

**Bidding for Success:
Why Direct Auction Privatizations Lead to
Successful Transitions**

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I. Introduction

Historians will look back and describe the 1990s as an era of radical decentralization of power and opening of markets throughout Eastern Europe and the former Soviet Union. 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.

During this transition period, many different privatization programs were attempted throughout the former Soviet bloc. When assessing the relative performance of these 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 [1998], Hoff and Stiglitz 2002). 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 (Hazlett 1996, Klaus 1997).

In this chapter, I will argue that far too much emphasis has been placed on the State's role in privatization. In addition, post-communist leaders throughout Eastern

Europe and the former Soviet Union have been far too willing to take credit for their role in the transition. As Hernando de Soto's *The Other Path* makes clear, a far more important source of economic development is the spontaneous *de facto* rights being created and enforced at the local level. According to De Soto, the informal sector plays a more central role in economic development than the established, formal sector.

In the informal sector, property rights are still emerging. They are not fully defined, well-enforced, or easily transferable. In some regions of the world, these *de facto* rights are considered illegal. Yet, many of these rights actually make use of the legal process, and some are consistent with the current legal code in their respective countries.

This paper will suggest that throughout the post-communist transition, more attention should have been focused on the definition and enforcement of rights that was taking place at the local level. Unfortunately, when it came to privatization in Eastern Europe, even the most free market reformers went astray by assuming that central planning would be a more effective approach to privatization. Reformers and citizens throughout Eastern Europe would have been better served if they had respected the decentralized nature of property rights formation and enforcement.

In the next section, I 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 these rights. After looking at these two theories of property rights, I will then suggest that,

throughout most of Eastern Europe, reformers were implicitly formulating policy with the latter version of property rights in mind.

In *Section III*, I explain how the legal positivist theory of property rights became popular across Eastern Europe and the former Soviet Union. In *Section IV*, I look at post-communist growth rates and other evidence related to post-communist economic performance in Eastern Europe; this evidence suggests that countries that relied on the direct sale of resources clearly outperformed more centralized privatization efforts. In *Section V*, I explain why the direct sale of resources was a far more efficient form of privatization. According to my argument, the direct sale approach did a better job of incorporating the *de facto* rights and values of the informal economy into the privatization process.

II. Common Law vs. Legal Positivist Theories of Property Rights¹

A. 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. The common law approach emphasizes the spontaneous nature of property rights and tends to confirm already developed practices and customs that are in place at the local level. It is a decidedly evolutionary approach that emphasizes the decentralized nature of information and the role of knowledge in decision-making. The common law approach to property rights recognizes that property rights do not originate from the law or some decree, but, rather, come about as a natural response to resource scarcity. Some

¹ In a recent paper, David Prychitko and I draw a distinction between evolutionary and teleological accounts of property rights. A large portion of this section is based on that earlier work. See Beaulier and Prychitko (2003).

of the more prominent common law theorists include De Soto (2002 [1989], 2000), Benson (1990), Anderson and Hill (1983, 1975), and Hayek (1983, 1973). Among the first to describe the common law approach to property rights were Menger (1994 [1871], 1963 [1883]) and Hume (1985 [1739-40]).

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], 315; emphasis in the original). In order to solve this problem, he distinguished between two different explanations of the origin of social institutions. The first is a “pragmatic” explanation:

There are a number of social phenomena which are products of the agreement of members of society, or of positive legislation, results of the purposeful common activity of society thought of as a separate active subject...Here the interpretation appropriate to the real state of affairs is the *pragmatic* one—the explanation of the nature and origin of social phenomena from the intentions, opinions, and available instrumentalities of human social unions or their rulers. (1963 [1883], 145; emphasis in the original)

He stresses that the origin of social institutions 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], 132; emphasis in the original). An example of this would be a “social contract” explanation of the origin of property; establishing property rights, in that approach, is the goal of the participants.

