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1

The political economy of property rights

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1.0 INTRODUCTION

Property rights, the relations among people concerning the use of things, lie at the nexus of economics and politics. Property rights systems, which include the rights themselves and the formal and informal institutions that create them, structure economic transactions, including decisions concerning the exchange and accumulation of physical, human, and intellectual capital, and the preservation of natural resources. The state, as maker and enforcer of formal rules, plays a fundamental role in shaping the property rights system. Yet more subtle forces are also at work. Economic change, such as the availability of new technology or major shifts in the relative prices of commodities and assets, often creates pressures for changes in property rights. The property rights system may affect political stability through its impacts on the creation and distribution of wealth. These more or less obvious connections suggest that understanding the institution of property rights is an extremely important project for political economists.

The political and economic transformations under way in the countries of Eastern Europe, the former Soviet Union, and China provide a unique "natural experiment" for studying change in the institution of property rights. More than a score of countries are attempting to move from centrally planned economic systems with extensive state ownership of the means of production to much more decentralized market economies. With the exceptions of perhaps China and the former Yugoslavia, previous attempts by centrally planned economies to achieve substantial economic decentralization largely failed, leading some experienced observers to identify changing the property rights system as an essential element of meaningful reform (Schroeder, 1988; Solinger, 1989; Kornai, 1990; Batt, 1991; Comisso, 1991).

The efforts currently under way, however, are taking place in very different political circumstances. All these countries except China have abandoned political systems in which communist parties forcibly maintain their "leading role" and have begun to establish democratic institutions. This simultaneous political transformation opens the door for substantial change in economic institutions, though it also complicates the task political economists face in sorting out the various interrelationships among changes in political and economic institutions. Thus it becomes all the more important for political economists to focus initially on a fundamental yet distinctly identifiable institution like property rights.

In this chapter I present a conceptual framework for thinking about the political economy of property rights. First, I consider property rights as an institution, reviewing the theoretical and empirical evidence concerning the system of property rights as an exogenous variable affecting economic and political performance. Second, I consider the emergence of new property rights systems as institutional change. This sets the stage for the chapters presented in this volume, which largely treat the system of property rights as endogenously determined by the interaction of political and economic actors. Finally, I provide a brief overview of the subsequent chapters, indicating how they fit within this framework.

2.0 PROPERTY RIGHTS AS INSTITUTIONS

Institutions are relatively stable sets of widely shared and generally realized expectations about how people will behave in particular social, economic, and political circumstances. Expectations structure behavior by informing individuals about the likely consequences of alternative courses of action. Formal institutions embody expectations in rules sanctioned by the state. Informal institutions embody them in the norms and conventions of various communities. Whereas formal institutions are maintained to some extent by centralized enforcement, informal institutions are maintained by decentralized enforcement alone.

Several aspects of this descriptive definition are worth noting. First, it distinguishes between institutions and organizations (North, 1990; Knight, 1992). Organizations are collective actors, perhaps with their own institutions of internal governance, that make choices subject to broader institutional constraints. The distinction has relevance to theories of institutional change that focus on the role of organized interests as agents of change (Olson, 1982; Knight, 1992; North, 1993). It is important in the chapters in this volume that consider the politics of privatization of state-owned enterprises.

Second, the definition leaves open the question of why the expectations are relatively stable: Why do people conform to the expectations? An emerging rational choice theory of institutions addresses this question directly (Schotter, 1981; Calvert, 1995). It defines an institution as an equilibrium strategy in a repeated game that represents some recurrent social interaction. As such, it avoids recourse to exogenous enforcement as an explanation for why people conform to expectations. It thus provides a useful framework for thinking about constitutional choices that must be enforced endogenously.

Third, laws do not always define institutions. For laws to be defining, people must expect that they will be followed. For example, one may legally own a bicycle left unprotected on a busy street. Yet if one has no expectation that the ownership will be respected by others, the legal ownership is not an institution. An institutional analysis of property rights must go beyond the law itself to the expectations that it engenders.

