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The Roles of the State and the Market in Establishing Property Rights

Andrzej Rapaczynski

It is an old saw of the economics profession that markets require a clear assignment of initial entitlements to most resources and well-enforced rules of contract. Governments intent on fostering a market economy should thus make sure to put an effective legal system in place, one in which property rights are unambiguous, secure and freely alienable. Even if the state gets some of the initial entitlements wrong, it is often added, the Coase theorem instructs us that the parties, if free to contract, will correct this by appropriate private agreements.

The experience of postcommunist countries in eastern Europe is a good reminder that economists tend to assume a can opener when one is needed. Indeed, the statement that property and contract rights must be “put in place” assumes away one of the most interesting and intricate questions concerning economic development. The creation of a system of enforceable entitlements to the diverse and complex forms of wealth characteristic of a modern society is itself a process subject to economic laws; as I shall argue here, it is in fact largely a product of market forces, rather than governmental fiat.

Does the Market Presuppose a Property Rights Regime?

A legal regime—or, indeed, the political system that supports it—is not an independent structure that undergirds the economic system; instead, it is embedded in the economic order at the same time as that order cannot exist without it.

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This is true not only in democracies, in which economic power is always felt in the political process and has an impact on legislation, but also in authoritarian regimes, which need something more than force to maintain themselves. Consequently, the legal-regulatory activity of any government does not follow some abstract and pre-determined rules (such as economists customarily propose for the mysteriously omnipotent “benevolent dictators”), but is basically reactive to the situation in the market, both in terms of the content of the regulations and the process by which they are promulgated. The market determines the strength of the various interest groups that formulate their plans for governmental regulation, including the establishment of property rights, and that regulation in turn modifies the forces of the market and the relative strength of the interest groups. The development of the legal-regulatory system, much as the development of other economic institutions, is not an outcome of a fully rational choice of “optimal” solutions, but rather a gradual, incremental and evolutionary process. Moreover, to the extent that the process through which economic forces shape the legal system is itself a form of competitive and evolutionary mechanism, it reveals a number of similarities to the market and should be analyzed with the help of some of the same tools as those used to explain economic phenomena. This political economy of property rights is all too often neglected in the economic discussions of the problems of transition.

But even apart from any political constraints on economic legislation, the notion that simply instituting an appropriate legal regime will establish a set of property rights that can undergird a modern economic system is deeply implausible, because most property rights can be only marginally enforced by the legal system.

The core of the institution of ownership is a matter of unquestioned and largely unconscious social and economic practices that must be rooted in nonlegal developments. This is the old Hobbesian problem: When most people obey the law, the government can enforce it effectively and (relatively) cheaply against the few individuals who break it. But when obedience breaks down on large enough scale, no authority is strong enough to police everyone. In such a setting, with enforcement becoming less and less effective, individuals have an incentive to follow their own interests, regardless of any paper constraints.

In answer to this Hobbesian problem, it is often said that respect for the law presupposes a set of cultural beliefs that make most people, even in the absence of a realistic threat of sanctions, deviate from purely self-interested behavior in favor of other norms, more conducive to the interest of the community. Such norms may be provided by morality and custom or—as Hobbes believed—they may be initially irrational from an individual point of view, but nevertheless collectively beneficial and result in an enforceable system of legal norms: if most people, for whatever reason, come to believe that the government is able to enforce the law (perhaps, for example, because it is believed to be divinely sanctioned), that very belief makes the sovereign *in fact* capable of making sure that its commands are obeyed.¹

¹ For an interpretation of Hobbes along these lines, see Rapaczynski (1987).

I do not mean to deny that a culture of respect for property rights is very helpful in making property rights effective. But virtue is itself a rather scarce commodity, and a system of habits and beliefs alone may be too flimsy a foundation for the multitude of complex and innovative behavioral patterns necessary to sustain a modern economy. An effective legal system requires a more solid support. This means that most property-related arrangements in an advanced economy must involve various *self-enforcing mechanisms* ingrained in the incentive structure of spontaneous economic behavior, so that moral virtue and the legal system are necessary to deal with only a thin layer of aberrational occurrences. The reason why most people perform their contractual obligations, for example, is not that they are afraid of remorse or state coercion, but that in the extended context in which they are expected to conduct their business, a breach would be against their best interests. However, the self-enforcing mechanisms on which compliance depends in the overwhelming majority of cases are themselves institutions produced by the market, not a set of rules that can be laid in advance.