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. Or, to use Adam Ferguson’s familiar phrase, social institutions are “the result of human action, but not the execution of any human design” (Ferguson 1966 [1767], 187). Menger labels these institutions, which arise in this spontaneous fashion, “organic”:

The social phenomena of “organic” origin are characterized by the fact that they present themselves to us as the unintended result of individual efforts of members of society, in other words, of efforts in pursuit of individual interests...*they are, to be sure, the unintended social result of individually teleological factors.* (Menger 1883, 158; emphasis added)

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.² That is, the institution develops gradually over time as a result of unintended consequences of intentionally acting individuals. In this way, the evolution and the organic, or spontaneous, formation of an institution are “twin conceptions” (Hayek 1973, 23). Throughout the rest of the paper I shall call this evolutionary approach the common law approach to property rights, as opposed to using Menger’s “organic” label.

The common-law theory developed by Menger describes two processes of institutional evolution (Vanberg 1986, 81). 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. That is, along with the traditional practices come new, competing practices, some of which become “systematically selected by individual imitation” and will spread, over time, throughout the society (Alchian 1950, 211-21). As demonstrated by Menger (1994 [1871], 257-62),

² Note that the distinction between “organic” and “pragmatic” origins does not have to be mutually exclusive (Vanberg 1986, 79, n. 5). “It allows for ‘intermediate’ cases, combining elements of both kinds of processes.” As Menger stated:

The present-day system of money and markets, present-day law, the modern state, etc., offer just as many examples of institutions which are presented to us as the result of the combined effectiveness of individually and socially teleological powers, or, in other words, of “organic” and “positive” origin (1963, 158).

and commonly agreed upon as a valid explanation by virtually all Austrian economists, a fine example of an institution of spontaneous, evolutionary origin is money.

In analyzing the emergence of social institutions, Hayek has also emphasized the difference between the rules of intentionally acting individuals and the cultural rules of a society. The rules governing individual action are innate behavioral regularities all humans possess (“genetic rules”), while the latter are rules of conduct generally recognized by specific groups (“cultural rules”).³ For Hayek,

The chief points on which the comparative study of behavior has thrown such important light on the evolution of law are, first, that it has made clear that individuals had learned to observe (and enforce) rules of conduct long before such rules could be expressed in words; and second, that these rules had evolved because they led to the formation of an order of the activities of the group as a whole which, *although they are the results of the regularities of the actions of the individuals, must be clearly distinguished from them, since it is the efficiency of the resulting order of actions which will determine whether groups whose members observe certain rules of conduct will prevail* (Hayek 1973, 74; emphasis added).

More specifically, with regards to the formation of private property, Hayek writes:

I think the first member of the small group who exchanged something with an outsider, the first man who pursued his own ends, not approved and decided by the head, or by the common emotions of the group, the first man above all who claimed private property for himself, particularly private property in land, the first man who, instead of giving his surplus product to his neighbours, traded elsewhere...contributed to the development of an ethics that made the worldwide exchange society possible.

All of this developed...in a competition among groups, each imitating those who adopted a somewhat advanced...system of practices, and in consequence, increased more rapidly in population, both by procreation and by attracting people from other groups (Hayek 1983, 31-2).

Hayek stresses that individuals never understood why they accepted the morals of private property... “[m]an was never intelligent enough to design his own society” (1983,

³ For more on innate rules, see Ridley (1996). For more on “cultural rules,” see Taylor (1982).

46-7). That is, “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” (1983, 47). Hayek calls this a process of “cultural selection,” which allows certain groups and practices to withstand the duration of time.

Outside of the Austrian School, David Hume’s (1985 [1739-40]) understanding of the emergence of property rights was clearly an evolutionary one. For Hume, property rights are similar to other useful conventions that are adopted spontaneously. For example, when:

[t]wo men pull the oars of a boat, [they] do it by an agreement or convention, though they have never given promises to each other. Nor is the rule concerning the stability of possession the less derived from human conventions, that it arises gradually, and acquires force by a slow progression, and by our repeated experience of the inconveniences of transgressing it...In like manner are languages gradually establish’d by human conventions without any promise. In like manner do gold and silver become the common manner of exchange (1985 [1739-40], 542).

