoslovakia, for example, government spending as a percentage of gross domestic product (GDP) accounted for 98% of gross domestic product in 1989; today, government spending as a percentage of GDP is approximately 20% of GDP. The collapse of communism in much of Eastern Europe and the former Soviet Union in 1989 led to a revival of interest in the subject of privatization and a concomitant shift in the ‘Washington Consensus.’

The economic development community shifted away from state-led industrial models of development towards ‘institutional reform’ and ‘conditionality’ models. As a whole, the “institutions matter” shift in academia and the policy world resulted in widespread reform, which, on net, has resulted in higher levels of economic freedom for the world. Since 1990, average economic freedom for 102 measured countries has increased from 5.87 to 6.7 (Gwartney and Lawson, 2009, p.15). The former Soviet Union led the march towards greater economic freedom, but the spread of freedom was not limited to the post-communist region: parts of Africa, Latin America, and Asia also enjoyed significant improvements.

While the overall picture for the world has been generally positive for the world, no two reform paths have been the same and the reality of reform has been disappointing in many countries. The mixed development results have led many economists and legal scholars to become interested in the different types of privatization approaches taken by different countries. In the former Soviet Union, for example, voucher privatizations were attempted while other countries reformed by directly auctioning off state-owned resources.

When assessing the relative performance of transition economies, most of the attention has been focused on the State's role in the privatization process. For example, elites in Russia's oligarchy have been heavily criticized for failing to appreciate *de facto* control rights during the privatization process (Boettke, 2001). By contrast, former Czech Finance Minister Vaclav Klaus's voucher privatization has been widely praised for its role in the relatively efficient and equitable transition in the Czech Republic. In the sections to follow we look at the post-communist transition and ask the following question: what happens when property rights are allocated by the invisible hand of the market rather than government decree? We categorize each privatization as more/less free and then evaluate the subsequent economic performance after privatization.

In the next section, we introduce two competing theories of property rights. One theory of property rights emphasizes decentralization, local knowledge, and the spontaneous process; the other theory of property rights emphasizes the State's role in the definition and enforcement of rights, centralization of rights, and clarification of rights. After looking closely at the two theories of property rights, it becomes clear that Eastern Europe reformers were implicitly formulating policy with the latter version of property rights in mind. In Section 3, we explain how the legal positivist theory of property rights became popular across Eastern Europe and the former Soviet Union. In Section 4, we look at post-communist growth rates and other evidence related to post-communist economic performance in Eastern Europe. In the final section, we provide some concluding thoughts.

## COMMON LAW VS. LEGAL POSITIVIST THEORIES OF PROPERTY RIGHTS

### The Common Law Approach

When examining the privatization process, it is useful to draw a distinction between a common law interpretation of property rights and the legal positivist alternative.<sup>2</sup> The common law approach emphasizes the spontaneous nature of property rights and tends to confirm already developed practices and customs in place at the local level. It is a decidedly evolutionary approach, and it emphasizes the decentralized nature of information and the role of knowledge in decision-making. According to the common law approach to property rights, property rights do not originate from the law or some decree, but, rather, come about as a natural response to resource scarcity. Some of the more prominent common law theorists include Anderson and Hill (1983, 1975), and Hayek (1973, 1983). Among the first to describe the common law approach to property rights was the Austrian economist Carl Menger (1994 [1871], 1963 [1883]).

For Menger, "[t]he problem that science must solve is...the explanation of human behavior that is general and whose motives do not lie clearly upon the surface" (Menger, 1994 [1871], p.315; emphasis in the original). The origin of social institutions for Menger is not the result of an economic process, but is rather "*the result of human calculation which makes a multiplicity of means serve one end*" (1963 [1883], p.132; emphasis in the original). An example of this would be a "social contract" explanation of the origin of property. The emergence of social institutions can also be explained as a product of the unintended results of historical development, rather than as the result of some common will. Menger labels institutions that arise in a spontaneous fashion, "organic" (Menger, 1963 [1883]). Instead of being part of a deliberate plan serving a single hierarchy of ends, institutions of "organic" origin are essentially spontaneous or unplanned, serving no single hierarchy of ends, but, rather, a multiplicity of individual, competing ends. In other words, the institution develops gradually over time as a result of unintended consequences of intentionally acting individuals. Thus, the evolution and the organic, or spontaneous, formation of an institution are "twin conceptions" (Hayek, 1973). Throughout the rest of the paper we shall call the evolutionary approach described above the common law approach to property rights (as opposed to Menger's "organic" label).