2.1 *Definition of property rights*

Property rights are relations among people concerning the use of things (Furubotn and Pejovich, 1972). They specify relations among those who have various rights and those who have duties to honor the rights, as well as the mechanisms that are available for inducing the compliance of duty bearers.

The rights themselves may take complex forms (Barzel, 1989). Consider, for instance, a house on a city lot. The owner of this asset has a right to live in it, but zoning laws may deny her the right to use it to house a business. She may have the right to sell it, but civil rights laws may deny her the right to close the sale to protected classes of people. She may have the right to the income stream generated from renting the house, but she may not have the right to rent it to three or more unrelated adults.

The rights to the ownership of organizations are typically even more complex. For example, a stockholder in a corporation may have the right to a share of its assets and the income it generates, but not the right to interfere with the use of the assets by the chief executive officer without the consent of the owners of a majority of shares. The feasibility and desirability of various distributions of rights in and among organizations depend on the institutions of corporate, contract, bankruptcy, tort, and property law.

When legal institutions are weak or incomplete, property rights are informal. For example, in Peru those wishing to establish housing on state land organize "invasions" to establish informal rights (de Soto, 1989). The invaders recognize each other's rights to the use of specific plots. Although these forms of property have no legal basis, and indeed may involve violation of laws, the government typically refrains from using force to evict the invaders. Eventually, the squatters' de facto rights may be made de jure.

Neoclassical economics classifies property by nominal ownership: Private property is owned by a specific individual who controls its use; common property is collectively owned by a defined set of individuals with some governance structure that determines use by individuals within the collectivity; state property is owned in the name of citizens, and its use is determined by an agent of the government; and open access property is owned by no one and available to be used by anyone who can physically gain access to it (Bromley, 1991). It is often analytically useful to classify property systems in terms of these broad categories. Nevertheless, a classification of property rights systems based on their functional characteristics provides a better basis for understanding them as institutions that shape economic behavior.

2.2 *Salient characteristics of property rights systems*

Four characteristics of property rights systems are especially relevant to economic behavior: clarity of allocation, cost of alienation, security from trespass, and credibility of persistence (Riker and Weimer, 1993, 1995). These characteristics affect the efficiency with which an economy uses its available assets. The credibility of persistence is also important for dynamic efficiency and political stability.

2.2.1 Clarity of allocation. Every economic system allocates rights to commodities and assets in some way. De jure allocation, while typically precise, is rarely complete. De facto patterns of use complete the allocation, sometimes superseding de jure allocations. Allocation by de facto use, however, often involves imprecision that precludes alienation and undercuts security from trespass and credibility of persistence.

Neoclassically based welfare economics assumes a clear and precise allocation of private property rights to all commodities and productive assets as a precondition for the Pareto efficiency of competitive equilibriums within a market economy. Markets fail to achieve Pareto efficiency when private property rights are not clearly defined. In the case of open access to natural resources, the so-called tragedy of the commons, inefficient overconsumption and underinvestment result. In the case of externalities, markets for certain goods, such as freedom from pollution, are missing so that inefficiency results because people do not have a mechanism for revealing their marginal valuations of the goods. The prominent neoclassical solution for correcting the inefficiency caused by externalities is the allocation of private property rights over the good to facilitate its market exchange (Coase, 1960).

Neoinstitutional economics explicitly considers specific structures of property rights and transaction costs (Eggertsson, 1990). A central concern in neoinstitutional economics is the structuring of contracts between principals and agents (Jensen and Meckling, 1976). The costs of writing, monitoring, and enforcing contracts, which depend on legal and social institutions, determine how much discretion the principal should optimally delegate to agents. The introduction of transaction costs greatly complicates welfare comparisons between alternative organizational forms (Bromley, 1989; Murrell, 1991).