More recent evolutionary arguments clearly point to privatization being a process rather than an outcome. Sugden (1989) offers a game theoretic interpretation of Hume when he suggests that all that is necessary for a convention to emerge is other individuals believing that other people are following the same convention. A rule, such as the right of first possession, can be adopted for no other reason than the fact that it is popular. As Anderson and Hill (1983, 414) 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. In an oft-cited

passage, De Soto argues that the *de facto* property rights are defined by where the dogs on local farms bark. As De Soto puts it,

If you take a walk through the countryside, from Indonesia to Peru, and you walk by field after field—in each field a different dog is going to bark at you. Even dogs know what private property is all about. The only one who does not know it is the government (2000, 214).

As the common law approach makes clear, the world is filled with different, and often competing, property rights systems. These rights are the result of ongoing interactions among the users of scarce resources. The State's role in the privatization process is therefore limited to the codification of already existing property rights systems.

B. 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, that existing set of customs and rules is often thought to be so perverted that a "Big Bang" is necessary to bring about the necessary economic reforms. Some of the more prominent legal positivists include Dworkin (1980), Tribe

(1985), Lipton and Sachs (1990), Riker (1991), Holmes and Sunstein (1999), and Murphy and Nagel (2002).

The legal positivist approach is ultimately grounded in a strong form of rationalism, so it is not surprising to discover that Thomas Hobbes (1991 [1651]) offers us 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 in claiming that private property does not exist in the absence of the State. For example, Holmes and Sunstein (1999) argue that since property rights involve public costs, property rights 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 so far as to suggest that 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. In an examination of Ghana's economic performance, Firmin-Sellers (1995) argues 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 these undefined rights.

III. 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 this distinction is admittedly simplistic, it serves a useful purpose in that 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. As Harold Demsetz put it in his seminal article on the emergence of property rights among Montagnais Indians of the Labrador Peninsula,

property rights develop to internalize externalities when the gains of internalization become larger than the cost of internalization. Increased internalization...results from changes in economic values, changes which stem from the development of new technology and the opening of new

markets, changes to which old property rights are poorly attuned. (1967, 350)

When beavers in the Labrador Peninsula became relatively scarce, property rights became more well-defined. 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, it is important that we 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 that emerges 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.

The general consensus among economists regarding the privatization process in Eastern Europe is that the privatization programs have failed because bureaucrats have been in charge of the privatization process. For economists, this result is not that surprising. As McChesney (1990, 298) points out,

...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.

For example, McChesney suggests that land privatization for Indians was halted when the budget of the Bureau of Indian affairs began to shrink.

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 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?⁴

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 that official?⁵

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.

In the next section, I will suggest that the legal positivist approach to privatization was actually the main reason for why the privatization process failed in so many transition economies. Economists from the West exported the legal positivist notion of property rights to Eastern Europe. As we will see, those countries that whole-heartedly attempted to design property rights systems anew are the countries that have performed most poorly since the collapse of communism. By contrast, those countries that relied on

⁴ Interview with a Czech cab driver while en route to my interview with Pavel Kuta of the National Property Fund on July 17, 2003.

⁵ 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.

a direct sale method of privatization—a method more consistent with the common law approach—have fared much better in their transitions.

IV. 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 these reforms. If top-down planning and legal positivism go hand in hand, then recent history suggests that legal positivism works! After all, this is the conclusion that Sachs and Warner (1995b, 61) reach when they point out that, "...all of the strong trade reformers [of Eastern Europe] achieved positive economic growth by 1994, while none of the other countries had done so."

While this explanation might be appealing, careful central planning cannot be the whole story behind these successes. As Marcouiller and Young (1995, 630-31) point out, in places like Nicaragua, the Philippines, and Zaire, decisive and powerful leaders have been predatory and "squeeze[d] the formal sector without pity and without limit." 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 those 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.