The common-law theory developed by Menger describes two processes of institutional evolution (Vanberg, 1986). The first is a "process of variation" in which new social norms are generated by means of separate individual choices. In other words, new practices are adopted as the result of the self-interest of one person or a few people. The second process—the "process of selection"—explains how a practice

will spread among society due to (self-interested) individual imitation. Along with the traditional practices come new, competing practices, some of which will be adopted widely and spread throughout society. As demonstrated by Menger (1994 [1871]) money is a fine example of an institution of spontaneous and evolutionary origin.

For Hayek (1983, p.47), “private property...was never ‘invented’ in the sense that people foresaw what its benefits would be,” but spread “because those groups who by accident accepted them prospered and multiplied more than others”. Hayek calls this a process of “cultural selection,” which allows certain groups and practices to withstand the duration of time. Recent evolutionary arguments clearly point to privatization being a process rather than an outcome. A rule, such as the right of first possession, can be adopted simply because it is popular with others (Sugden, 1989). As Anderson and Hill (1983) point out, the evolution of property rights in land, water, timber, and livestock on the American frontier was the result of a messy process involving homesteaders and other *de facto* owners of the resources: property rights were allowed to emerge in the West rather than being imposed by the State. As the common law approach makes clear, the world is filled with different, and often competing, property rights systems. The different systems are the result of ongoing interactions among the users of scarce resources. From a common law perspective the State’s role in the privatization process is therefore limited to the codification of already existing property rights systems.

### **The Legal Positivist Alternative**

The legal positivist theory of property rights places far greater emphasis on deliberative action and planning. Unlike the common law approach, the legal positivist approach views legal practices and customs as artifacts of the State. The legal positivist approach recognizes a significant role for the State in the privatization process: in most cases, the State is given the exclusive authority to define and enforce property rights. As Lipton and Sachs (1990: 294) describe it, “Privatization means creating anew the basic institutions of a market financial system, including corporate governance of managers, equity ownership, stock exchanges, and a variety of financial intermediaries...” The emphasis is, therefore, on creating something new rather than attempting to recognize the existing bundles of rights. In fact, the existing set of customs and rules is often thought to require a “Big Bang” to bring about the necessary economic reforms. Some of the more prominent legal positivists include Riker (1991), Holmes and Sunstein (1999), and Murphy and Nagel (2002).

The legal positivist approach is ultimately grounded in a strong form of rationalism, and we find Thomas Hobbes (1991 [1651]) offering one of the earliest legal positivist theories of property rights. In Hobbes’s state of nature, there is no property. According to Hobbes, property rights were the result of the commonwealth. Since the commonwealth exists only through the civil laws granted by the sovereign, property rights are a vacuous concept in the absence of the State or sovereign authority.

Many contemporary legal theorists and political philosophers have followed Hobbes by saying private property does not exist in the absence of the State. According to Holmes and Sunstein (1999), property rights involve public costs. Therefore, they are not going to be well-protected unless there is a large State to pay for the public costs of the rights. Murphy and Nagel (2002) go farther by saying property rights do not even exist in the absence of taxation.

Contemporary economists and political scientists also emphasize the State’s role in creating, defining, and enforcing property rights. For example, in an examination of Ghana’s economic performance, Firmin-Sellers (1995) says that Ghana’s central government “lacked sufficient coercive authority.” In the absence of a strong state, the informal rights in Ghana failed to inspire investment and growth. McFaul (1995) makes a similar point when examining Russia’s difficult transition: without a strong State defining and enforcing property rights, Russia’s privatization programs were destined to fail.