Moreover, property rights in a modern society are too complex to be “put in place” in advance of the development of a market economy. To be sure, some very basic entitlements, such as one’s right to personal property, a home, chattels, and so on, are not difficult to define, although the phenomenal rise in crime against persons and property in some eastern European countries shows that their protection may sometimes collapse in times of transition. But the simple entitlements to physical objects are only a small part of the property rights characteristic of a modern economy.² Consider the assets held by an average American. The only significant tangible thing that person is likely to own is a house; the rest of the wealth probably consists in various rights to future income streams, such as a pension, return on shares in a mutual fund, expectations of support from Social Security or Medicare, or benefits of a status granted by the state (like a license to practice law or conduct business). When one looks at the more “propertied classes” of modern America, the intangibles become ever more prevalent and ever more esoteric: patents, futures, financial derivatives, tax shelters, mortgage-backed securities, junk bonds and instruments that only a few wizards understand.

The problem with most of these sophisticated forms of property is that the law of even the most powerful, rational and benevolent states cannot fully define or protect them. This does not mean that the law does not play a very important role in their definition and enforcement—the thousands of volumes of corporate and securities laws, administrative law, court decisions, and agency rules and regulations do just that. But the law must work here with other mechanisms, because the benefits to be derived from the complex forms of property crucially depend on good-faith cooperation among a number of parties and on additional enforcement mechanisms that are necessarily more flexible than any legal rules. As in marriage, in

² For a view that “physical” control rights over productive assets play a significant role in eastern Europe, see Shleifer (1995). Clearly, the view expressed here runs against this idea.

which the law also has a deep interest, but where legal definition and enforcement of such matters as who cleans the dishes, who takes care of the children and how often the other spouse visits the mother-in-law would destroy the fabric of the relation, so in many economic contexts, the rights of various parties make sense only against an institutional background structured by nonlegal interactions.

Consider, for example, the institution of minority rights in a modern corporation.³ These rights are not a straightforward form of ownership. In fact, they are a rather delicate product of a peculiar institutional configuration and a special form of financing. A minority shareholder provides often substantial funds and receives in exchange neither a firm commitment to a specified form of repayment (such as that promised to an ordinary creditor) nor any significant control rights. Instead, this shareholder relies on the controlling stakeholders and the management to conduct the business of the corporation in such a way as both to maximize its value and to share the upside potential with the passive investor.

To be sure, every legal system provides some protection of minority shareholders and puts certain fiduciary obligations on the majority. But like divorce in a marriage, these are, of necessity, effective only in the most extreme situations. The legal system cannot, in the name of protecting the minority, tie the hands of the majority and its management team in the exercise of their best business judgment; indeed, the whole institution of minority shareholding relies on the ability of an investor to “piggyback” on the often ineffable skills and efforts of the controlling parties, without a need to look over their shoulders and second-guess important business decisions. An effort to subject these decisions to a set of legal rules would be like prescribing the number of visits that a husband must pay his mother-in-law: it would eviscerate the benefits of the whole relation. Thus, the institution of minority shareholding cannot rest primarily on the ability of such investors to vindicate their rights through the legal system. Instead, it must fundamentally rest on the confidence of investors in the fact that, in an overwhelming majority of cases, the majority will honor its commitments to the minority, without any individual monitoring or a threat of legal sanctions.

We have noted already that the investor’s confidence is not likely to be based primarily on his reliance on the force of moral norms as a guide to the actions of the majority. Much as the expectations of a spouse are often backed by more than conjugal love, the investor’s confidence is backed by a self-enforcing system of the market. The basis of all the incentives and expectations responsible for the confidence level necessary for a viable institution of minority shareholding is the fact that most companies must come back to the market for more financing. If a firm does not make a credible commitment to outside investors or casts doubt on their right to participate in the income streams produced by the firm, the firm’s access to capital markets will be closed, and it will not be able to generate capital in the

³ The point made here concerning minority rights is based on Frydman and Rapaczynski (1994, pp. 179ff).

future. But the connection between a firm's failure to commit to minority investors' rights and the severing of its access to finance is not a simple matter, and it is precisely its complexity and specificity that makes it unsuitable for legal definition and enforcement.

To begin with, breaches of faith to minority investors are not a clear-cut issue; whether a minority investor is receiving sufficient returns, given the firm's performance, general market conditions, the balance between short-term income and long-term appreciation, and so on, is a rather murky question in most cases. The market must assimilate this ambiguous information, analyze and disseminate it, and produce a spontaneous response from a great number of prospective investors in the future, so that parties abusing minority rights will indeed have difficulties with access to new funds. It is this complex institutional framework of a market economy that constitutes, in large part, the background regime necessary to support modern forms of private property, which, consequently, cannot be "put in place" in advance of its creation.