Part of the problem for the post-communist countries in their transitions has been that they all have relied on specialized government bureaus to direct the privatization process, leading them to ignore the *de facto* property rights that were 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 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) sponsored a project that 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 these imperfections, the EBRD's classification system does provide us with a more concrete indicator of the degree of centralization in the privatization process.

In Figure 1 and Figure 2, I 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 these tables indicate, the method of privatization is highly correlated with economic performance. In countries that relied heavily on voucher privatization, the average rate of post-communist growth has been approximately -3% per year. Countries that relied primarily on management-employee buyouts have, on average, experienced a -1.5% average rate of economic growth from 1990-2002. By contrast, post-communist countries that relied primarily on direct sales of assets have experienced 0.4% economic growth per year since the collapse of communism.

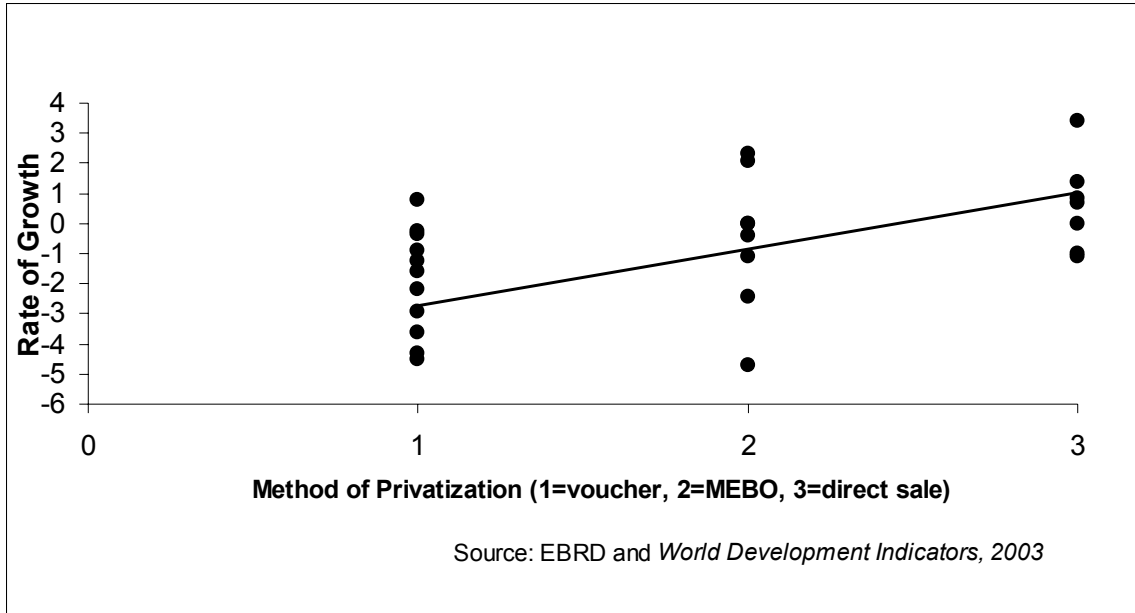


Figure 1: Privatization Methods and Post-Communist Growth Rates (1990-2002)