The legal positivist approach to privatization has difficulty recognizing property rights in the absence of the State. According to the legal positivist interpretation, the State is necessary for the enforcement of rights. Without the State, rights would be severely fragmented. As legal positivists see it, without some kind of centralized authority, rights will be scattered and there will be a permanent war of all against all over the undefined rights.

## LEGAL POSITIVISM IN EASTERN EUROPE

The common law versus legal positivist dichotomy is an important one when we turn our attention to Eastern Europe and the former Soviet Union. If reformers are promoting a common law approach to privatization, power tends to be decentralized and decisions flow from the bottom up. By contrast, if reformers are promoting a legal positivist approach, the organizational structure is highly centralized; power is concentrated in the hands of a few (or one), and decisions flow from the top down.

While the distinction between common law and legal positivist approaches is admittedly simplistic, it helps us understand how much information is embedded in different property rights arrangements. According to the common law interpretation (Anderson and Hill, 1975; Demsetz, 1967), the allocation of property rights is like any other scarce good: scarcity determines the quantity and quality of property rights. The efficient allocation of property rights is, thus, a result of resource scarcity, and it cannot be easily determined in advance.

When we seek to make sense out of the transition economies of Eastern Europe and the former Soviet Union, we must first understand the common law versus legal positivist interpretation of property rights. If property rights are, indeed, like other goods and services, granting the State the exclusive right to privatization can seriously hamper the quality and quantity of rights. If, by contrast, property rights are a scarce good, which emerge from the market process, then policymakers should be less concerned with how to allocate rights and more concerned with how to encourage an environment conducive to the emergence of rights.

Many economists believe the privatization process in Eastern Europe failed because bureaucrats were in charge of the privatization process. For economists, the result is not surprising. As McChesney (1990, p.298) points out in a different context,

...there is no guarantee that government actors will choose the optimal system of ownership in privatizing some common resource; government officials will prefer an inefficient private-rights assignment if it is beneficial to them personally.

Citizens in Eastern Europe and the former Soviet Union had a similar experience. After the first two waves of privatization in the Czech Republic, the National Property Fund (2000) failed to follow through on promised privatizations of banking and other heavy industry. As one Czech citizen put it, The National Property Fund is the “National Property Fraud.” According to their original mission, they should not even exist today. Yet, they still hold 15-20% of Czech assets. What would happen to their jobs if they privatized their remaining assets?<sup>3</sup>

Individuals on the street in the Czech Republic seem to realize the crucial point in McChesney’s model: why would a leader or bureaucrat acquiesce to the privatization of resources if privatization promised a reduction in wealth and power for the bureaucrat in control?<sup>4</sup>

The degree to which bureaucrats and government officials cling to power depends largely on the structure of the privatization process. If the privatization process is going to be determined by private citizens who are able to bid on resources, the resources will be allocated and used more efficiently. If, instead, ill-informed bureaucrats—without much to gain if they do a good job—guide the privatization process, less efficient property systems are likely to result.

As the next section makes clear, the legal positivist approach to privatization was actually the main reason for why the privatization process failed in many transition economies. Economists from the West exported the legal positivist notion of property rights to Eastern Europe. The countries most determined to design property rights systems anew were the ones enjoying the worst post-communist economic performance. By contrast, countries committed to the direct sale method of privatization—a method more consistent with the common law approach—have fared much better in their transitions.

## EVIDENCE FROM TRANSITION ECONOMIES

At this point, the careful reader might be asking: weren’t the transitions in the Czech Republic, Estonia, Hungary, and Poland cases where top-down planning worked? Moreover, when we look at other

successful transitions in places like Chile, Ireland, and New Zealand, high degrees of centralized authority also went hand-in-hand with reforms. If top-down planning and legal positivism go hand in hand, then recent history suggests legal positivism works! After all, this is the conclusion Sachs and Warner (1995, p.61) reach when they write, "...all of the strong trade reformers [of Eastern Europe] achieved positive economic growth by 1994, while none of the other countries had done so."