Nevertheless, the use of private assets is in general more clearly allocated, and therefore more efficient, than the use of state assets because the principals designing and executing contracts delegating the use of state-owned property have weaker incentives to specialize in monitoring capabilities than do private principals (De Alessi, 1983; Lott, 1987; Vining and Weimer, 1990). A considerable empirical literature supports the assertion that private assets are more efficiently used than state assets (for reviews, see Boardman and Vining, 1989; Vining and Boardman, 1992).

The governance structure of common property determines how clearly it allocates rights to members of the collective. Elinor Ostrom (1990) identifies a number of factors that contribute to long-enduring common property resources: clearly defined borders, congruence between rules and local conditions, representative collective choice arrangements, agents with an incentive to monitor use, the graduated application of sanctions, the availability of conflict-resolution mechanisms, and the recognition of the collective by government authorities. Yet, as she notes, long endurance does not imply that the common property is being used efficiently. For example, Libecap and Johnson (1980) find that grazing on Navajo land is long-enduring but clearly inefficient. Perhaps the most striking evidence on the general inefficiency of common property resources is the dramatic increase in Chinese agricultural output after the shift in the organization of agriculture from the collective farm to the household responsibility system (Lin, 1992).

Socialist economies, with large amounts of state and common property, have less clear allocations of use rights than do market economies and therefore are likely to be less efficient (Moore, 1981; Kornai, 1990). In the post-communist countries, the weakening of the central political and economic planning institutions makes the allocations of use even less clear, providing an explanation for their immediate economic decline (Olson, 1992). Allocations are also muddied by claims against property that was previously expropriated by communist governments. More extensive de jure private ownership improves the clarity of allocation and generally leads to a more efficient use of assets.

2.2.2 Cost of alienation. Efficient responses to changes in technology, the distribution of wealth, and consumer tastes require reallocation of commodities and assets. The less costly it is to alienate property, the more effectively market forces can move commodities and assets to their highest-valued uses. The costs of alienation are likely to be high for transferring de facto use rights. Human history suggests that black markets readily develop for illicit commodities. However, such markets are less likely to develop and work effectively for long-lived and lumpy assets, like land and industrial capital, that cannot be easily broken down into small units suitable for hidden spot transactions. The costs of alienation may render de facto use rights unsuitable as collateral for loans, undercutting the development of capital markets, which in turn hinders the development of effective private markets in housing and other capital goods. Indeed, the difficulty of alienating apartments to which individuals often have strong use rights in many of the post-socialist countries also hinders the development of national labor markets by interfering with residential mobility.

Legal restrictions on the transfer of formal property rights may also impede alienation and lead to inefficiency. In the case of privatized Native American tribal lands in the United States, for instance, restrictions on alienation through both sale and bequest resulted in a fragmentation of farms (McChesney, 1990). Empirical research finds this fragmentation of holdings to be one of the major reasons for relatively low agricultural productivity on reservation lands (Anderson and Lueck, 1992).

Government policies can raise the cost of alienation in numerous ways. Several of the post-communist countries, for example, have placed restrictions on the sale of assets to foreign investors. Price controls, a lingering legacy for selected commodities in many of the post-communist countries, often raise the cost of alienation by pushing exchanges to black markets. Failure to establish and enforce effective contract law obviously raises the costs of alienating property that cannot be transferred through simple spot transactions (Frye, 1995). At the macroeconomic level, the failure to establish a stable currency raises the cost of intertemporal transfers.

In the case of common property, governance structures that are successful in making them long-enduring are also likely to pose high collective action costs for disbanding in favor of a higher valued use. For example, depending on the collective decision rule in place, it might be very costly to get a sufficient majority of common owners of a mountain pasture to agree to sell it for use as a more economically valuable ski resort. The large number and special status of cooperatives in many socialist countries are likely to reduce economic efficiency by slowing the movement of assets to their most valued uses.