I should add that the institution of *majority* investment in a modern corporation is not very much less complex and dependent on a number of background conditions. The controlling investor in a modern corporation is usually also incapable of enforcing his rights directly, as against such other stakeholders as workers, management and the state. In fact, even a majority shareholder is quite removed from any simple "physical" control of the corporate assets.

The Special Case of Eastern Europe

In the early stages of a market economy, there is little need for many of the more sophisticated forms of entitlements. Instead, the market develops coextensively with its legal system, so that the necessary background institutions come about gradually together with refinements in the legal structure and the state enforcement mechanisms. The peculiar problem of eastern Europe is that the state of its capital stock by far exceeds the development of its institutional environment. The rapid industrialization during the communist period produced an enormous concentration of assets in an organizational form that was largely dysfunctional, both in terms of internal governance structure and in terms of the interfirm coordination mechanisms necessary for a successful economy. The reform movement in eastern Europe thus cannot proceed by laying down a few simple rules and waiting for evolutionary growth to do the rest. Instead, if most of the assets controlled by the state are not to be wasted, an advanced form of a market economy, together with its complex institutions, must be created in an unusually short period of time.

The problems generated by this condition are not limited to the well-travelled political and logistical difficulties of effecting an asset transfer of unprecedented proportions. What makes this transfer particularly difficult is the fact that a system of property rights sufficient to support viable entitlements to the kinds of assets being transferred does not exist and cannot be created overnight. A successful

reallocation and restructuring of the former state assets requires that they be put in a new organizational configuration, which already presupposes the complex types of entitlements characteristic of the advanced market economies, and yet those types of entitlements are to be established for the first time by the asset transfer itself. Consequently, the background necessary for the transfer may be missing or incomplete, and the state, even when it genuinely intends to divest itself of the resources it controls, might fail to convey them effectively to other parties (Frydman and Rapaczynski, 1994, pp. 188–89).

This unique situation of eastern Europe makes the question of how property rights are created of particular importance in the region. If establishing property entitlements is primarily a matter of legislation and state enforcement, then the reconstruction of the state is a task of extreme urgency on which the whole reform effort is likely to depend.⁴ If, on the other hand, the establishment of viable property rights characteristic of a modern economy is as much an outcome of the development of market institutions as of any government's legislative and enforcement activity, then certain economic measures undertaken by the government may contribute more to the establishment of viable property rights than volumes of new codes and legions of new judges and policemen.

For example, if my discussion of the prerequisites for a viable system of property rights of minority shareholders is correct, the introduction of hard budget constraints for enterprises—thus forcing them to go to the market for any additional capital—may do more for the development of effective property rights of minority shareholders than investing heavily in the regulatory and enforcement capacities of a securities and exchange commission. The same hard budget constraints may ultimately do more for the protection of creditors than most bankruptcy laws.

A related problem of particular concern in eastern Europe, though surely not unique to the region, is that the state itself is often the most significant threat to the security of property rights. Indeed, the role of the state in securing property rights from encroachments by third parties is probably much less significant than its ability to precommit credibly to respect these rights itself.

The state can go wrong in this area in several ways. The first possibility, most often noted but perhaps not the most important, is that rights that are clearly granted will be revoked in the future. Most states, including all eastern European ones, provide some constitutional and legislative guarantees against such takings, and although the relevant legal provisions are usually quite fuzzy at the edges, outright confiscations are in fact relatively rare.

But the fuzziness of the takings law is not accidental. Every state routinely engages in various kinds of taxation and regulation that impair the value of people's investments, and most of such encroachments are not considered compensable

⁴ For an argument that this strategy is not likely to succeed in the short run, see, for example, Shleifer (1995).

takings. Despite the refinements of takings jurisprudence in many countries, the transaction costs of most compensatory procedures are so high that only the most egregious kinds of encroachments can be subject to legal control. More gradual or surreptitious encroachments on property interests can result in no less cumulative impairment than the “outright” takings. And yet the law, at least property law, usually provides no remedies for these types of infringements.

What does provide some degree of protection in this respect is the political system, together with the economic pressure groups that ensure that the state does not go “too far” in interfering with the owner’s control over assets. This politically determined thin line may be understood as the real definition of property rights conferred by the state, as distinct from the somewhat fictitious legal notion of property rights. How broadly property rights are defined in this real sense and how effective state’s (largely nonlegal) commitment is to their security is a more serious problem than the issue of legal protections against the more traditional form of takings. But precisely because these commitments are not of a legal nature, but rather inhere in the structure and practices of political institutions, they are difficult to put into place in a short time. In fact, without a significant historical record of state forbearance from excessive and redistributive regulation, it is hard to make the state’s commitment credible.