Careful central planning cannot be the whole story behind the successes. Early on in the Eastern European privatization process, just about every transition economy had a high degree of centralization with significant power vested in the hands of a few key reformers. If leaders in Eastern Europe had chosen to abuse their power, we could have seen results similar to the transition experiences of Nicaragua, the Philippines, and Zaire. Furthermore, if concentration of power and authoritative (if not authoritarian) leadership were all it took to be successful, then every Eastern European country should have done reasonably well.

The reliance on specialized government bureaus to direct the privatization process has been a serious problem for many reforming countries, and it has led them to ignore the *de facto* property rights already in existence. In the Czech Republic, for example, the National Property Fund ran Klaus's voucher privatization programs. Under Section 5 of the Privatisation Act, the National Property Fund (2000) has the sole authority to define and create property rights:

- (1) The Government of the Czech Republic (hereafter "Government") shall make decisions concerning the selection of State property and capital interests in other legal entities suitable for privatisation [sic].
- (2) The transfer of property under this Act shall be realised [sic] based on the decision to privatise [sic] a company or its part, or based on the decision to privatise the capital interests of the State in other legal entities (hereafter "privatisation decision"), issued on the basis of a privatisation project proposal.

In Section 6, the scope of the National Property Fund's power is clearly defined:

- (1) The Company Privatisation Project is a sum total of economic, technological, asset, time and other data that contains:
  - a) the designation of the company and definition of the assets intended for privatisation in compliance with this project (hereafter "privatised assets"),
  - b) information concerning how the State acquired the privatised assets,
  - c) definition of the parts of the concerned assets that cannot be used to business purposes (for example, bad debts, inapplicable fixed assets and stocks of materials),
  - d) valuation (assessment) of the privatised assets,
  - e) method of transfer of the privatised assets including the settlement of the claims of the entitled subjects,
  - f) in the case of establishment of a commercial company, designation of its legal form,
  - g) in the case of establishment of a joint stock company, state the method for distribution of the shares, their stakes in company, as the case may be, the types, as well as information concerning whether and to what extent the investment vouchers would be applied,
  - h) in the case of sale, the method of sale, determination of price, payment and other conditions,
  - i) method for the transfer of industrial or other intangible rights agreed with the Industrial Rights Office, if such rights are the property of the company.

As Sections 5 and 6 of the Privatisation Act make clear, even the Czech Republic, a country whose post-communist transition was fairly successful, was unable to avoid the tendency towards central planning in the privatization process; in essence, they used central planning in an attempt to decentralize their resources.

The Czech Republic is not the exception to the rule. A similar agency, the Estonia Privatization Agency, directed Estonia's privatization. In Poland, the Ministry of Ownership Transformation was responsible for the Polish privatization. Similarly, the State Committee for the Management of State