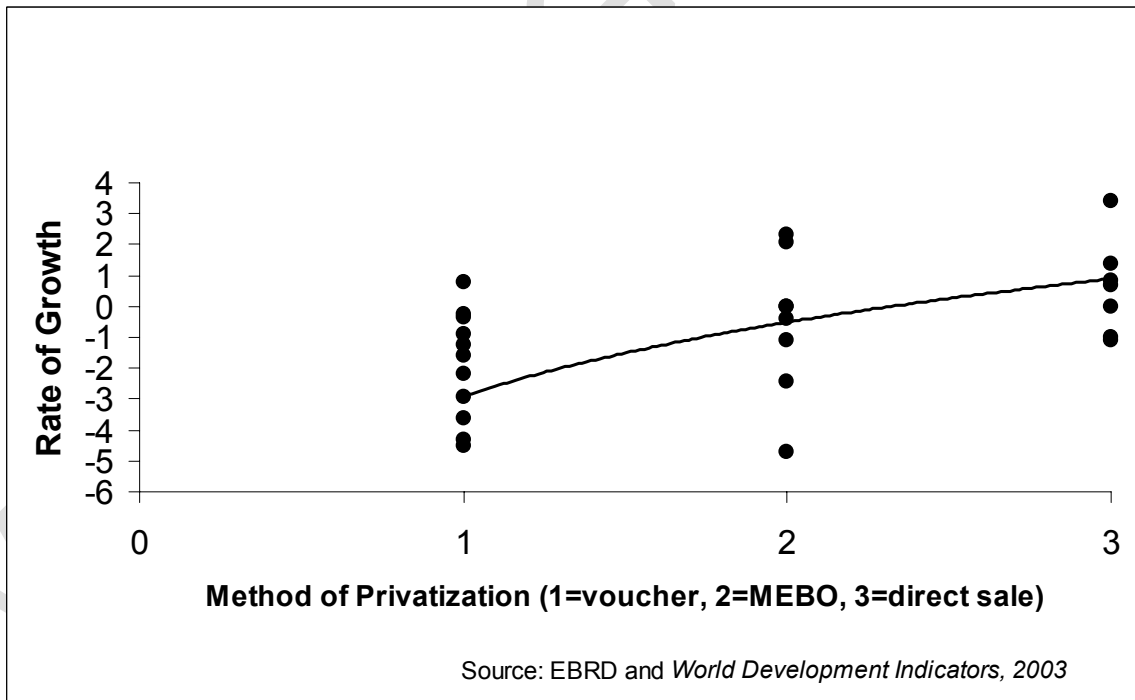


Figure 2: Privatization Methods and Post-Communist Growth Rates (1990-2002)

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 3 and Figure 4, we can see that the same general relationship described in Figure 1 and Figure 2 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.