The threat posed by the state to the security of broadly defined property rights is particularly severe when the state also happens to own a significant proportion of national assets—something that characterizes all of the states in eastern Europe. A state that conducts much of its policy through the exercise of its ownership rights (which leave a lot of discretion to the decision maker) tends to neglect the development of its regulatory capacities (where a certain degree of transparency and procedural regularity is required) and thus increases the degree of arbitrariness in the pursuit of its economic policies. Often, such a state uses subsidies, regulatory redistribution and various rigidities to protect its own inefficient state sector. Finally, because the states of eastern Europe hold a near monopoly in certain areas of ownership—commercial real estate, for example—they can *de facto* restrict the types of interests that other parties may hold in assets of a given type, even if formally the rights of ownership are unrestricted and broadly defined.⁵

The East German Exception

Every rule has its exceptions, and East Germany is a glaring example of a situation in which a complete legal order was put in place at the very beginning of the transition. In fact, the whole machinery of the West German state had been transplanted to the former GDR, including its constitution, legislation, regulatory

⁵ I will discuss the case of real estate below. For a discussion of the effects of state ownership on the nonstate sector, see Pistor and Turkewitz (1996).

regime, judicial system, police, and so on. But East Germany was indeed a very special case. The reform process was imported wholesale from outside, with no human capital limitations (West Germany providing a nearly inexhaustible source of qualified managers, judges and state administrators) and at a cost of some \$100 billion a year for a number of years. Suffice it to say that at this rate, five years of reform in Russia would require an influx of some \$4 trillion (!) and that the per capita subsidy to East German citizens was alone over twice as large as the per capita GDP in the rest of eastern Europe. As a result, it is very doubtful whether the East German case provides any analogies with or lessons for the rest of the region, and I will ignore it in the rest of this paper.

The Experience of Eastern Europe with Property Rights

Property Rights in the New Private Sector

The most dynamically growing part of the eastern European economies is the new private sector: a multitude of stores, service outlets, trading companies, small manufacturing operations, and so on. Most of these businesses are unincorporated; those that operate in company form usually employ just a few workers, often other family members. To what extent is this development related to the establishment of secure property rights and what type of rights play an important role?

The first observation is that the more complex types of entitlements discussed above play nearly no role in the rise of small business. Although a small minority of them operate in a corporate form, they are de facto owned by a single individual or a very small group of people who do not in any significant way rely on corporate and securities laws: they do not raise capital from the public, their shares do not trade, and corporate procedures are complied with in the most minimalistic of fashions. Debt capital also plays an insignificant role—perhaps a loan from a family member or a friend, at most some working capital loan from a bank. Except for rights to real estate, which will be discussed presently, the operation of these businesses requires minimal support in the form of state protection of their property rights. Indeed, the most important contribution of the legal system to their growth was the elimination of obstacles that the state itself had been putting in their path in the form of a panoply of restrictions on registration, employment, operations, access to foreign currency, confiscatory taxation, and so on. Even in these areas many obstacles remain. Taxes, especially payroll taxes that often reach 40–50 percent, are very burdensome in all countries, registration of a company is difficult and costly in many, and prices (especially of real estate and energy) are often controlled.

The Role of Contract Enforcement

Most eastern European states have upgraded their legal systems to provide more protection for businesses. New civil and commercial codes were enacted or, as in Poland, prewar legislation was put back in force. Although the provisions of

these codes are usually quite broad (and sometimes antiquated) and they lack the necessary judicial and scholarly elaboration, they are probably sufficient for the enforcement of simple contract rights. Little was done to modernize the court system, but the private bar was reestablished, providing for the possibility of effective legal assistance. A number of private arbitration tribunals have been created to facilitate resolution of business disputes.

In the light of such changes, it is surprising that the demand for legal services seems to have dropped precipitously in some countries and risen less than one might have expected in others. The available data is so far very limited. That collected for Russia shows that between the first half of 1993 and 1994 alone, the number of economic disputes in the Arbitrazh Court (despite the name, actually not an arbitration tribunal, but an ordinary commercial court) fell by 30 percent, and the 1993 figure had already been much smaller than the number of disputes prior to 1991. The private arbitration tribunals have been practically unused. And all this has been happening at the time when the number of existing businesses and, presumably, also business transactions, has increased dramatically and when galloping inflation and a disruption of preexisting business routines could have been expected to result in a dramatic increase in the number of disputes. In other countries the number of cases went up, most notably in Poland, but after an initial spurt stabilized at about twice the level of 1989. Given that the number of legal entities in Poland trebled (to over 33,000) during the same period and over one million individual entrepreneurs entered the market, the rise is actually quite small. As a result, although much contract law has been enacted and some institutions created, the impact of these changes does not seem to be very significant.⁶