2.2.3 Security from trespass. The efficient use of assets depends on their security from trespass. Insecure rights divert resources to defensive, or even predatory, activities that reduce productivity (Baumol, 1990). Both formal and informal institutions affect security from trespass. Criminal and tort law provide varying degrees of deterrence against trespass, depending on the certainty, fairness, and speed of their administration. Security from trespass also depends on social norms regarding respect for person, property, and the rule of law. The effectiveness of these supporting institutions in providing security from trespass affects the efficiency of market exchange.

Self-protection substitutes for effective institutional support for security from trespass. Owners may take a variety of actions to protect vulnerable assets: They may "harden" them with physical security systems; they may guard them with their own vigilance or that of hired guards; they may hide them from easy observation; they may use violence as retaliation against trespassers; or they may simply shed assets that would otherwise be desirable. All these efforts divert resources from consumption and production.

Weak institutional support for security from trespass encourages opportunism by increasing the relative payoffs from illegitimate versus legitimate activity. Theft, extortion, and fraudulent contracting are not only costly in terms of the self-protection they induce, but also because they involve the diversion of the resources of the predators away from productive uses.

Post-communist countries face a number of obstacles in establishing "economic legality" (Litwack, 1991). They lack traditions of independent courts, and they generally have inadequate judicial and enforcement capabilities to achieve security from trespass through formal institutions. Networks of relationships previously developed to exploit black-market opportunities facilitate the development of criminal organizations that seek to corrupt public officials. These problems appear especially serious in the countries of the former Soviet Union, where "mafia" often extort payments from businesses.

2.2.4 Credibility of persistence. Not just currently held property rights, but also the credibility of their persistence, affect efficiency and economic growth. Uncertainty about the persistence of property rights to natural resources encourages their too rapid exploitation and discourages their preservation (Libecap and Wiggins, 1989; Johany, 1979). The greater the perceived risk of losing existing property rights, the less likely the holders of those rights will be to forgo current consumption to accumulate property, thus slowing investment that contributes importantly to economic growth.

Governments play an especially important role in the credibility of the persistence of property rights. As highly decentralized informal institutions are likely to change slowly, the greatest threat to the persistence of property rights comes from changes in government policy.

A number of economic historians have noted the importance of credible property rights, especially in terms of freedom from arbitrary seizures of property by governments, for understanding relative rates of growth in different time periods and regions (North and Thomas, 1973; North, 1981, 1990; Jones, 1981; Rosenberg and Birdzell, 1986). In addition to fostering economic growth through the accumulation of capital, secure property rights facilitate innovation in economic organization. For example, Douglass North attributes the successful economic development of Western Europe over the last five hundred years to the gradual expansion of the scope of credible commitments to support increasingly complex contracting among economic agents (North, 1993: 19).

Recent cross-sectional comparisons of economic growth rates bolster the assessments made by economic historians. In a study of sixty-eight developed and developing countries, Johan Torstensson (1994) finds a strong negative statistical relationship between the rates of growth of per capita gross domestic product and the index of risk of arbitrary governmental seizure of private property developed by Gerald W. Scully and Daniel J. Slottje (1991). In view of the sensitivity of parameter estimates to changes in specification generally found in growth models (Levine and Renelt, 1992), the robustness of the relationship found by Torstensson gives it added credence. Interestingly, the degree of state ownership of property does not have a statistically significant effect on growth rates after controlling for the risk of seizure.

In parallel work, Stephen Knack and Philip Keefer (1995) construct indexes of the security of property rights using information provided by private firms that assess country risk for investors. They find that these indexes are strong predictors of economic growth.

David A. Leblang (1994) also finds a relationship between property rights and economic growth based on a statistical study of 106 countries using the measure of economic freedom developed by Raymond Gastil and Lindsay M. Wright as a proxy for the strength of property rights. Countries with strong property rights systems appear to have growth rates almost twice those of countries with weak property rights systems. Whether a country has a democratic regime does not appear to have an effect on economic growth once its property rights system is taken into account. Indeed, the imperfect correlation between democracy and the security of property rights may help explain why there does not appear to be consistent empirical evidence that democracy contributes to economic growth (Sirowy and Inkeles, 1990; Przeworski and Limongi, 1993).