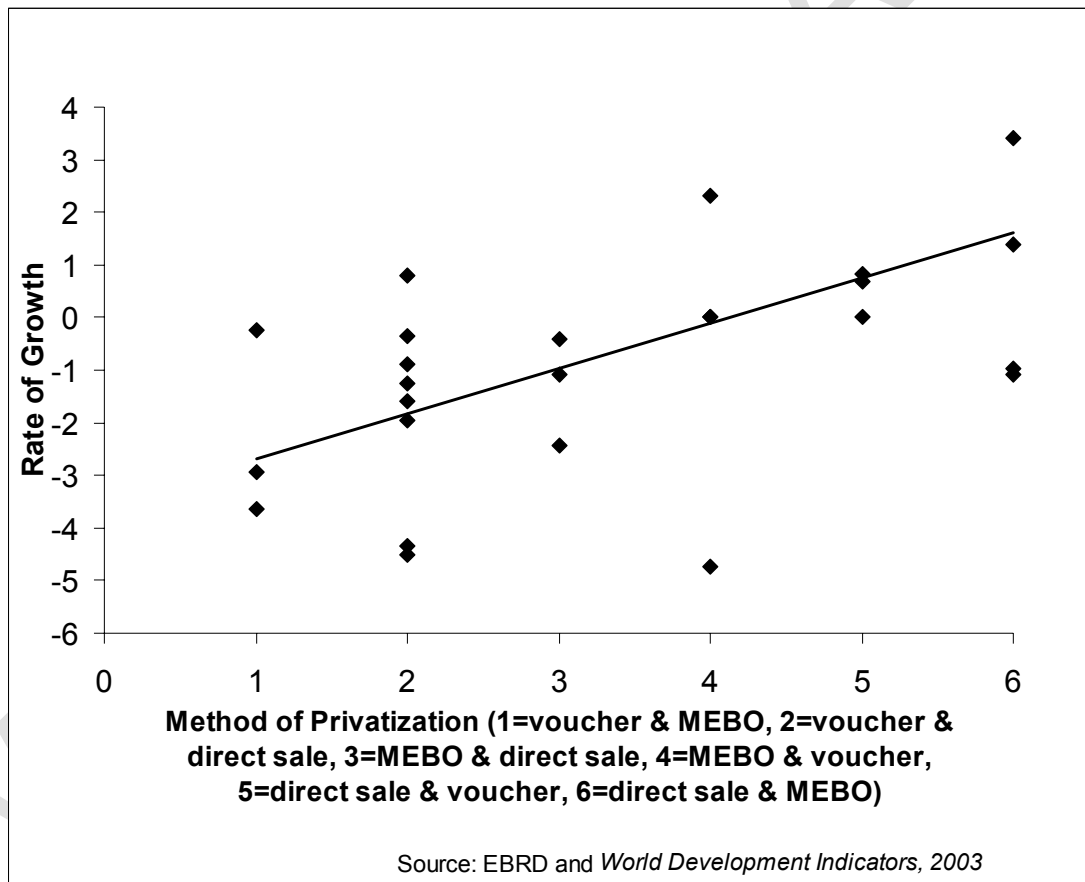


Figure 3: Method of Primary and Secondary Privatization and Economic Growth in Post-Communist Countries (1990-2002)