This strange development has many potential causes. It is possible that business people, especially private entrepreneurs, lack confidence in judicial institutions traceable to the old regime and that courts in such countries as Poland are overburdened. It is also likely that many small businesses, especially in Russia, operate on the borderlines of legality, avoiding taxes, siphoning revenues from state enterprises, or engaging in illegal arbitration transactions. The fear that contracts concerning these transactions would be either unenforceable or, even worse, expose them to prosecution, might make them unwilling to use the courts. Recourse to unofficial dispute resolution and enforcement mechanisms, such as organized crime, may also dampen demand for court services.⁷

But still, the drop in demand for legal services in the fastest-growing area of the new market economies is a striking reminder that the economists' insistence

⁶ For more detailed figures concerning the fall in demand for legal services in Russia and a discussion of possible causes, see Pistor (1996). For figures on Poland, see Pistor (1995). It would be interesting to know whether the initial increase in the number of disputes was due to the disruption of routines among state enterprises or to an influx of new private actors, but the data are not available.

⁷ For an account assuming that many Russian businesses use organized crime for dispute resolutions and providing proposals for improvements in the judicial system that might change this preference, see Hay, Shleifer and Vishny (1996).

on clear enforcement of property rights and contracts as a prerequisite to a functioning market may be putting the cart before the horse.⁸ To be sure, it is likely that the greater inefficiency of the legal system in Russia, as compared to, say, Poland or the Czech Republic, is also responsible for a slower rate of growth of Russia's private sector. But the dynamic growth of the private sector in all the countries of eastern Europe in which certain minimal macroeconomic reforms were put in place is an indication that economic policy changes have a much more direct impact on growth than the reforms of the legal system.

The falling demand for legal services in eastern Europe offers some support for the hypothesis that a relatively simple market economy does not need much in terms of judicially enforced property rights; some simple homegrown mechanisms will suffice. The growth of business transactions mainly involves smaller exchanges, where the transaction costs of recourse to courts are probably too high, given the stakes involved.⁹ Many customers are likely to be repeat players, so that a refusal to deal with someone in the future is a more effective remedy than a formal lawsuit. Instead of relying on judicial enforcement, as under the old regime, many creditors are now requiring collateral.¹⁰ To be sure, some transactions must not be taking place because of the unavailability of sophisticated enforcement mechanisms,¹¹ but the open form of contracting among repeat players must also produce substantial savings.

The Rights to Real Estate

Commercial real estate is the one area related to the growth of the new private sector where the establishment of new property rights may be quite important, and where more effective state action might have been quite useful. The reason for this is that desirable commercial premises are a scarce commodity, and they were nearly wholly monopolized by the state and semistate cooperatives. Moreover, at the beginning of the reform process, real estate was the most important asset of most small business establishments. Given the conditions of chronic shortages under communism, shops, service establishments and other small outlets had no inventory of any value. Nor did they have any goodwill among their clientele: the gruffness of the retail salespeople was legendary. Their only asset was the control of valuable real estate. But despite the insistence on quick privatization of the retail and service

⁸ Theoretically speaking, the fall in demand could also result from the fact that the legal system became very efficient. A high degree of predictability and smooth enforcement of judicial decisions would, of course, lead to high levels of settlement prior to litigation. But one thing on which just about everyone agrees is that the legal systems of eastern Europe are neither predictable nor efficient.

⁹ It is also likely that courts were overused under the old regime, since firms hardly cared about legal costs, while managers may have been in trouble if they did not protect all the property of the enterprise.

¹⁰ Use of collateral might also require some judicial enforcement. But the burden of proceeding with the case is often reversed and the enforcement is much simpler.

¹¹ Contraction of credit may be cited as one negative effect of weak protection of contracts. But the general macroeconomic conditions (high inflation and high interest rates) together with the inefficiency of the banking system, which is incapable of risk assessment under the new conditions, are more likely culprits. Increased transaction costs of lending to smaller businesses may also play a role in certain sectors.

sectors in nearly all reforming countries of eastern Europe, little effort went into the privatization of commercial real estate.

Russia and some other former Soviet Republics have been the most backward in this respect. Unlike the western rim communist countries, the Soviet Union had no legal basis for private ownership of land. Thus, at the beginning of the reform period, all land in Russia formally belonged to the state, with no legal basis of private ownership in agricultural, commercial, or residential real estate. Moreover, given the role that collectivization had played in Soviet ideology, and given that the old peasant class had been either physically wiped out or transformed into a peculiar form of rural proletariat,¹² establishing the principle of private property in land was extremely controversial. A series of laws attempted to give individuals the right to some control over farmland, but for quite a long period of time a number of restrictions (mostly on alienability) had persisted and true ownership was not legalized (Frydman, Rapaczynski and Earle et al., 1993).