2.3 Political implications of property rights systems

Historical experience suggests that a decentralized market system with substantial private property is a necessary, though not sufficient, condition for democracy (Lindblom, 1977: ch. 12). What explains this strong empirical relationship between effective private property rights and democracy?

One explanation is that effective private property rights contribute to economic conditions conducive to the preservation of democracy. John Helliwell (1994) finds a positive and robust effect of per capita income on democratic political freedoms. It may be that the redistributive functions of democracy are less divisive in more rapidly growing economies. Thus, by contributing to income growth, effective property rights may help preserve democracy. As there appears to be a positive relationship between wealth and the equality of its distribution (Ward, 1978), economic growth may contribute indirectly to democratic stability as well by reducing the disparity in economic interests. Further, greater equality in the distribution of wealth may result in public policies that are more conducive to economic growth (Alesina and Rodrik, 1994). Specifically with respect to property rights, Gerald Scully (1991) finds that the middle three income quintiles account for a substantially larger fraction of total income in countries with high levels of economic freedom than in those without it. Effective private property rights thus contribute to economic growth and more equal distributions of wealth, which in turn help preserve democracy by lessening the divisiveness of redistributive conflict.

A second explanation recognizes private property rights as generating wealth that can serve as a basis for opposing the concentration of power in the state. Privately held wealth can be used to purchase resources, ranging from newspapers to FAX machines to foreign contacts, that give voice to opponents of the state. It also provides an alternative to state support for social, political, and economic organizations, giving them greater independence and hence increasing their capacity for opposing the state. Thus, decentralized economic resources provide a basis for resisting the concentration of political power that may eventually undermine democratic regimes.

A third explanation for why effective private property rights are a necessary condition for democracy can be found in social choice theory. No social choice rule satisfying minimal conditions of fairness can guarantee a transitive social ordering of alternatives (Arrow, 1963). In the case of unrestricted majority rule voting over alternatives with multiple dimensions, for example, "chaos" results in the sense that, in all but trivial cases of preference patterns, any alternative can be defeated by some other alternative preferred by a majority (Plott, 1967; McKelvey, 1976). The instability of majority rule can be reduced by the introduction of institutional constraints that induce equilibria (Shepsle, 1979). Property rights that have some "constitutional" status in the sense that they are immune from simple majorities serve as such a constraint by reducing the dimensions of routine political choice (Riker and Weimer, 1993; Ordeshook, 1993). Credible property rights thus reduce the risks of democratic instability.

Though these explanations do not speak to the emergence of democracy, they indicate how democratic innovations of whatever origin are more likely to survive in an institutional environment that includes effective private property.

3.0 THE SYSTEM OF PROPERTY RIGHTS AS AN ENDOGENOUS VARIABLE

The preceding discussion considered the implications of particular aspects of the institution of property rights for economic performance and democratic viability. It treated property rights as an exogenous variable within the disciplinary concerns of economists and political scientists. An important task for political economists, however, is to endogenize property rights in the sense of treating them as the result of strategic interaction between economic and political actors. It is an essential task for political economists seeking to understand fundamental economic change in post-communist countries.

3.1 Transformation of property rights as institutional change

A number of theories of institutional change offer conceptual foundations for studying the transformation of property rights in post-communist countries. For our purposes, they can be grouped into three categories: economic, public choice, and distributional theories.

The economic theory sees institutional change as resulting from the realization of opportunities for changes in rules that are Pareto improving (North and Thomas, 1973). Specifically with respect to property rights, Harold Demsetz (1967) and John Umbeck (1981) see new rights emerging through the decentralized cooperation of affected parties to find rules to internalize externalities that become significant because of scarcity resulting from changes in relative prices or technologies. Gary Libecap (1989) extends the economic model by introducing a passive government that provides the framework for bargaining among affected parties. Changes are Pareto improving, but transaction costs may prevent the