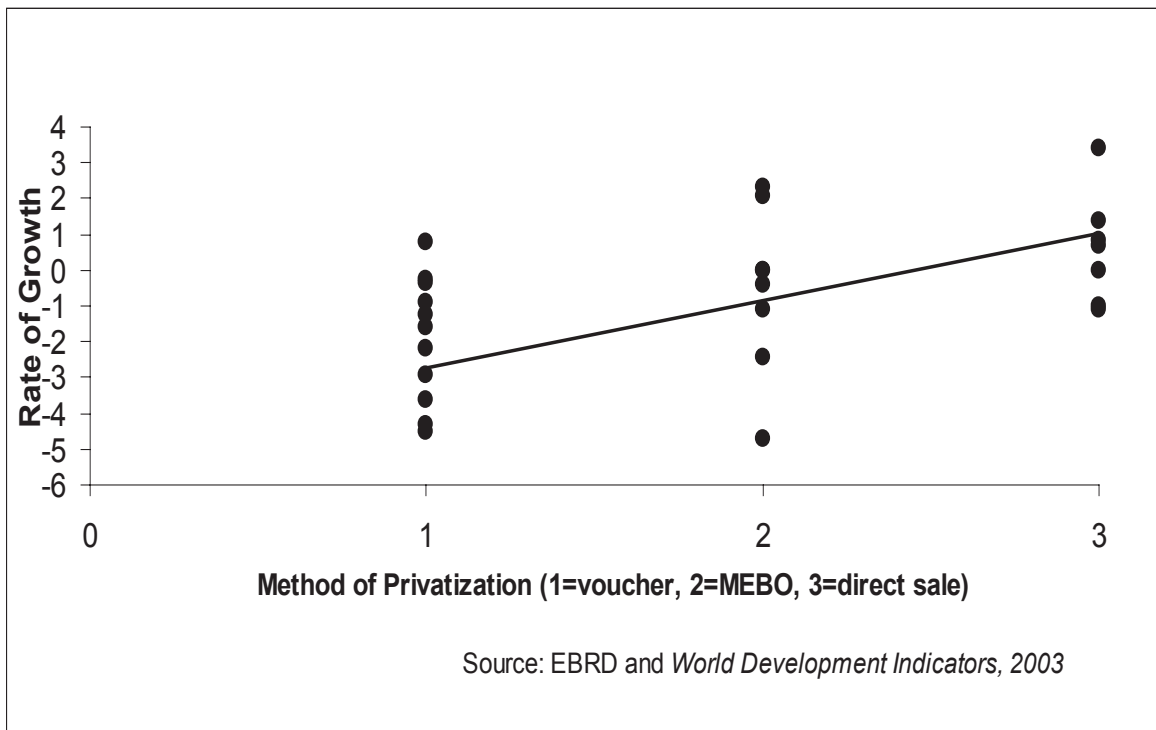
Property (GKI) controlled Russia's privatization, and, in 1991, the generally pro-market Anatoli Chubais became its chairman. Throughout Eastern Europe and the former Soviet Union, the collapse of communism meant the collapse of central planning in the market for goods and services; yet, at the same time, the increased opening of markets did not lead to a decentralization of the allocation of property rights.

In 1998, the European Bank for Reconstruction and Development (EBRD) classified the methods of privatization in post-communist countries. The EBRD's classification system, while imperfect, indicates the level of centralization in the privatization process. The EBRD first classified a country's primary method of privatization as one of the following: voucher, management-employee buyouts (MEBOs), or direct sales. The EBRD also listed a secondary method of privatization. To illustrate the EBRD's classification system: Albania's primary method of privatization was a MEBO privatization, and their secondary method of privatization was a voucher privatization.

The EBRD classification system is clearly an imperfect measure of the privatization process. For instance, Russia's voucher privatization was far more extensive than Moldova's. Yet, the EBRD classification system puts the two into the same discrete group. Despite the imperfections, the EBRD's classification system does provide us with a more concrete indicator of the degree of centralization in the privatization process. At a minimum, however, these classifications allow for a preliminary look into the success of various privatization approaches.

In Figure 1, we look at the method of privatization and the economic performance of post-communist countries from 1990-2002. The data for economic growth rates was taken from the *World Development Indicators, 2003*. As the figure indicates, the method of privatization is highly correlated with economic performance. In countries dependent on voucher privatization, the average rate of post-communist growth has been approximately -3% per year. In countries where management-employee buyouts were the preferred method, average economic growth was -1.5% from 1990-2002. By contrast, when direct sales of assets were the preferred approach, positive economic growth of 0.4% per year was enjoyed.