In the area of residential real estate, the situation was equally unpropitious, since there was practically no demand for private property rights. Indeed, because housing had been (and largely still continues to be) subsidized to such an extent that rents could not even cover maintenance, the population has largely perceived efforts to establish private property in housing as a means for the authorities to raise the amounts paid by tenants for housing. While extreme housing shortages persist, housing stocks in the hands of many enterprises and governmental units have been viewed as liabilities rather than assets. Although a law on turning existing apartments into a condominium form of ownership finally passed in 1994, it remains a paper creation, since the methodology for its implementation is largely nonexistent and very few conversions have actually occurred.

The situation with respect to commercial real estate in Russia is even more complicated. The growth of private business has created a great deal of demand for commercial premises, but a variety of interest groups are keen to preserve many elements of the status quo. In Russia, several parties often have different rights to a particular plot of commercial real estate (Harding, 1995). In particular, the rights to income from premises are separated from the right of use, and a third party often has a right to decide about future uses. Moreover, the law does not allow the various parties to buy the remaining pieces of the property bundle from the others: for example, a user who derives only small benefits from the premises cannot legally buy from the government (indeed, often several different departments of the government), which is the official "owner," the right to sublet the premises and split the additional rental revenues. Reallocation of the existing space is thus largely blocked in Russia. Various efforts have been made to clean up the situation by revising the whole legal framework of urban land use and giving firm ownership rights to one party, but like most efforts to

¹² Some historians have argued that the principle of private property in land had never existed among the peasantry of Russia (Pipes, 1990).

clean Augean stables in one fell swoop, they have neglected the smaller reforms (such as making secure and alienable leases possible) and nothing much has changed on the ground.

The absence of a workable system of legal entitlements has clearly played a retarding role in the growth of small businesses in Russia. Many new Russian businesses operate out of kiosks and other temporary structures, while existing real estate is woefully underutilized. But like most problems relating to property rights, the problem of creating secure titles to commercial real estate transcends the matter of legal enactments. Indeed, the western rim countries in transition—such as Hungary, Poland and the Czech Republic—have by and large created a legal basis for private ownership of land of all kinds. Although this fact has certainly contributed to the fast growth of the new private sector, the rights actually acquired by most users of commercial premises have been significantly less complete and more insecure than those made possible by the legal system (Earle, Frydman, Rapaczynski and Turkewitz, 1994).

The reason for this lies primarily in the fact that the government (mostly local government) has retained close to a monopoly on commercial real estate.¹³ Given the absence of a real estate market capable of reliably pricing the premises in the hands of local government (especially in times of high inflation), and given the unwillingness of local bureaucrats to divest themselves of these valuable and often personally enriching sources of power, local governments were not eager to end their outright ownership. As a result, the various privatization programs concerning small businesses failed to convey a secure title to the most important asset of most of these establishments. What was usually conveyed was a leasehold of very short duration, with uncertain rights of renewal and other restrictions,¹⁴ at mostly below-market rentals. Contrary to what one might expect, the below-market price was not a function of the very partial interest that was being conveyed. Instead, the below-market rentals were a further manifestation of the role of local government owners who were concerned about patronage. Most rentals were made to former employees who could not afford to pay market rents, and thus became even more beholden to the local officials. An empirical study of small businesses in three east European countries shows that the real estate title restrictions had a significant dampening effect on the amount of postprivatization restructuring (Earle, Frydman, Rapaczynski and Turkewitz, 1994). Still, the pace of development, at least in Poland, Hungary and the Czech Republic, has been quite impressive.

¹³ In some countries, such as Poland, the former cooperatives are also significant real estate owners in some areas and provide some competition to the state sector. In others, such as the Czech Republic, programs of restitution passed a significant portion of commercial real estate into private hands.

¹⁴ These restrictions were usually much more burdensome in Russia, where government monopolies were much more complete, than in the western rim countries. They often included such minute details as what a store may sell on the premises, prohibitions on employee dismissals, transfer limitations, and so on. The restrictions in the western rim countries were less severe, and the terms were also usually much shorter.