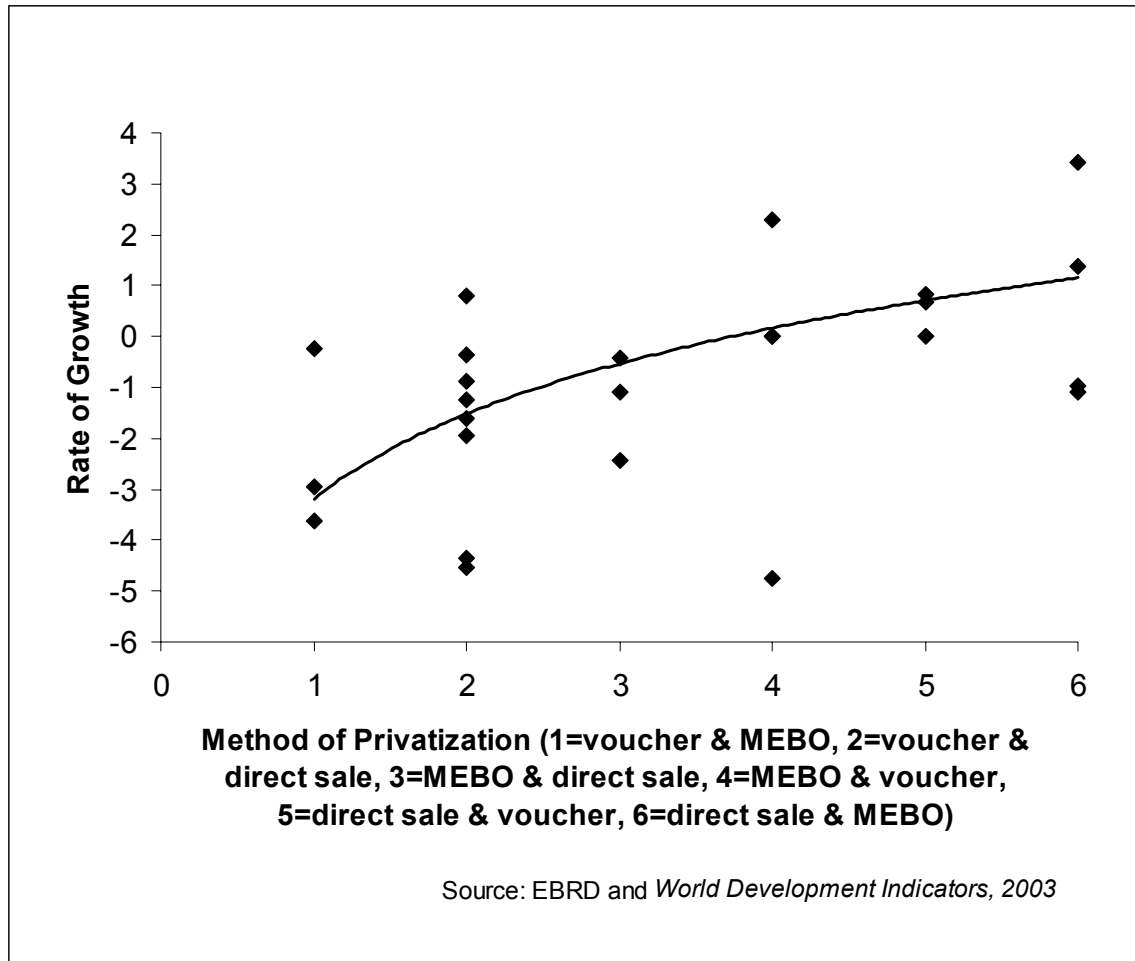


Figure 4: Method of Primary and Secondary Privatization and Economic Growth in Post-Communist Countries (1990-2002)

The relative superiority of direct sales privatization over the other two methods isn't that surprising: 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.

Unlike the direct auctioning of resources, voucher privatizations went about valuing resources without the knowledge necessary to place appropriate values on those resources. As Peter Boettke (2001 [1994], 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, it is important that we recognize that 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 this 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, case studies of management-employee groups suggest that these firms were run as job-saving

firms with little concern for the efficient use of resources (see, for example, Frydman et al. 1993a, 1993b).

V. *Direct Sales as Common Law Privatization*

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, privatizing, and privatizing" (Friedman 1991) 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, this important element of the privatization process is left to the market.

As I have already mentioned, direct auctions allow those who most value a particular resource to bid and obtain that resource. We would expect that, in many cases, the individuals who value the resource most highly are those who have secured informal rights to it. Since these individuals 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.

In *The Other Path*, Hernando de Soto describes the informal networks of street vendors in Peru. According to De Soto, these street vendors gather together to form small markets. If, suddenly, some of these small markets were up for grabs in an auction, we would expect these vendors to be among the first to bid on the rights. Why? Since

they incurred the cost of establishing the small markets in the first place, street vendors have already demonstrated that they place a high value on the resource. The same logic operating in De Soto's story of informal markets in Latin America seems to apply in Eastern Europe.

Direct sales were the most effective method of privatization because they were, by far, the approach that was 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,

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 (2003, 502).

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.

VI. Conclusion

Hernando de Soto's (2002 [1989]), 2000) argument is that the unofficial economy is at the heart of the development problem. As De Soto puts it,

...most people's resources are commercially and financially invisible. Nobody really knows who owns what or where, who is accountable for the performance of obligations, who is responsible for losses and fraud, or what mechanisms are available to enforce payment for services and goods delivered. Consequently, most potential assets in these countries have not

been identified or realized; there is little accessible capital, and the exchange economy is constrained and sluggish (2000, 32).

While De Soto focuses primarily on the informal rights of Latin America, this paper has argued that the evolving rights of the unofficial economy in Eastern Europe were the key variable in post-communist transitions.

Countries that relied primarily on the direct auctioning of resources have outperformed other methods of privatization because direct auctions are more effective at bringing the invisible knowledge described by De Soto to the surface. This result is important for reforming countries: when given a menu of privatization options, more decentralized approaches promise higher economic growth.

Moreover, the evidence provided in this chapter forces us to see the role of leadership in a new light. At best, post-communist leaders can serve a useful purpose in codifying *de facto* rights and giving the unofficial economy space to grow and evolve. Reformers *should not* be involved in the creation or micro-management of property rights. Unless they are extremely lucky, legal positivist reformers will be disappointed by the results of their privatization efforts.

The most successful privatizations are those that are not only hands off in their policy rhetoric, but also hands off when it comes to the definition and allocation of rights. As I have shown in this chapter, the common law approach to privatization has a rich history that extends back to Hume. It is unfortunate that most post-communist leaders did not pick up on the common law notion of property rights. By choosing the legal positivist alternative to privatization, many Eastern European reform attempts have lost their legitimacy. We can only hope that, in the future, transition economies will look at

some of the successful Eastern European transitions. If they look closely, they will discover that direct auctions and a common law approach is the best option available for their own privatization programs.

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