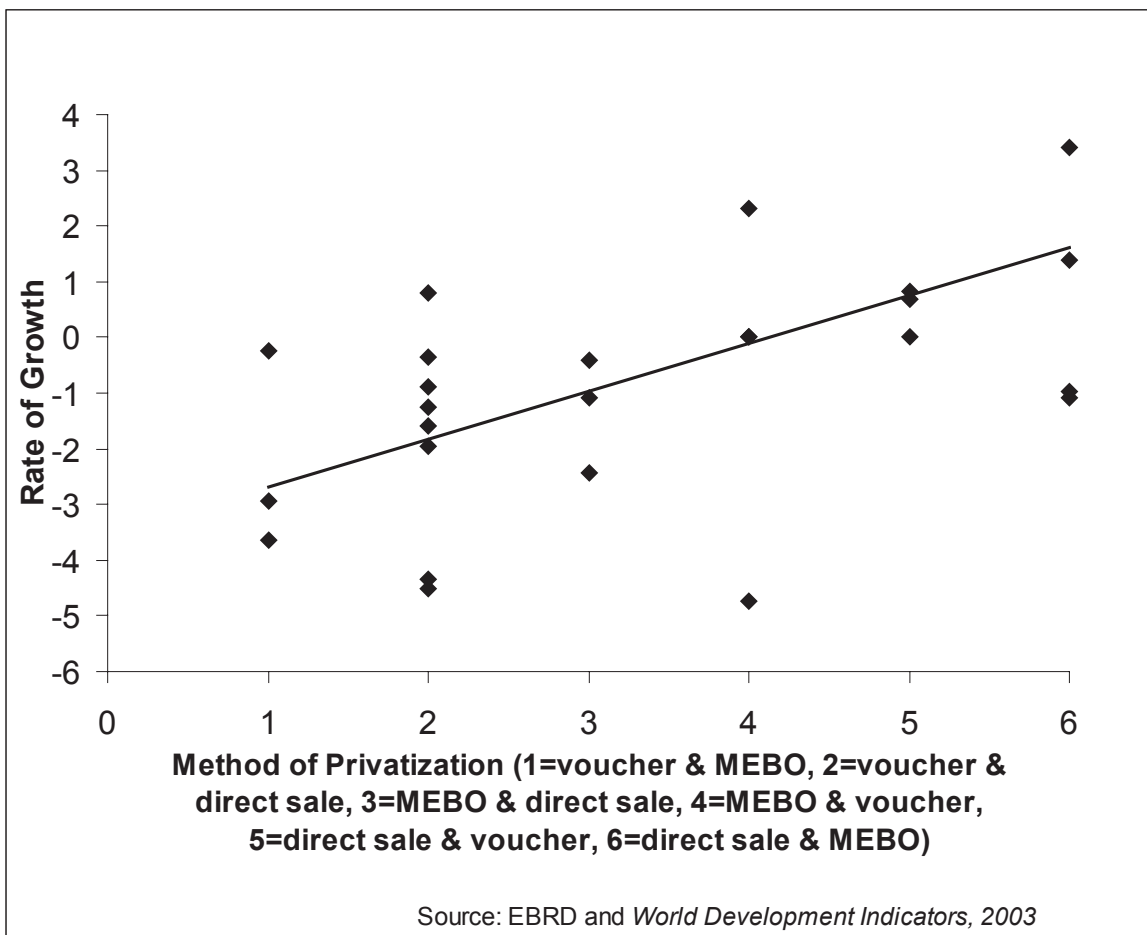
**FIGURE 1**  
**PRIVATIZATION METHODS AND POST-COMMUNIST GROWTH RATES (1990-02)**



The EBRD classification system also allows us to look at the effect of privatization on economic performance when both the primary and secondary methods of privatization are taken into account. In Figure 2, the same general relationship described in Figure 1 holds even when we factor in secondary privatization methods. Voucher privatization, when used as the primary method, is still the worst performing method. Management-employee buyout is still in the middle, and direct sale is still the best performing method of privatization.

The relative superiority of direct sales privatization over the other two methods is not surprising because when resources are auctioned, they tend to be allocated towards their highest valued use. Moreover, the specification problems inherent in voucher privatizations are reduced through direct sales because any ambiguities about the property rights are embedded in the market value of the resource.