Shareholder Rights to Corporate Property

As noted already, the lack of rights to corporate property does not much affect the predominantly small firms of the dynamic new private sector. But the issue matters a great deal with respect to large former state enterprises that need to be restructured both in terms of their internal operations (technology and governance) and in terms of their ownership structure. These larger firms are often unsuited for simple individual ownership. Most of the scholarly attention in this context has been directed toward devising mechanisms for a transfer of large state enterprises into private hands. But privatization also poses the problem of establishing a proper rights background for a successful transfer. Whether privatization involves a traditional sale or a voucher-type transaction, it remains true that the enterprise assets must be first put in a form suitable for private ownership. If a share in the new firm is then to be conveyed to a particular private party (an individual or another corporation), the party in question must be capable of ownership, and the rights conveyed must be tolerably clear and secure.

Under the old regime, state firms were operated in a purely administrative fashion, not much differently from government departments, and various firms were subordinated to a large number of specialized ministries. The preliminary step in the privatization process was thus to transform state enterprises into a standard corporate form and bring their governance structure in line with that prevalent in the private sector. This process, together with the appointment of appropriate company boards, was supposed to introduce the legal concept of state ownership, distinct from political administration. Already at this stage, eastern European states have experienced the limitations of legal reforms not backed by an evolutionary development of background economic institutions. Although the state now received legal title, its own institutions have not been sufficiently transformed to exercise its ownership rights in a comprehensive fashion. In some countries, like Hungary, the title is vested in a specialized agency; in others, like Poland, it rests with a ministry; in still others, like Russia, it is in a fund formally subject to parliamentary control. The various supervisory bodies are generally rudderless, incapable of genuine monitoring, and the effect of the legal change was often to lessen rather than increase the states control over its own assets. The main consequence of this has been to increase immensely the powers of corporate insiders. These insiders, mostly managers, are firmly in control of everyday operations and also the most strategic and long-term decisions. The rights to a number of important decisions, often concerning privatization, are not clearly assigned at all, thus introducing an element of uncertainty quite harmful to the business prospects of many firms.

The next step was to privatize; that is, to find appropriate private parties to whom ownership could be conveyed. However, despite further legal changes, the rights of private parties to corporate property have also remained incomplete. The easiest job was to pass a law on corporations, although the quality of these documents, especially in the absence of judicial elaboration, is generally quite low. Poland, for example, simply brought back its prewar commercial code. Perhaps surprisingly, in the light of the great strides made by privatization, until the end of

1995 Russia had no systematic body of corporate law and managed with a series of poorly drafted stopgap decrees.

But even if Russia had a better set of laws, it would make little difference. Laws in Russia have a tendency to remain pieces of paper. Moreover, Russian firms are dominated by the management and, to a lesser extent, employees (Frydman, Pistor and Rapaczynski, 1996; Frydman, Rapaczynski and Earle et al., 1993; Boycko, Shleifer and Vishny, 1995), and maximizing the value of the firm is often not the most important objective of these insiders. Maximizing employment, for example, is clearly important for the employees. The management is often busy plundering corporate assets by transferring them to firms of which it owns a greater share, and much of the corporate game in Russia is about gaining access to subsidized credits and other rents from the state. All the while, the insiders try to disempower the minority outside owners by refusing to provide them with access to information, declining to register share transfers of which they disapprove, packing the board of directors, violating provisions concerning the conduct of shareholder meetings, and so on (Frydman, Pistor and Rapaczynski, 1996). The fact that all these practices also happen to be illegal does not seem to make any difference. Even if the Russian state were not near collapse, it is questionable whether it could police a system in which the incentives of the parties are so far out of harmony with the purposes of the law. More likely, until the sources of soft financing disappear and firms are forced to finance their operations through the market, no legal system will be able to enforce the rights of outside owners. And even then, the nongovernmental market-driven institutions necessary to support an effective legal right to corporate property will develop only gradually.

The situation of equity owners in the western rim postcommunist countries is superficially better, but with the possible exception of the Czech Republic, they are also far from having successfully established a new system of corporate property rights. Poland, for example, has so far failed to privatize the overwhelming majority of its large industrial enterprises; the state has lacked the power to make private ownership the rule rather than an exception. Hungary has standard property rights on the books, but perhaps the most confusing and fragmented ownership structure in the world. Here, because the state was never able to regain its own full ownership rights to the nominally state property, it was never really able to transfer those rights to new owners. As a result, managers of former state firms used this vacuum to perpetuate their control through a series of cross-ownerships, joint ventures, pyramids of holding companies, legal entities created solely to hold debts or liabilities, and other structures so arcane as to leave much of the productive assets in Hungary with no conventional owners at all (Stark, 1996).

The Czech Republic may have been the most successful so far in giving real existence to corporate property rights. Its legislation and legal infrastructure differ little from Poland or Hungary. But the Czech authorities have consistently pursued policies to create the market institutions supporting the effectiveness of modern property rights. In particular, they opted for a mass privatization program that not only conferred paper titles on millions of private parties, but also created an incen-

tive for the development of new and powerful forces demanding the effectuation of their formal entitlements. This demand, in turn, created not only a political constituency for governmental restraint and further legal refinements, but also an incentive for private parties to come up with alternative means of securing the initially shaky entitlements.

Two features of the Czech mass privatization plan have been particularly important. The first was a broad giveaway of vouchers exchangeable for the shares of privatized enterprises to millions of individual citizens, regardless of their status as insiders or outsiders of any firm. The second was the possibility of depositing one's vouchers with an investment fund that would then acquire shares of privatized enterprises and act as their legal owner, with the voucher depositors becoming owners of the shares of the fund itself. Since opening an investment fund promised to be lucrative, many such funds were created and they became a powerful lobby for the interests of shareholders not otherwise related to the corporation. Many foreign financial institutions joined with Czech partners in forming investment funds, thus importing many institutional features of the more advanced market economies. The value to the funds of their reputation gave small investors a realistic chance of piggybacking on the large players' efforts to monitor the performance of many Czech firms, and this contributed more than anything else to the establishment of property rights of minority shareholders.

But even in the Czech Republic it is too early to say whether these rights are genuinely secure. After the completion of the two "waves" of mass privatization, the main source of future capital for the funds is not the small voucher holders, but large foreign and domestic investors. Consequently, the funds' incentives to protect their small shareholders are much less strong. It is possible that new legislation protecting minority investors (for which there is considerable pressure) may now be desirable. But it is also possible that in the absence of a sufficiently strong background of market-based self-enforcement mechanisms, new legislation will do more to blunt the dynamism of the new governance structures and further strengthen the role of state intervention than to guarantee the security of real income streams to small investors. Indeed, the very high level of state ownership among the banks controlling the largest funds is already a troubling factor.

Creditors' Rights

The protection of creditors' rights, especially vis-à-vis corporate debtors, is perhaps the most notable case of how a legal regime cannot work without the backing of an appropriate institutional framework. Most eastern European countries have spent considerable energy in preparing and passing elaborate bankruptcy laws. (Poland, again, resorted to bringing back its rather antiquated pre-war legislation.) However, except for Hungary, no country in eastern Europe actually sees a significant number of bankruptcies, even though by all accounts a large number of big firms are chronically in the red. Even in Hungary, it is doubtful whether the number of bankruptcies indicates that the legislation has achieved its original purpose. Most firms declaring insolvency do so on their

own motions, rather than because of creditors' petitions. Often the reason behind this is that the assets of a bankrupt company may be sold by the court, thus allowing for the management and its allies to go through a privatization without the supervision of the State Property Agency, which must otherwise approve all privatization transactions.

Although bankruptcy is often billed as the ultimate creditor's remedy, its role is predicated on a very small number of firms actually going under. The system is very costly, and only has the capacity to process a small number of cases. Even in those, it is doubtful that the courts are really able to bring about a decent reallocation (or reorganization) of the firm's assets. Bankruptcy is thus likely to be mainly a threat, used to terrify inefficient managers. But even this effect is absent when the threat of bringing most debtors down is not credible, because closing a large number of big firms is politically unacceptable and economically wasteful.

Creditors' rights in an economy in transition are unlikely to be well protected by a threat of bankruptcy. More probable is a scenario in which credit is genuinely scarce for an extended period of time and firms have strong incentives to invest in their reputation as creditworthy debtors.¹⁵ This involves developing long-standing relations with their creditors, but also providing demand for such services as ratings, instruments allowing risk diversification, and so on. Only when these market responses produce a high enough level of voluntary compliance with debt obligations will the state judicial intervention become a significant factor in enhancing their effectiveness.

Conclusion

The absence of well-defined and secure property rights in eastern Europe clearly contributes to a slower rate of transition. But the effect of the absence of these rights is not uniform throughout the economy; the new private sector is least hampered by imperfect definition and enforcement. Progress in the development of a functioning system of entitlements, especially with respect to the more complex types of assets in the economy, cannot be expected to come primarily from the perfection of the legal system. Instead, contrary to the common economists' assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable private property regime. Property rights, like most other goods, are produced in response to market demand. Although the state may satisfy a portion of this demand, market responses often come first and provide more effective solutions. Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms.

¹⁵ Although credit has been tightened in many transition economies, the progress of genuine banking reform, which is necessary if firms are ever to face a truly hard budget constraint, has been slow.

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