**FIGURE 2:  
METHOD OF PRIMARY AND SECONDARY PRIVATIZATION AND ECONOMIC GROWTH  
IN POST-COMMUNIST COUNTRIES (1990-2002)**



Unlike the direct auctioning of resources, voucher privatizations went about valuing resources without the knowledge necessary to place appropriate values on the resources. As Peter Boettke (2001, p.192) notes,

The problem with the conventional privatization package, however, is that one cannot value assets without a market, but a reliable market cannot exist without private property. The whole point of the privatization schemes of vouchers or public auction is to create

private ownership. But how is the value of assets to be determined without a market in the first place?

While Boettke correctly summarizes the problem of conventional privatization programs, some privatization programs are better than others when it comes to incorporating local knowledge.

Under the voucher schemes, centralized bureaus fixed the value of the goods and services, and the vouchers were only effective in determining who had majority control of different companies. The voucher schemes didn't produce anything close to an efficient outcome. Instead, in places like Russia, well-informed insiders quickly acquired the vouchers, and their actions thwarted any kind of competitive bidding for the resources. Furthermore, poorly defined ownership rights under voucher schemes did not lead to a lower market value for the resources being privatized.

The direct sale of resources was also superior to management-employee buyouts. Under direct sales, management-employee groups could enter as one of the bidders. If they were the highest valued bidder, resources were allocated efficiently. However, if resources were simply promised to the management-employee groups, potential owners who placed a higher value on the resources were kept out of the market. In addition, firms were often run as job-saving firms with little concern for the efficient use of resources.

## CONCLUSION

Relative to voucher privatization and management-employee buyouts, the direct sale method of privatization is much more consistent with the common law notion of property rights mentioned earlier. The direct sale approach isn't about privatizing in the same kind of technocratic manner as the alternative approaches. Instead, the direct sale approach allows the market to determine the efficient quantity and quality of privatization. The very nature of the direct sale approach is much more bottom-up in its orientation: leaders and property funds are not asked to be specific about the value of resources. Instead, the determination of resource values is left to the market.

We have already mentioned, direct auctions allow the people who most value a particular resource to bid and obtain the resource. In many cases, the individuals who value the resource most highly are the same people who have secured informal rights to it. Since the individuals on the spot have local knowledge regarding the true value of the privatized resources, they can easily determine whether the going market price of the auction is a reasonable one.

Direct sales were the most effective method of privatization because they were the approach most consistent with the common law theory of property. Among others, Vernon Smith (2003) has drawn a distinction between policymakers as farmers versus policymakers as engineers. According to Smith (2003, p.502),

Rules emerge as a spontaneous order—they are found—not deliberately designed by one calculating mind. Initially constructivist institutions undergo evolutionary change adapting beyond the circumstances that gave them birth. What emerges is a “social mind” that solves complex organization problems without conscious cognition.

Given the choice between voucher, MEBO, and direct sale privatizations, the policymakers who relied primarily on a direct sales approach were behaving much more as farmers and less like engineers. By relying on direct auctions of state-owned resources, the direct sales approach let the market handle the insurmountable epistemic constraints of the privatization process.

Our paper has focused on the evolving rights of the unofficial economy in Eastern Europe. When countries relied primarily on the direct auctioning of resources, they outperformed other methods of privatization. As a preliminary investigation, this provides some evidence of the benefits of the direct auctioning approach, although additional work needs to be done to appropriately deal with selection bias. It might be underlying factors that led to different privatization types that are driving these results and further research will be devoted to addressing that bias.



## NOTES

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2. Beaulier and Prychitko (2006) draw a distinction between evolutionary and teleological accounts of property rights. Our discussion here is based, in part, on their discussion.
3. Interview with a Czech cab driver while en route to an interview with Pavel Kuta of the National Property Fund on July 17, 2003.
4. Of course, this begs the question as to why any amount of privatization would take place. In addition to the bureaucracy’s wealth and power, there also must have been some concern over legitimacy. Had institutions like the National Property Fund held onto all or most of the Czech assets, it’s safe to assume that they wouldn’t have held onto power for very long.

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